

**Meeting Between Governor Waller and Staff of the Federal Reserve Board and  
Representatives of the Securities Industry and Financial Markets Association (SIFMA)**  
**February 27, 2024**

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

Kenneth Bentson, Carter McDowell, Peter Ryan, Joseph Seidel, and Guowei  
Zhang (SIFMA)

**Summary:** Governor Waller and staff of the Federal Reserve Board met with representatives of SIFMA to discuss a range of issues including the agencies' Basel III endgame notice of proposed rulemaking (Basel III endgame proposal). The SIFMA representatives shared views, consistent with those in their written presentation, on the likely effects of the Basel III endgame proposal on the industry and financial market functioning.

Attachment



# **The Basel 3 Endgame Proposal: Impacts on the Capital Markets**

**PRESENTED BY**

**SIFMA**

**February 2024**

## 1

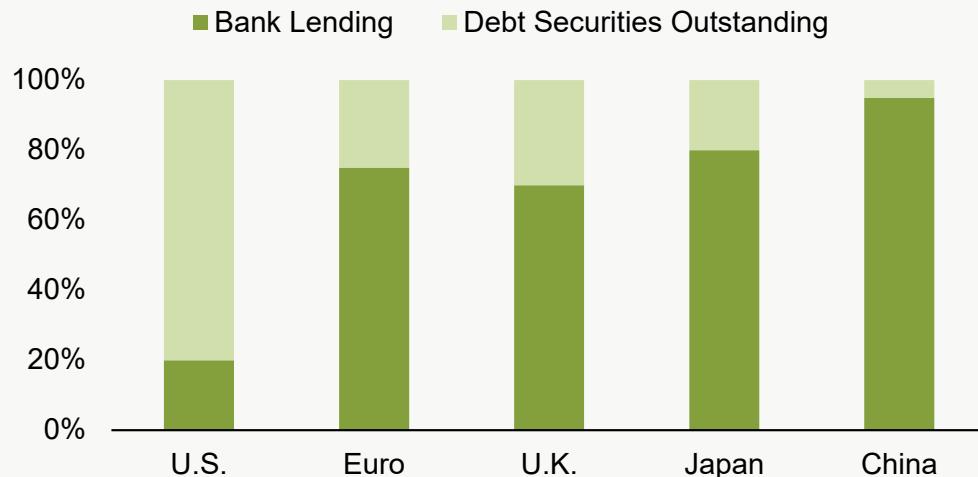
# Executive Summary

- The U.S. capital markets are critical to U.S. economic activity, funding **three-quarters of equity and debt financing for non-financial corporations**. Banks play a critical role in facilitating capital formation and ensuring liquidity in these markets.
- The Basel 3 Endgame will significantly overhaul the current risk-based capital framework. Based on the latest industry QIS data, capital levels will increase by **more than 30% for the U.S. G-SIBs** as a result of the Basel and GSIB surcharge proposals, while capital for large banks' **market risk (FRTB) and CVA risk will increase by 129%**.
- The large increases in capital for trading activities will likely result in banks reducing their capital markets activities:
  - Increasing cost of capital will reduce ROE, disincentivize compared to other financing activities.
  - No certainty that capacity will be replaced by other market participants.
  - End-users could face higher funding costs and/or reduced market access.
  - Reduced market liquidity during times of stress.
- Several capital markets activities are likely to be severely impacted by the Basel 3 Endgame. These include **derivatives, securitization products trading, securities underwriting, equity investments in funds and securities borrowing transactions**.
  - Over 100 non-financial corporate end-users have commented that the proposal will raise costs, reduce market access, and make it more difficult to hedge risk. This is in addition to dozens of pension funds, insurers, and asset managers that have submitted comments raising serious concerns about the proposal's negative impacts.
- SIFMA has proposed a number of data-driven changes to the proposal to ensure it is appropriately risk sensitive and avoids adversely impacting the U.S. capital markets. We believe the best way of enacting the material calibration changes needed would be through a full re-proposal of the rule for public comment.

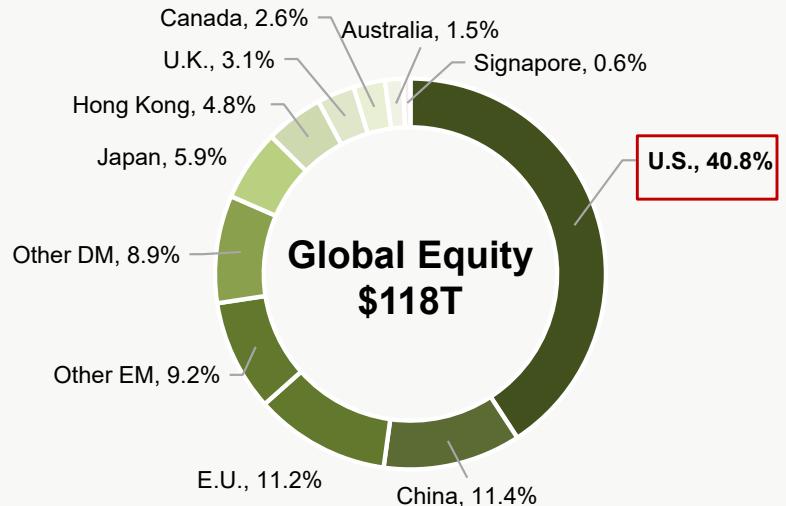
## 2 The U.S. Capital Markets

- The U.S. capital markets account for 40% of global equities and fixed income securities.
- As of year-end 2022, the U.S. capital markets funded **over 75%** of equity and debt financing for non-financial corporations. This is in sharp contrast with all other major jurisdictions, where most fundings to non-financial corporations come from bank lending.
- Banks (particularly G-SIBs) play a critical role in facilitating capital formation and ensuring liquidity in these markets.

