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By Electronic Mail

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Washington, DC 20219

Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue NW
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Federal Deposit Insurance Commission
550 17th Street NW
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Re: Notice of Proposed Rulemaking, Regulatory Capital Rule: Large Banking Organizations and Banking Organizations with Significant Trading Activity, Federal Reserve Docket No. R-1813 and RIN 7100-AG64, OCC Docket ID OCC–2023–0008, FDIC RIN 3064-AF29

The Institute of International Bankers ("IIB") appreciates the opportunity to comment on (i) the notice of proposed rulemaking issued by the Agencies regarding proposed changes to the large bank capital requirements and (ii) the notice of proposed rulemaking issued by the Federal Reserve regarding proposed changes to the calculation of capital surcharge for globally systemically important bank holding companies ("GSIBs").[1]

This letter addresses themes common to both the Capital Proposal and the GSIB Surcharge Proposal, and includes specific comments on the Capital Proposal. The IIB is

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[1] Board of Governors of the Federal Reserve ("Federal Reserve"), Office of the Comptroller of the Currency ("OCC") and Federal Deposit Insurance Corporation ("FDIC"), *Regulatory Capital Rule: Large Banking Organizations and Banking Organizations With Significant Trading Activity*, 88 Fed. Reg. 64028 (proposed Sept. 18, 2023) (the "Capital Proposal"); Federal Reserve, *Regulatory Capital Rule: Risk-Based Capital Surcharges for Global Systemically Important Bank Holding Companies; Systemic Risk Report (FR Y-15)*, 88 Fed. Reg. 60385 (proposed Sept. 1, 2023) (the "GSIB Surcharge Proposal" and, together with the Capital Proposal, the "Proposals"). Together, the Federal Reserve, the OCC and the FDIC are the "Agencies."

separately submitting a comment letter more specifically focused on the GSIB Surcharge Proposal.

The IIB represents internationally headquartered financial institutions from over 35 countries around the world doing business in the United States. The IIB's members consist principally of international banks that operate branches, agencies, bank subsidiaries and broker-dealer subsidiaries in the United States ("international banks").

The IIB supports the general goal of revising the capital requirements to be consistent with recent changes to international capital standards ("Basel III Endgame") issued by the Basel Committee on Banking Supervision (the "BCBS") and with the implementation of those capital standards in other countries. However, the IIB also believes that significant revisions to the Proposals are necessary to better align the capital framework with U.S. statutory mandates; to remain consistent with internationally agreed principles that respect the roles of home- and host-country supervisors of international banks; and to provide the public with sufficient data and time to assess the impact of the Proposals.

I. Summary of Key Recommendations

- The Agencies should permit certification by an international bank or its intermediate holding company ("IHC") of application of home country operational risk capital requirements consistent with Basel III Endgame, and not require that IHCs separately calculate the operational risk element. Barring this change, a number of modifications to the operational risk capital requirements are needed, particularly with regard to the overweighting of the Services component. In particular:
    - The Agencies should set the internal loss multiplier ("ILM") at 1 and allow an IHC flexibility to use an ILM less than 1 if its parent would be permitted to do so under home country rules;
    - To the extent that operational risk is included in both the risk-weighted assets calculation and in stress testing, recalibration is required;
    - The Agencies should exclude income from intercompany services and transfer pricing for IHCs from the Business Indicator component; and
    - The Agencies should amend the Services component of the Business Indicator to allow netting of income and expenses, particularly in relation to client clearing activity.
- The Agencies should not make the proposed changes to the numerator calculations for all Category III and IV institutions, except for the accumulated other comprehensive income ("AOCI") change. The Agencies also should retain the 100 percent risk weight for non-significant equity exposures in unconsolidated financial institutions.
- The Agencies should reconsider and simplify the approach to calculation of minimum capital in the Capital Proposal, by reducing or eliminating the multiple calculations and backstops proposed. Potential approaches include:

- giving *all* banking organizations the option to conduct calculations under the expanded risk-based approach ("ERBA"), thus making ERBA the generally applicable risk-based capital requirement in accordance with the Collins Amendment, but allow non-Category I-IV banks the ability to elect the current standardized approach; or
- issuing an interpretation or determination that, to be compliant with the Collins Amendment, banking organizations need only conduct the ERBA calculation because the calculation under ERBA would not be less than the generally applicable risk-based capital requirement.