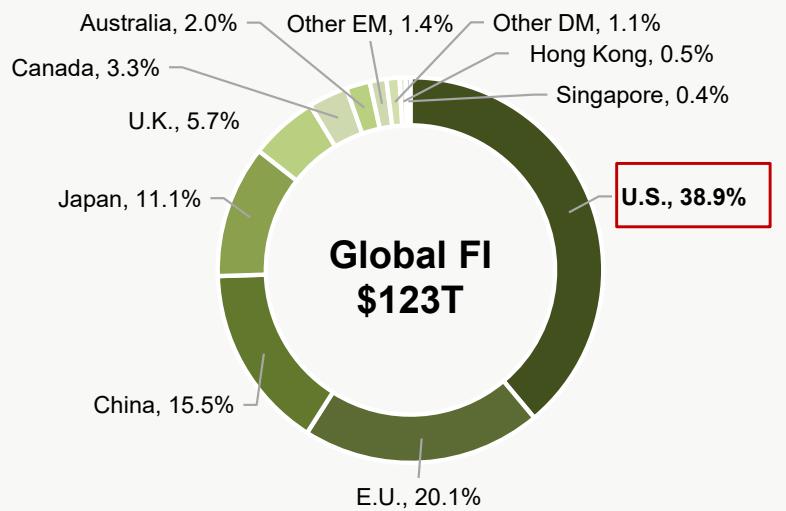
### Debt Financing of Non-Financial Corporations



### Global Equity Markets

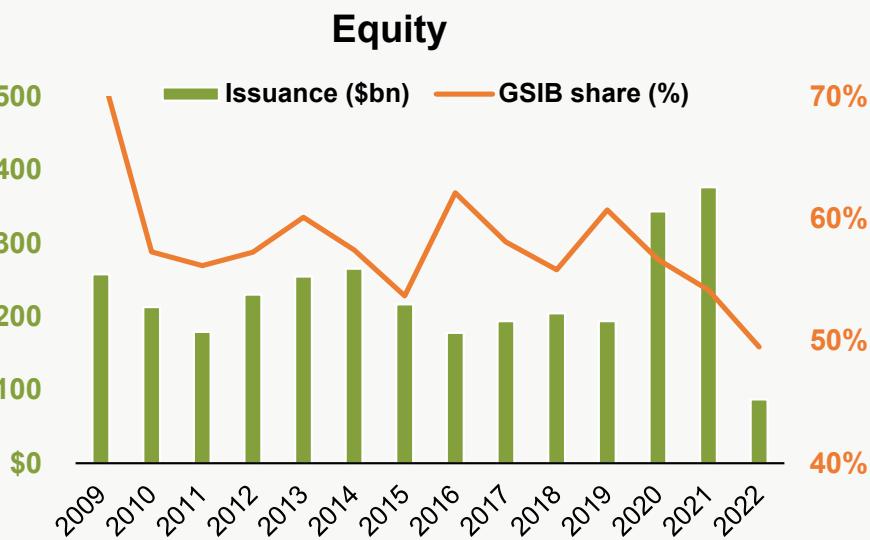
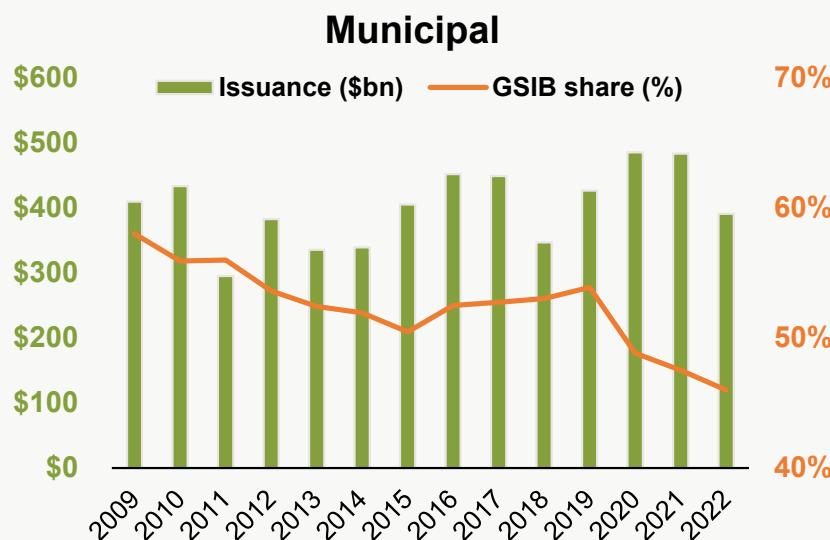
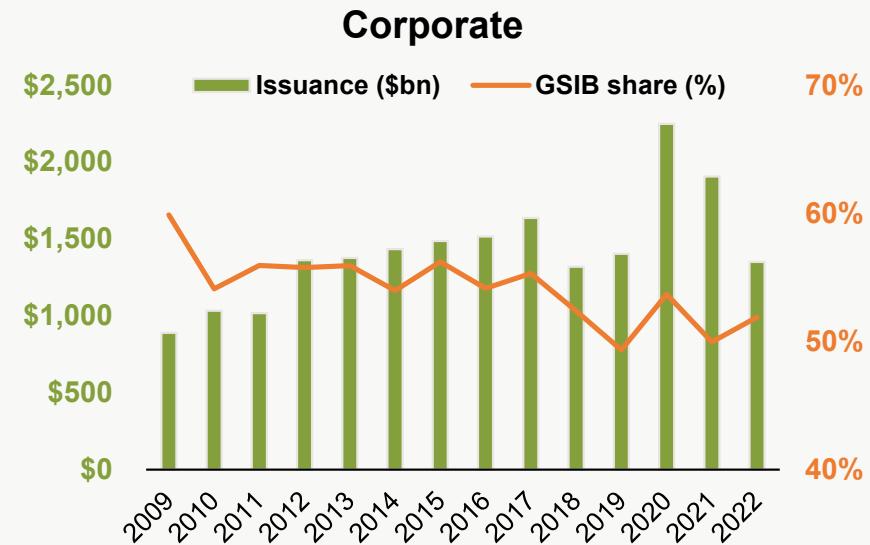


### Global Fixed Income Markets



# 3 U.S. G-SIBs' Role in Securities Underwriting

- The U.S. G-SIBs' market share for equity, corporate and municipal debts issuances have been falling steadily since 2009.
- This decrease coincided with the introduction of higher requirements for underwriting and market-making through Basel 2.5 and the Global Market Shock ("GMS").



## 4

# Basel 3 Endgame - Capital Markets Components and Impacts

- Impacts on banks' capital markets activities primarily stem from the new market risk rule - the FRTB - as well as the CVA and the SFT minimum haircut frameworks. The FRTB and CVA changes alone will result in **129% increase in capital** for market and CVA risk, while the SFT haircut framework would disrupt key funding markets.
- Amongst the product areas that will be most adversely impacted by the proposed changes are **derivatives, securitizations, securities underwriting, securities borrowing by banks and equity funds**.

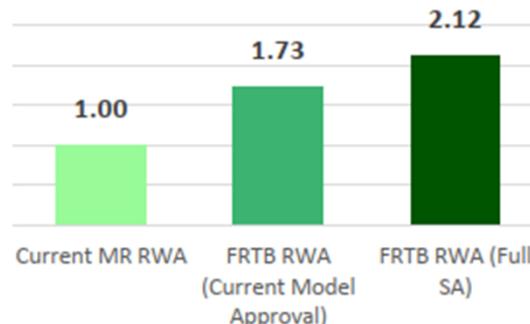
| Rule Change                       | FRTB   | CVA   | Minimum Securities Financing Transaction ("SFT") Haircuts   |
|-----------------------------------|--|---|---|
| <b>Description</b>                | <ul style="list-style-type: none"> <li>Stress test to capture market risk on trading activities</li> </ul>   | <ul style="list-style-type: none"> <li>Stress test for the mark-to-market of derivative counterparty risk</li> </ul>  | <ul style="list-style-type: none"> <li>Intended to limit build-up of leverage to hedge funds</li> </ul>   |
| <b>Market / Products Impacted</b> | <ul style="list-style-type: none"> <li>Market-making, underwriting and derivative hedging</li> </ul>   | <ul style="list-style-type: none"> <li>OTC and client-cleared derivatives</li> </ul>  | <ul style="list-style-type: none"> <li>The securities borrowing market will not be able to function in its current form</li> </ul>  |
| <b>End-Users Impacted</b>         | <ul style="list-style-type: none"> <li>Mainstream funding (investment in equity funds, securitizations)</li> <li>Underwriting (equity, corporate and municipal)</li> <li>Derivative hedging by commercial and financial end-users</li> </ul> | <ul style="list-style-type: none"> <li>Derivative hedging by commercial and financial end-users</li> <li>Particularly impactful for client-clearing for which banks are not subject to any CVA losses – penalizes agricultural firms, food producers, insurance companies, and pension funds</li> </ul> | <ul style="list-style-type: none"> <li>Overly broad scope results in pension funds, mutual funds, and insurance companies being treated the same way as hedge funds</li> <li>Penalizes retirement accounts and may increase insurance premiums</li> </ul> |
| <b>International Adoption</b>     | <ul style="list-style-type: none"> <li>The Basel Committee allows the use of models for the "Default Risk Charge" for equities and credit products</li> </ul>  | <ul style="list-style-type: none"> <li>E.U. exempt commercial end-users and pension funds</li> <li>U.K. and E.U. exempt client cleared derivatives</li> </ul>   | <ul style="list-style-type: none"> <li>Basel exempts jurisdictions if market regulations already address the risk</li> <li>U.K., E.U., Japan, and Canada have not adopted</li> </ul>  |

## 5

# QIS Results Overview

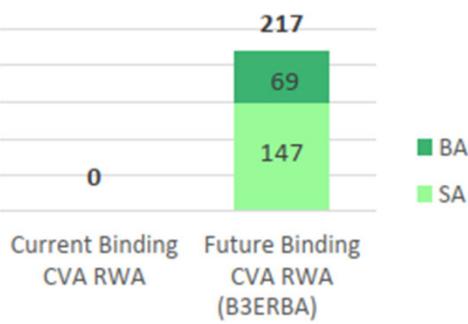
- Overall, the QIS found that capital for large banks' **market risk (FRTB)** and **CVA** risk will increase by **129%** under the **ERBA** versus the current standardized approach.

### FRTB Impact



Market Risk changes will result in a **73% - 112% (\$278 Bn- \$428 Bn) increase in RWA**. The 73% assumes current model approval, but there is risk the internal models scope will reduce, hence increasing the impact.