- The Agencies should allow international banks to apply the current standardized treatment for bank exposures, including a minimum risk weight of 20%, particularly with regard to inter-affiliate exposures.
- The Agencies should adopt the Basel III Endgame risk weighting standards for exposures to securities firms, which allows application of bank risk weights to securities firms, particularly with regard to inter-affiliate exposures.
- The Agencies should revise the definition of "collateral agreement" for the standardized approach and ERBA in order to allow more efficient recognition of financial collateral in jurisdictions where there may be a stay.
- The applicability of the standardized approach for counterparty credit risk ("SA-CCR") to IHCs should be revisited for Category III and IV IHCs. Category III and IV IHCs should be permitted to (1) opt in to using SA-CCR, with the default being the Current Exposure Methodology ("CEM"), and (2) if SA-CCR is chosen, use their home country's SA-CCR methodology instead.
- The Agencies should recalibrate either or both the revisions to the market risk capital rules and the Global Market Shock ("GMS") / Largest Counterparty Default ("LCPD") components of stress testing and the stress capital buffer, as they overlap significantly.
- The Agencies should revise the market risk approach to be more commensurate with the risk profile of institutions by:
  - only applying it to Category III and IV organizations that have $20 billion in trading assets and liabilities ("TAL");
  - allowing Category III and IV institutions to apply market risk requirements at the firm, rather than desk, level;
  - allowing IHCs to apply models approved by their home country regulators and certified to the Agencies; and
  - allowing Category III and IV organizations to run monthly, rather than weekly, standardized market risk calculations.
- The transition periods for the revised market risk approach should be clarified; namely, the new market risk rules should not be incorporated into the standardized approach at all during the three-year transition period, and instead

become fully incorporated into the standardized approach only at the end of the three-year transition period.

- The treatment of government-sponsored enterprise ("GSE") exposures should be broadly recalibrated so as to treat securities and related exposures deliverable by Fannie Mae and Freddie Mac as the same issuer, and a higher correlation between a number of GSE exposures should be implemented.
- The Agencies should use a quantitative measure for determining which firms are exempt from credit valuation adjustment ("CVA"). They should only apply ERBA and CVA to "Other Firms" (generally less than $100 billion) after notice and response, and should only seek to exercise this discretionary authority in limited circumstances.
- The Agencies should eliminate sovereign exposures that are risk-weighted at 0% and eliminate funds on deposit at any qualifying central bank from the supplementary leverage ratio ("SLR") denominator.
- The Agencies should adopt a 3-year transition period for all of the numerator modifications, in addition to certain other revisions:
  - The transition period for ERBA, operational risk, CVA and market risk calculations for Category III and IV institutions should be extended by an additional one year;
  - More time must be provided for Category III and IV institutions to be able to commence the calculations they are required to make; and
  - Additional time is necessary for firms to obtain appropriate model approvals under the market risk framework.

II. Background: Role of International Banks in the United States

International banks are a critical part of the United States financial system. The Proposals, through their disproportionate impact on international banks, would threaten international banks' robust operations in the United States.

Our members' U.S. operations, in the aggregate, perform a vital role in providing credit to U.S. businesses, enhancing liquidity to U.S. financial markets, offering robust competition in financial services and contributing to the employment of hundreds of thousands of people in the United States in the financial sector and through related services. For example:

- IIB members hold more than $4 trillion in assets in the United States.
- IIB members employ approximately 200,000 people in the United States.
- IIB members represent more than half (55%) of U.S. primary dealers.

- And more than 40 percent of all commercial and industrial loans in the United States are made by foreign-headquartered financial institutions.

Federal Reserve Chairman Powell has noted the contributions of international banks to U.S. lending and capital markets and the resulting economic gains in the United States.[2]

As discussed further in Section XI.C, the Proposals do not sufficiently consider the negative effect on banks' ability to provide essential financial services to U.S. households and businesses, as compared to the claimed benefits of increasing capital requirements for increase's sake. This is especially the case with respect to the IHCs and combined U.S. operations ("CUSO") of international banks. Erosion of the tiering structure for enhanced prudential standards, divergences from the international implementation of Basel III Endgame, and insufficient cost-benefit analysis all lead to a miscalibration of the holistic capital framework with respect to international banks. Miscalibration and significantly greater-than-expected effects on international banks would disincentivize international banks from providing credit, investment and other financial services in the United States—even more so than their peer domestic banks—potentially impeding the domestic economy.

We believe that these disincentives ultimately would increase concentration of assets and services in large U.S. banks and create less diversity and competition in the market. Miscalibration could encourage international banks to shrink their U.S. operations, constrain their growth in the United States or exit entirely. International banks must weigh the relative costs and benefits of enhancing products and investing in continued or expanded participation in different geographic markets on a frequent basis. Experience has shown that ever-increasing capital requirements can significantly affect incentives to invest in the United States and participate in lending and capital markets.[3] For example, after the implementation deadline for the IHC rule in 2016, which subjected IHCs to capital planning and stress testing requirements as an enhanced prudential standard, international banks pared back operations in the United States.[4] Further incentives to shrink international bank presence are present in the Proposals, such as the lack of adherence to statutory mandates to tier institutions in accordance with risk. An increased concentration of the banking organizations remaining in the United States could itself be a source

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2 *See* Jerome H. Powell, Chairman, Federal Reserve, Opening Statements on Proposals to Modify Enhanced Prudential Standards for Foreign Banks and to Modify Resolution Plan Requirements for Domestic and Foreign Banks (Apr. 8, 2019), https://www federalreserve.gov/newsevents/pressreleases/powell-opening-statement-20190408 htm ("Foreign banks play an important role in our economy. They facilitate commerce, and provide credit and needed investment."). *See also* Federal Reserve, Financial Stability Report at 64 (May 2023), https://www.federalreserve.gov/publications/files/financial-stability-report-20230508.pdf (noting the crucial role of international banks, including in providing dollar liquidity via U.S. dollar-denominated swaps).

3 *See generally* Securities Industry and Financial Markets Association ("SIFMA"), *Insights: The Importance of FBOs to US Capital Markets* (Apr. 2019), https://www.sifma.org/wp-content/uploads/2019/04/SIFMA-Insights-The-Importance-of-FBOs-to-US-Capital-Markets.pdf.

4 James DiSalvo, *How Foreign Banks Changed After Dodd-Frank*, Federal Reserve Bank of Philadelphia Economic Insights 1 (Third Quarter 2019), https://www.philadelphiafed.org/-/media/frbp/assets/economy/articles/economic-insights/2019/q3/bt-dodd-frank-foreign-banking.pdf.

of systemic risk.[5] Ultimately, this trend could reduce the resiliency and available liquidity of U.S. credit and other financial markets. In our view, the Economic Growth, Regulatory Relief and Consumer Protection Act ("EGRRCPA")[6] and the resulting tiering regulations were a direct response to smaller and less risky banking organizations having to shoulder the burden of one-size-fits-all, post-Dodd-Frank-Act regulation that diminished their operations. Yet, contrary to statutory authority, the Proposals undo a lot of the burden-reduction that emanated from EGRRCPA and the rules promulgated under its mandates.

As an example, the Capital Proposal's application of materially more stringent capital requirements to all banking organizations with over $100 billion in total assets, without differentiation, would constrain growth in competition from international banks with smaller U.S. footprints. This stringency worsens the "cliff effect"[7] of crossing the $100 billion threshold, subjecting IHCs to significantly increased capital requirements that are more commensurate to those applicable to U.S. GSIBs.[8] Furthermore, to the extent any differentiation is left among categories, the GSIB Surcharge Proposal's inclusion of derivatives in the Cross-Jurisdictional Activity ("CJA") measurement in the Form FR Y-15 exacerbates this cliff effect, given the new potential for smaller organizations to inadvertently leap all the way to Category II, near the realm of U.S. GSIBs. The resulting jump in stringency for previously lower-category organizations and the cliff effect upon rising into Categories I-IV are daunting and near-prohibitive of growth and expansion of smaller institutions. Were the largest organizations already in Category I-IV to grow, however, marginal effects on capital stringency would be minimal.