### CVA Impact



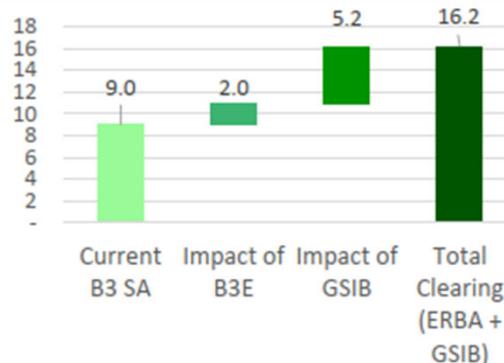
CVA will be fully additive under ERBA which we expect to become the binding constraint. We estimate this structural change to add **\$217 Bn of RWAs**.

### SFTs Impact



The proposed changes for SFTs would **increase RWAs by 18% (\$87 Bn)**.

### Clearing Impact



For the clearing businesses we estimate a **\$5.2 Bn capital requirement increase** and a **\$2 Bn capital requirement increase** from including client clearing activity in the GSIB surcharge and moving from Standardized to ERBA, respectively. This is an **80% increase**.

## 6

# Overall Recommendations

- **Re-proposal Necessary:** Material changes need to be made to the Basel Endgame proposal to mitigate its negative impacts on the U.S. capital markets. To effectively make these changes and address analytical gaps in the proposal, the rule should be re-proposed in full for public comment.
- **Interaction With Stress Tests/Other Prudential Requirements:** There should also be a comprehensive evaluation of how the proposal would interact with other prudential requirements, particularly the stress testing framework, as well as the GSIB Surcharge and long-term debt requirements.
- **Implementation Timeline:** The agencies should provide an appropriate amount of time to implement the final Basel framework (at least 18 months from finalization of the final rule).
- **Calibration Changes:** aims to (1) ensure capital requirements are commensurate with risks, (2) enhance micro resilience not endangering macro resilience of the banking system. E.g., incentivize use of internal models and SFT haircut floor incentives.

| Capital Markets Impact  | Potential Areas for Mitigation   |
|---|--|
| Negative effect on the liquidity and vibrancy of capital markets                    | <ul style="list-style-type: none"> <li>• Improve recognition of diversification in FRTB (in SBM, IMCC, and NMRF)</li> <li>• Remove SFT Minimum Haircut Floor</li> <li>• Remove public listing requirement for collateral</li> </ul>  |
| Increased capital requirements misaligned to underlying risks in certain markets    | <ul style="list-style-type: none"> <li>• Clarify treatment of UMBS TBAs and UMBS eligible pools</li> <li>• Exempt certain sovereign and quasi-sovereign exposures (i.e., MDBs and supranationals) from DRC and SBM.</li> <li>• Appropriately calibrate the securitization framework</li> </ul>                                   |
| Adverse effect on derivative end-users with downstream impact to investors          | <ul style="list-style-type: none"> <li>• Exempt client facing leg of client cleared exposures from CVA</li> <li>• Distinguish between regulated and unregulated financial entities in the CVA framework</li> <li>• Appropriately recognize hedges of CVA exposure</li> </ul>   |
| Excessive volatility misaligned with underlying risks and disincentivizing FRTB-IMA | <ul style="list-style-type: none"> <li>• Implement the PLA requirement as a qualitative test, avoiding introduction of artificial volatility in capital levels</li> <li>• Cap total FRTB-IMA capital at FRTB-SA to provide appropriate incentives for FRTB-IMA development and recognize the conservatism of FRTB-SA.</li> </ul> |

- **Operational Risk:** Additional changes should be made to the operational risk and the stress testing frameworks to reduce the negative impact on banks' capital markets businesses (see slide 10).

## 7

# Key FRTB Recommendations

- We believe modifications to certain key elements of FRTB Internal Models Approach (“IMA”) and Standardized Approach (“SA”) will significantly improve risk sensitivity while still appropriately capitalizing for market-making activity.

|                                | IMA: Non-Modellable Risk Factors (“NMRF”)  | IMA: Profit and Loss Attribution Test (“PLAT”)   | SA: Diversification Recognition  |
|--------------------------------|--|--|--|
| NPR Change                     | <ul style="list-style-type: none"> <li>Reduced hedge recognition for less liquid positions</li> </ul>  | <ul style="list-style-type: none"> <li>Banks must pass PLAT, which measures model effectiveness, in order to be able to use models</li> </ul>  | <ul style="list-style-type: none"> <li>Sensitivities-Based Method (“SBM”) and the Default Risk Charge (“DRC”) component of SA does not allow any diversification across asset classes</li> </ul>                     |
| Core Issue                     | <ul style="list-style-type: none"> <li>Increases hedging costs for companies who may choose sub-optimal hedges and hold basis risks</li> <li><b>Less liquid does not mean unhedgeable</b></li> </ul>     | <ul style="list-style-type: none"> <li><b>Requirements to pass are overly onerous. The rigid PLAT metrics</b> (e.g., Spearman Correlation and K-S tests) should not be the primary indicators of model efficacy</li> </ul> | <ul style="list-style-type: none"> <li>Lack of diversification across asset classes is not <b>supported by publicly available</b> data</li> <li>Diversified business models are stronger / more resilient</li> </ul> |
| Examples of End-Users Impacted | <ul style="list-style-type: none"> <li>Commodity markets (e.g., natural gas utilities)</li> <li>Long-dated cross-currency swaps</li> <li>Smaller corporates with less frequently traded bonds</li> </ul> | <ul style="list-style-type: none"> <li>All counterparties with which banks engage in market risk activity</li> </ul>   | <ul style="list-style-type: none"> <li>All counterparties with which banks engage in market risk activity</li> </ul>   |
| Potential Alternative          | <ul style="list-style-type: none"> <li>Rescale or reduce role of NMRFs in IMA calculation so they do not overwhelm model-based (Expected Shortfall or “ES” ) component of IMA</li> </ul>                 | <ul style="list-style-type: none"> <li>Consider <b>making PLAT</b> for model effectiveness a <b>qualitative or supervisory overlay</b> instead of a strict model approval</li> </ul>                                       | <ul style="list-style-type: none"> <li>Change the SBM aggregation formula to <b>allow partial recognition of diversification between asset classes</b></li> </ul>  |

# Interaction of Basel Endgame and SCB

The structure and design of FRTB and GMS are nearly identical...