We are also concerned that one of the more serious consequences of the Proposals could be the negative effects of the market risk capital proposals on capital markets activity. International banks currently represent over half of the primary dealers, playing a key role in providing market liquidity in the essential U.S. Treasury market. The significant increase in market risk capital requirements creates disincentives for all banks to provide liquidity to primary and secondary markets, and could constrain banks in times of volatility in the Treasury

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[5] *See* Michelle W. Bowman, Governor, Federal Reserve, *The Role of Research, Data, and Analysis in Banking Reforms* (Oct. 4, 2023), https://www federalreserve.gov/newsevents/speech/bowman20231004a htm ("Year after year, researchers have presented evidence that a banking system with diverse business models and sizes is better for business formation and leads to better penetration of financial services products across all industry sectors.").

[6] *See* Section XI.A below.

[7] *See* David Hou & Missaka Warusawitharana, *Federal Reserve, Effects of fixed nominal thresholds for enhanced supervision* (July 19, 2018), https://www.federalreserve.gov/econres/notes/feds-notes/effects-of-fixed-nominal-thresholds-for-enhanced-supervision-20180719.html.

[8] *See* Section XI.A regarding the lack of differentiation and lack of tiering that causes and exacerbates this effect. *See also*, *e.g*., Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") § 115(b)(3)(B) (recommendations by FSOC are required to, "to the extent possible, ensure that small changes in the factors listed in subsections (a) and (b) of section 113 would not result in sharp, discontinuous changes in the prudential standards established"), § 165(b)(3)(B) (enhanced prudential regulations promulgated by the Federal Reserve are to, "to the extent possible, ensure that small changes in the factors listed in subsections (a) and (b) of section 113 would not result in sharp, discontinuous changes in the prudential standards established under paragraph (1) of this subsection"). The Proposals are not consistent with these statutory requirements.

market, just when they are most needed.[9] To the extent that individual banks', and particularly international banks', cost-benefit analysis leads to a departure from certain markets, liquidity shocks like those that have been seen in the past 5-10 years, even in typically safe Treasury markets, will likely be more frequent and deeper.[10] This would counteract the significant recent efforts across various government agencies to make the Treasury markets more resilient.[11]

Indicative of the weaknesses that flow through the Proposals, the Agencies themselves admit that the impact of capital on market making requirements and market liquidity "remains a research question needing further study."[12] The financing of corporate growth and job creation in the U.S. economy is dependent, more so than most other countries, on a liquid debt security market.[13] The possible effects of the proposed significant capital increase with respect to trading activity on such a critical element of the U.S. economy should not be left to be determined through finalizing a rule and then seeing what happens. Another example of a lack of holistic review in the Proposals is the lack of modifications to the GMS component of stress testing, which has reduced banks' holding of debt securities and consequently banks' ability to act as market-makers.[14] More effort is needed to calibrate a market risk capital rule and the elements of the GMS to eliminate their additive nature. Without recalibration, the Proposals would further constrain banks in their efforts to provide liquidity to U.S. capital markets.

Furthermore, banks' withdrawals from or reduced involvement in various areas of the economy or the markets likely will only serve to push these activities to nonbank financial

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[9] *See, e.g.*, Michelle W. Bowman, Governor, Federal Reserve, Remarks on the Economy and Prioritization of Bank Supervision and Regulation at the New York Banker's Association's Financial Services Forum, Palm Beach, Florida (Nov. 9, 2023), https://www federalreserve.gov/newsevents/speech/bowman20231109a htm (risks to the Treasury markets "could be exacerbated if bank holding company-affiliated market makers experience balance sheet constraints during periods of volatility").

[10] For example, recent disruptions to the Treasury market include, but are not limited to (i) the "flash rally" of October 2014, when yields on Treasury bonds plunged for unclear reasons, leading to sharp increases in prices and a sharp drop in liquidity; (ii) the September 2019 repo market disruptions, when repo rates accelerated dramatically amidst a large withdrawal of reserves from the banking system and during the settlement of Treasury securities auctions, which generated a significant need for cash reserves; and (iii) the COVID-19 shock of March 2020, when market uncertainty caused a spike in volume in the market for Treasury securities and a drop in liquidity provision, particularly by inter-dealer brokers, prompting intervention by the Federal Reserve.