FRTB

GMS

|                              |   |   |
|------------------------------|---|---|
| <b>Framework Objective</b>   | <ul style="list-style-type: none"> <li>• Ensure a bank's resilience to a severe market distress</li> </ul>  | <ul style="list-style-type: none"> <li>• Ensure a bank's resilience to a severe market distress</li> </ul>  |
| <b>Risk Capture</b>          | <ul style="list-style-type: none"> <li>• Market risk losses arising from trading operations</li> </ul>  | <ul style="list-style-type: none"> <li>• Market risk losses arising from trading operations and certain other fair valued instruments, e.g., private equity</li> </ul>  |
| <b>Loss Estimate</b>         | <ul style="list-style-type: none"> <li>• Extreme tail loss</li> </ul>   | <ul style="list-style-type: none"> <li>• Extreme tail loss</li> </ul>   |
| <b>Framework Calibration</b> | <ul style="list-style-type: none"> <li>• Risk factor shocks calibrated to specific time periods during which many risk mitigation actions taken by a bank are ignored while constraining diversification benefit</li> </ul> | <ul style="list-style-type: none"> <li>• Risk factor shocks calibrated to specific time periods during which many risk mitigation actions taken by a bank are ignored while constraining diversification benefit</li> </ul> |

...resulting in outsized capital requirements, in certain cases exceeding max loss

- Especially for private equity, securitization positions and corporate credit the calibration of GMS on top of point-in-time capital requirements results in firms needing to capitalize beyond maximum economic loss.
- However, if the GMS and the NPR are meant to capitalize for different risks, a sequential application of GMS and FRTB would seem appropriate; under this approach, the GMS would be applied on the pre-stress market value, followed by the FRTB being calculated on the post-stress market value.

**8**

# Interaction of Basel Endgame and SCB

- Total capital charges can be in excess of exposure.
- The percentages below are capital requirement as % of securities' market value. The highlighted four columns are total capital requirement under:
  - 1 **Current Framework:** Current market risk rule + GMS
  - 2 **NPR Framework:** FRTB + GMS
  - 3 **Alternative 1:** GMS + FRTB applied on post-stress market value
  - 4 **Alternative 2:** Max of FRTB and GMS

| Public Credit Rating | Collateral Type | Vintage              | Attach      | Detach | Total Capital |        |        |       |
|----------------------|-----------------|----------------------|-------------|--------|---------------|--------|--------|-------|
|                      |                 |                      |             |        | 1             | 2      | 3      | 4     |
| Bond A               | AA              | CMBS CDO             | 2021        | 10     | 35            | 93.1%  | 118.8% | 86.1% |
| Bond B               | BBB             | Cash Non-Agency CMBS | 2020        | 0      | 55            | 110.1% | 123.4% | 86.1% |
| Bond C               | B               | European RMBS        | Unspecified | 12.5   | 80            | 88.5%  | 97.5%  | 86.9% |
| Bond D               | NR              | Corporate CLO        | 2014        | 0      | 40            | 117.2% | 134.7% | 89.6% |

**9**

# Key CVA Recommendations

|                                | Client-Cleared Derivatives   | Regulated Financial Institutions   | Margin Period of Risk (“MPoR”)   |
|--------------------------------|--|--|--|
| NPR Change                     | <ul style="list-style-type: none"> <li>NPR applies CVA charges to client-cleared derivatives</li> </ul>  | <ul style="list-style-type: none"> <li>NPR does not differentiate between regulated and unregulated financial institutions; e.g., banks and pension funds are treated similarly to private equity and hedge funds</li> </ul>   | <ul style="list-style-type: none"> <li>The revised CVA framework has a 10-business day floor for the MPoR, which is more conservative than standard industry practice</li> </ul>   |
| Core Issue                     | <ul style="list-style-type: none"> <li>As a clearing member, banks are only subject to the default risk of the clearing client, which is already captured through counterparty credit risk</li> <li><b>As a result, no actual CVA risk arises for banks on these transactions</b></li> </ul>     | <ul style="list-style-type: none"> <li>Regulated financial institutions subject to minimum capital requirements and limits on leverage are treated identically to less regulated and highly levered financial institutions</li> <li>Does not take into account post-crisis reforms which have improved the safety and soundness of regulated institutions</li> </ul> | <ul style="list-style-type: none"> <li>Penalizes collateralized derivatives and <b>does not take into account reforms made to uncleared margining rules (“UMR”)</b></li> <li>The proposal assumes banks will be unmargined for 10-business days, even on derivative transactions subject to UMR and daily margining</li> </ul> |
| Examples of End-Users Impacted | <ul style="list-style-type: none"> <li>End-users who transact in mandatorily-cleared derivatives and are not members of clearing organizations, e.g., agricultural and manufacturing companies on commodity derivatives, insurance companies and pension funds on interest rate swaps</li> </ul> | <ul style="list-style-type: none"> <li>Pension funds hedging rates and mortality risk through derivatives</li> <li>Insurance companies and regional banks use interest rate swaps to hedge their liability risks</li> </ul>  | <ul style="list-style-type: none"> <li>Financial end-users (e.g., pension funds) and corporates use collateralized derivatives to hedge risk</li> </ul>  |
| Potential Alternative          | <ul style="list-style-type: none"> <li><b>Exclude client-cleared derivatives from CVA scope similar to E.U. and U.K. regulators</b></li> </ul>   | <ul style="list-style-type: none"> <li><b>Adjust risk weights</b> to incorporate level of regulation of financial entities</li> </ul>  | <ul style="list-style-type: none"> <li><b>Leverage the five-day MPoR</b> used for client-facing derivatives which is more reflective of the actual gap risk for OTC collateralized derivatives</li> </ul>  |

10

# Key Operational Risk Recommendations

Client clearing and underwriting directly impacted; also relevant for other major business lines

- Operational Risk requirements are a 15-year calibration on all lending and intermediation activity (not sensitive to risk by business line; no netting or capping for services component)
- Need to harmonize Operational Risk component with CCAR operational loss projections

|   | Overarching Issue   | Recommendation   | Potential Adjustments  |
|---|---|--|--|
| 1 | <ul style="list-style-type: none"> <li>• Capitalization for cumulative 15-year historical losses + CCAR</li> </ul>                      | <ul style="list-style-type: none"> <li>• Remove / reduce CCAR operational losses and/or rescale Operational Risk RWA to harmonize</li> </ul>                                     | <ul style="list-style-type: none"> <li>• Remove / reduce CCAR operational losses</li> <li>• Restructure Operational Risk RWA calculation</li> </ul>  |
| 2 | <ul style="list-style-type: none"> <li>• Service component not capped or netted, negatively impacting fee income heavy firms</li> </ul> | <ul style="list-style-type: none"> <li>• Modify the services component to reflect the modest loss history of certain services businesses and their expense structures</li> </ul> | <ul style="list-style-type: none"> <li>• Apply firm-specific profit-before-tax ("PBT") margins as a percentage haircut to the services component</li> <li>• Apply variable weightings to services component business lines to reflect their specific loss histories</li> </ul> |
| 3 | <ul style="list-style-type: none"> <li>• ILM floored at 1.0x. Lower BIC increases ILM</li> </ul>  | <ul style="list-style-type: none"> <li>• Set ILM at 1.0 or, alternatively, recalibrate floating ILM</li> </ul>   | <ul style="list-style-type: none"> <li>• Cap services at 25 percent of the Business Indicator Component ("BIC")</li> <li>• Set ILM at 1.0x</li> <li>• If ILM floats, it should not be floored, and the 15x loss history multiplier should be rescaled</li> </ul>               |



# **Appendix**

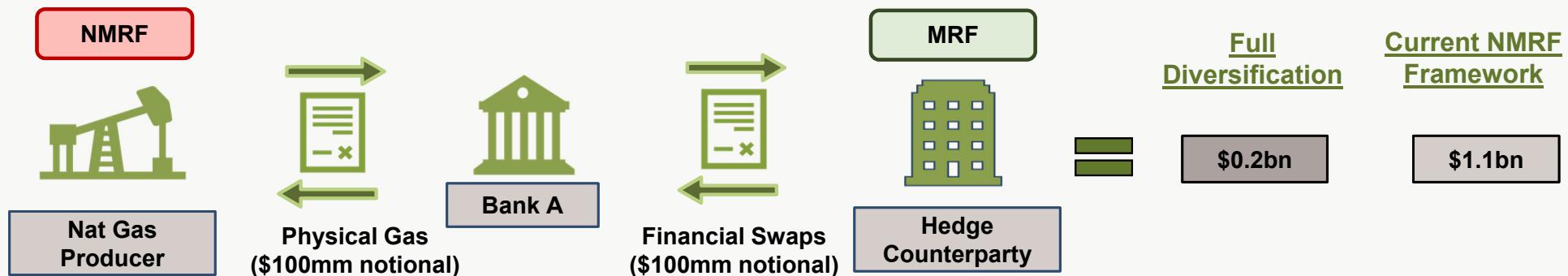
# Fundamental Review of the Trading Book: NMRF

Punitive NMRF framework will hurt non-financial companies looking to hedge their underlying business

|                             |  |
|-----------------------------|--|
| Concerns and Considerations | <ul style="list-style-type: none"> <li>Allow for more appropriate recognition of diversification between less liquid positions and their liquid hedges</li> <li>Banks hold less liquid positions because of facilitating client trades, e.g., non-financial companies such as energy or farming looking to hedge their underlying business. The current NMRF framework does not allow for diversification between less liquid positions and their liquid hedges, with the former subject to separate, more punitive requirements</li> <li>High capital requirements arising from NMRF are one of the key reasons banks are giving up modeled approaches</li> </ul> |
| Client and Market Impact    | <ul style="list-style-type: none"> <li>General liquidity providers are over-penalized, reducing liquidity of markets</li> <li>Higher hedging costs may force companies to choose sub-optimal hedges and hold onto basis risks, with a lessened ability to manage or diversify risks away</li> </ul>  |
| Potential Alternative       | <ul style="list-style-type: none"> <li>Allow better diversification in the NMRF framework, creating the right incentives for banks to avoid risky portfolios of concentrated illiquid risks that are still subject to rigorous review</li> <li>“Less liquid” should not be considered synonymous with “un-hedgeable”</li> </ul>  |

## Example

- Dominion North Natural Gas producer sells physical forwards to Bank A at the point of production, to lock-in prices and future revenue
  - Dominion North is a less frequently traded, physical-only market
- Bank A hedges risk with financial swaps on nearby Dominion South, a more liquid location and highly connected to Dominion North
- The basis risk of this trade is marginal, with >95% correlation between the two markets, but regulatory capital is high given lack of diversification