[11] *See* SEC, *Standards for Covered Clearing Agencies for U.S. Treasury Securities and Application of the Broker- Dealer Customer Protection Rule With Respect to U.S. Treasury Securities* (Dec. 13, 2023), https://www.sec.gov/rules/2022/09/standards-covered-clearing-agencies-us-treasury-securities-and-application-broker. In addition, several government agencies have taken significant action to improve the resiliency of the Treasury markets recently. *See* Inter-agency Working Group for Treasury Market Surveillance, *Enhancing the Resilience of the U.S. Treasury Market: 2023 Staff Progress Report* (Nov. 6, 2023).

[12] *See* Capital Proposal at 64170-71.

[13] *See* SIFMA, *2023 Capital Markets Fact Book* (July 2023) at 6 (bar chart indicating that debt financing of non-financial corporates is comprised of 75% of debt securities issuances and only 25% bank loans in the United States, whereas the Euro area (11.5%), the UK (24.3%), Japan (20.6%) and China (28.9%) have a materially lower dependence on debt security capital markets).

[14] *See* Adam Freedman and Francisco Covas, *The Global Market Shock and Bond Market Liquidity*, Bank Policy Institute (May 23, 2019), https://bpi.com/the-global-market-shock-and-bond-market-liquidity/.

institutions, which are more lightly regulated and growing in size and influence.[15] This migration could, in fact, increase risks to U.S. financial stability, in contrast to the stated goals of the Proposals.[16]

III. Operational Risk

A. Applying the operational risk element as proposed would place additional and unique burdens on IHCs that depart from the proposed and/or finalized international standards, and would apply different requirements for operational risk across different countries.

Applying operational risk capital charges to an IHC subsidiary of a larger organization ignores the realities of how technology and systems are used across borders.

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[15] *See generally*, *e.g.*, Lisa D. Cook, Governor, Federal Reserve, Remarks at the Central Bank of Ireland, Dublin, Ireland on Financial Stability: Resilience, Challenges, and Global Connections (Nov. 8, 2023), https://www federalreserve.gov/newsevents/speech/cook20231108a htm (non-bank financial institutions "have become an integral part of the financial system and are increasingly interconnected with the banking sector. It is crucial for relevant authorities to implement stronger oversight and appropriate prudential requirements for nonbanks. This is especially important amid concerns that proposed higher capital requirements for large banks could cause some bank activities to migrate to the more lightly regulated" non-bank financial institutions); Martin J. Gruenberg, Chairman, FDIC, Remarks at the Exchequer Club on the Financial Stability Risks of Nonbank Financial Institutions (Sept. 20, 2023), https://www fdic.gov/news/speeches/2023/spsept2023 html ("In conclusion, nonbank financial institutions have become an integral part of the financial system . . . . Banks and nonbanks need to be seen as an interconnected whole and overseen accordingly. A comprehensive strategy utilizing the authorities of individual agencies and the FSOC is needed to address the financial stability risks posed by nonbank financial institutions"). *See also* Agencies, *Shared National Credit Program: 1st and 3rd Quarter 2022 Reviews* (Feb. 24, 2023), https://www.occ.treas.gov/publications-and-resources/publications/shared-national-credit-report/files/shared-national-credit-report-2022.html ("U.S. and foreign banks own the largest share of SNC commitments, while nonbanks hold the largest share of special mention and classified loans. Nonbank holdings are concentrated in non-investment grade term loans identified and reported as leveraged by agent banks").

As FDIC Director McKernan has noted, the lack of sufficient public rationale for many of the Agencies' choices in the Capital Proposal would impede the ability of regulators to impose similar requirements on similarly situated market participants. *See* Jonathan McKernan, Director, FDIC, Remarks at the New York State Bar Association and Mayer Brown on the Basel Endgame and Long-Term Debt Proposals (Oct. 4, 2023), https://www fdic.gov/news/speeches/2023/spoct0423a.html ("I'm left struggling to see how we can work to harmonize requirements across banks and nonbanks when we have sometimes not offered a calibration rationale for the bank requirements, and indeed some aspects of the Endgame proposal arguably might even be contrary to the available evidence. How are other regulators supposed to regard our work product here?").

[16] *Compare*, *e.g.*, Capital Proposal at 64032 ("By strengthening the requirements that apply to large banking organizations, the proposal would enhance their resilience *and reduce risks to U.S. financial stability* and costs they may pose to the Federal Deposit Insurance Fund in case of material distress or failure.") (emphasis added), *with* Michelle W. Bowman, Governor, Federal Reserve, Remarks on Financial Stability in Uncertain Times at the Reinventing Bretton Woods Committee and Policy Center for the New South Marrakech Economic Festival, Marrakech, Morocco (Oct. 11, 2023), https://www federalreserve.gov/newsevents/speech/bowman20231011a htm (noting the "financial stability vulnerabilities posed by large nonbank financial institutions" and that "[h]edge fund leverage remains elevated and prime money market funds, insurance companies, and some corporate bond mutual funds remain vulnerable to run risks.").

IHCs—as subsidiaries of broader banking organizations that are themselves subject to various prudential standards, including operational risk capital requirements on a consolidated basis level—would be uniquely affected by this requirement.

The Capital Proposal would result in the implementation of different requirements for operational risk across countries. This would create additional and unique burdens on IHCs. Measuring the same risks in different ways—i.e., under one set of requirements at the level of the IHC and another set of requirements at the level of the home country parent—can itself create operational risks and burdens.

A factor that exacerbates this issue is the Agencies' decision to set an internal loss multiplier ("ILM") floor at one. The reasoning for this policy choice is not clear given that it is a departure from proposed and/or finalized international standards: the BCBS and other countries have either (i) permitted the ILM to go above or below one[17] or (ii) proposed to fix the ILM at one.[18] The Agencies do not sufficiently justify this departure from international standards, or justify why IHCs should potentially be subject to different ILMs for home country purposes and for U.S. purposes. The Agencies simply broadly assert that this multiplier will prevent the operational risk capital requirement from being too low.[19] The Agencies also do not justify how they can predict that "potential future operational risks" will be large "even [if] . . . historical operational losses have been low".[20] If the Agencies are skeptical of the information provided by historical losses—as are we—then perhaps the path taken by the UK would be appropriate. The UK Prudential Regulatory Authority stated that it "considers that a mechanical link to past losses is inappropriate for a number of reasons, including that . . . past events (particularly over a lengthy historical period) are generally not good predictors of future losses."[21] Indeed, the

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17 BCBS, Basel Framework, OPE 25.9. *See* Office of the Superintendent of Financial Institutions (OSFI), Canada, *Capital Adequacy Requirements (CAR) Chapter 3 – Operational Risk*, https://www.osfi-bsif.gc.ca/Eng/fi-if/rg-ro/gdn-ort/gl-ld/Pages/CAR22_chpt3.aspx.

18 BCBS, Basel Framework, OPE 25.11 (". . . at national discretion, supervisors may set the value of ILM equal to 1 for all banks in their jurisdiction"). *See* European Commission, "Explanatory Memorandum: Proposal for a REGULATION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL amending Regulation (EU) No 575/2013 as regards requirements for credit risk, credit valuation adjustment risk, operational risk, market risk and the output floor" (Oct. 27, 2021), https://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX:52021PC0664 ("In the Union, the minimum own funds requirements for operational risk will be solely based on the BIC [Business Indicator Component] (Article 312)," yielding a proposed ILM of 1) (the "EU Explanatory Memorandum"); UK Prudential Regulatory Authority, *PS17/23 Implementation of the Basel 3.1 standards near-final part 1*, at paras. 5.18-5.20 (Dec. 12, 2023), https://www.bankofengland.co.uk/prudential-regulation/publication/2023/december/implementation-of-the-basel-3-1-standards-near-final-policy-statement-part-1 (decision to maintain proposal to set the ILM equal to 1) (the "UK Implementation Document").