# Fundamental Review of the Trading Book: NMRF

The Stressed Expected Shortfall (“SES”) Formula should be revised to better recognize variations in the data availability of NMRFs

|                             |   |
|-----------------------------|---|
| Concerns and Considerations | <ul style="list-style-type: none"> <li>NMRF treats all assets identically irrespective of data availability, which impacts capital requirements for smaller corporate issuers</li> <li>Securities issued by smaller corporates generally trade in lower volumes and are more likely to be subject to NMRF per the NPR</li> <li>This outcome is new in the NPR whereas current capital standards focus on financial risk characteristics of the traded instrument</li> </ul> |
| Client and Market Impact    | <ul style="list-style-type: none"> <li>Smaller corporate issuers and companies that trade in location-based or bespoke derivatives would be adversely affected</li> </ul>   |
| Potential Alternative       | <ul style="list-style-type: none"> <li>Distinguish NMRFs with higher data availability (“Type A”) from NMRFs with lower data availability (“Type B”).</li> <li>In the case of corporate bonds, banks that have mature specific risk models and a well-developed framework to assess the robustness of such models would be allowed to categorize corporate bond NMRFs as Type A.</li> </ul>   |

## Example

- Below is an **illustrative example based on two non-financial U.S. issuers** of corporate bonds.
  - Issuer 1 has a market capitalization between \$150 and \$200 billion
  - Issuer 2 has a market capitalization between \$8 and \$12 billion
- The modified calculation aligns the capital treatment between Issuer 1 and Issuer 2, while appropriately accounting for liquidity differences.

Pro-forma<sup>1</sup> Expected Shortfall (“ES”) / NMRF per the NPR

| Bond Issuer | Notional     | ES        | NMRF        | Maturity | Total ES / NMRF Capital |
|-------------|--------------|-----------|-------------|----------|-------------------------|
| Issuer 1    | \$10,000,000 | \$424,231 | \$0         | 5 Years  | \$424,231               |
| Issuer 2    | \$10,000,000 | \$105,936 | \$1,143,477 | 4 Years  | \$1,249,413             |

Pro-forma<sup>1</sup> ES / NMRF with Type A / B NMRF distinction

| Bond Issuer | Notional     | ES         | NMRF | Maturity | Total ES / NMRF Capital |
|-------------|--------------|------------|------|----------|-------------------------|
| Issuer 1    | \$10,000,000 | \$ 424,231 | \$0  | 5 Years  | \$424,231               |
| Issuer 2    | \$10,000,000 | \$ 578,012 | \$0  | 4 Years  | \$578,012               |

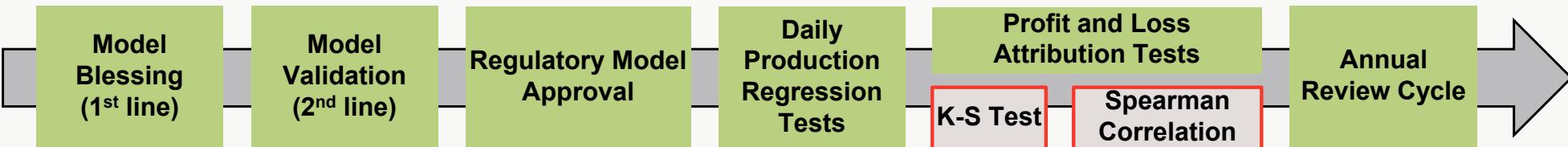
<sup>1</sup>Pro-forma calculations exclude the effect of DRC to highlight differences in the ES / NMRF elements of the calculation.

# Fundamental Review of the Trading Book: PLAT

“Banks are planning to ditch internal models for calculating market risk capital requirements once new trading book rules kick in... arguing that the potential reduction in capital requirements don’t justify the extra costs” – Risk.net, November 2023

|                             |   |
|-----------------------------|---|
| Concerns and Considerations | <ul style="list-style-type: none"> <li>The requirements to qualify for the use of the modeled approach are incredibly onerous</li> <li>There is growing evidence that many G-SIBs will not even apply for the use of models because of the challenges involved in qualifying for the use of models</li> <li>Banks must pass “Profit and Loss Attribution” test, with metrics that measure model effectiveness by comparing books and records versus risk systems’ profit and loss <ul style="list-style-type: none"> <li>Spearman Correlation: Measures strength of relationship between books and records vs risk system’s profit and loss</li> <li>Kolmogorov-Smirnov (“K-S”): Measures whether risk models are accurate</li> </ul> </li> </ul> |
| Client and Market Impact    | <ul style="list-style-type: none"> <li>Spearman Correlation is overly sensitive to small divergences, resulting in high failure rates. This creates procyclical effects in periods of stress, which can result in reduced market liquidity when it is most needed</li> </ul>  |
| Potential Alternative       | <ul style="list-style-type: none"> <li>Consider making the Spearman Correlation test for model effectiveness a qualitative or supervisory overlay instead of a strict model approval requirement</li> </ul>   |

## Example



Despite rigorous model approval, the criteria for passing these statistical tests are so rigid that routine accounting adjustments cause models to fail these tests

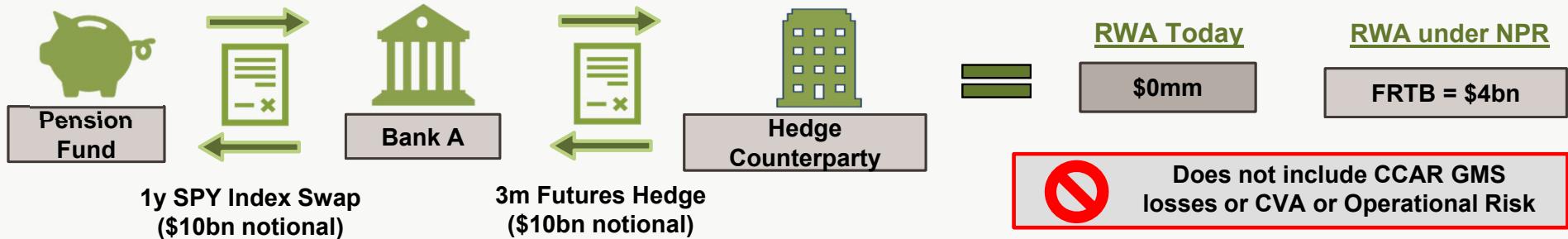
# Fundamental Review of the Trading Book: SA-DRC

Higher costs of hedging will make investment products and savings vehicles less affordable

|                             |  |
|-----------------------------|--|
| Concerns and Considerations | <ul style="list-style-type: none"> <li>Allow better hedge recognition in SA-DRC as NPR disallows models in a deviation from the Basel rule</li> <li>Maturity weighting causes hedge breaks when applied to offsetting derivatives positions</li> <li>Lack of appropriate hedge recognition for derivatives vs. derivatives can increase cost of hedging and/or result in inferior hedging (e.g., cash equity hedges could carry funding costs and unwanted dividend risk)</li> </ul> |
| Client and Market Impact    | <ul style="list-style-type: none"> <li>Banks typically facilitate longer dated derivatives with pension funds and insurance companies and hedge with more liquid short-dated derivatives, which would have a cost under the NPR</li> </ul>   |
| Potential Alternative       | <ul style="list-style-type: none"> <li>Expand maturity alignment available to cash vs. derivative transactions to derivative vs. derivative transactions</li> <li>Recognize Optional Early Termination (“OET”) date for maturity calculation where effective duration risk is shorter than stated maturity</li> <li>In absence of enhanced diversification in SA-DRC, allow use of models</li> </ul>   |

## Example

- Pension funds and asset managers invest in equity indices as a major portfolio strategy for average Americans
- An asset manager enters a 1-year S&P index swap with Bank A
  - Bank A hedges that risk with a 3-month future, the most appropriate and liquid hedge, and rolls forward the hedges
  - Under current Basel 2.5, minimal capital charge given full netting. In FRTB, this will increase to more than \$4bn RWA



# Credit Valuation Adjustment: Client-Cleared

The NPR applies CVA charges to client-cleared derivatives despite no CVA risk existing for banks on these transactions

|                                    |   |
|------------------------------------|---|
| <b>Concerns and Considerations</b> | <ul style="list-style-type: none"> <li>▪ Includes client-clearing activity, even though banks cannot suffer CVA losses on transactions where the bank is acting in an agent capacity           <ul style="list-style-type: none"> <li>• As a clearing member, banks are only subject to the default risk of the clearing client which is capitalized through SA-CCR; for this reason, client-cleared derivatives are not included in market risk (FRTB) requirements and accounting CVA</li> <li>• NPR excludes SFTs from CVA for the same reasons</li> </ul> </li> </ul> |
| <b>Client and Market Impact</b>    | <ul style="list-style-type: none"> <li>▪ Corporate clients, including agricultural, manufacturing and commodity end-users who are not members of a clearing organization and must clear through banks</li> <li>▪ E.U. and U.K. regulators have excluded client-cleared activity from CVA</li> </ul>   |
| <b>Potential Alternative</b>       | <ul style="list-style-type: none"> <li>▪ Exclude client-cleared derivatives from CVA scope</li> </ul>   |

## Example

- In this example, a food producer enters into a cleared \$5bn commodity futures contract to hedge against food price fluctuations
- Under the current approach, these transactions would take SA-CCR charges; under the NPR, these transactions will also take CVA charges
- **RWAs increase 1.65x under the NPR (2.7mm to 4.4mm)**, which would directly result in higher costs charged to clients



# Credit Valuation Adjustment: MPoR

The 10-business day floor for MPoR is overly conservative and does not reflect the improvements to market efficiency achieved through legislation, increasing the hedging costs of collateralized derivative end-users

|                             |  |
|-----------------------------|--|
| Concerns and Considerations | <ul style="list-style-type: none"> <li>▪ The CVA framework has a 10-business day floor for the MPoR which is more conservative than standard industry practice</li> <li>▪ This results in a significant increase in CVA capital associated with collateralized derivatives, even though these transactions are low risk for a bank and should be incentivized by regulators</li> <li>▪ Significant reforms have been made to the functioning of OTC Derivative markets through margining rules that is not reflected in the 10-day floor, such as uncleared margin rules (“UMR”) reforms, initial margining, mandatory clearing, and CCAR stress testing</li> <li>▪ The 5-day floor prescribed for client-facing derivative transactions is more reflective of the actual gap risk for OTC collateralized derivatives</li> </ul> |
| Client and Market Impact    | <ul style="list-style-type: none"> <li>▪ Financial end-users, such as pension funds, and increasingly corporates, use collateralized derivatives to hedge their risk and are significantly impacted by the gap risk component captured by the MPoR</li> <li>▪ Higher capital requirements will result in either less hedging by end-users or increased cost of hedging to them</li> </ul>  |
| Potential Alternative       | <ul style="list-style-type: none"> <li>▪ Use an MPoR of no more than 5 days</li> </ul>   |

## Example

- In this example, a pension funds enters into a 30-year USD interest rate swap (“IRS”) to hedge mortality risk
- Implementing a 5-day MPoR would decrease SA-CVA RWA by 30% and better align with risk