19 *See* Capital Proposal at 64086 ("This floor would ensure that the operational risk capital requirement provides a robust minimum amount of coverage to the potential future operational risks a banking organization may be exposed to, as reflected by its overall business volume through the business indicator component, even in situations where historical operational losses have been low in relative terms.").

20 *Id*.

21 UK Implementation Document, at para. 5.20. *See also* EU Explanatory Memorandum ("[I]n order to ensure a level playing field within the Union and to simplify the calculation of operational risk capital,

unreliability of historical losses as a predictor of future losses weighs against allowing the ILM to float above 1, as this imposes undue penalties for historical losses, and long-dated historical losses, without providing a commensurate financial stability benefit. Indeed, being penalized for long-dated historical losses creates disincentives to investing in operational improvements if the penalty is not going to be alleviated by those operational improvements.

Furthermore, to the extent that the support for this gold-plating is linked to the March 2023 banking stress, the Agencies have not advanced any argument that operational risk charges more stringent than those required internationally would have had any ameliorative effect on those events.

We also note that applying the same operational risk considerations to all Category I through IV banking organizations—and, more specifically, extending the operational risk coverage from nine advanced approaches banking organizations to all Category I through IV banking organizations—is one of many examples of the rollback of tiering that is statutorily required by EGRRCPA[22] and further increases the burdens on the smaller and less risky IHCs. In one stroke, the Capital Proposal undermines the final rules implementing EGRRCPA's requirements (the "<u>2019 Tiering Rules</u>")[23] and reverses the decision to allow IHCs to opt-out of the more complex approaches (previously and recently permitted in recognition of the burdens that this would impose on IHCs).[24]

The next few sections describe our recommendations to enhance consistency of the operational risk proposal with U.S. statutory requirements, existing Agency rules and international implementation of the Basel III Endgame. Where the Basel III Endgame would lead to regulations that have illogical or unintended consequences, we have proposed solutions as well.[25]

B. <u>The Agencies should permit certification by an international bank or its IHC of application of home country consolidated operational risk capital requirements consistent with Basel III Endgame, and not require that IHCs separately calculate the operational risk element.</u>

For the reasons discussed in Section III.A immediately above, the operational risk element of the Capital Proposal should not apply to the IHCs of international banks that apply

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those discretions are exercised in a harmonised manner by disregarding historical operational loss data for all institutions.").

22 *See* Section XI.A below.

23 *See* Federal Reserve, *Prudential Standards for Large Bank Holding Companies, Savings and Loan Holding Companies, and Foreign Banking Organizations*, 84 Fed. Reg 59032 (Nov. 1, 2019) (the "<u>2019 Enhanced Prudential Standards Rule</u>"), and Agencies, *Changes to Applicability Thresholds for Regulatory Capital and Liquidity Requirements*, 84 Fed. Reg. 59230 (Nov. 1, 2019).

24 *See* footnote 52 below.

25 *See* Jonathan McKernan, Director, FDIC, Remarks at ISDA's Conference on Trading Book Capital: Basel III Implementation (Dec. 12, 2023), https://www fdic.gov/news/speeches/2023/spdec1223.html# ftnref2 ("…the final standards issued by the Basel Committee include little, if any, discussion about the public comments on the consultative standards or why the Basel Committee made its key design decisions.").

the Basel III Endgame standardized measurement approach (the "SMA") on a consolidated basis through their top-tier parent (i.e., a "home country certification" or "substituted compliance" approach). The Agencies have effectively used this approach in relation to a number of key international consistency issues.[26] This would greatly mitigate our concerns about the inefficiencies and burdens of having one set of requirements at the level of the IHC and another set of (importantly, consolidated) requirements at the level of the home country parent. Furthermore, the statute requires the Agencies to make an in-depth consideration of this solution.[27]

To the extent that the Agencies require some indication that an appropriate portion of an international bank's global operational risk capital is allocated to the U.S. IHC, the stress tests applicable to all Category I-IV institutions already incorporate operational risk in a forward-looking manner.[28] Given the U.S. stress capital buffer (which is also a divergence from international methodologies), the forward-looking losses over the nine-quarter stress horizon are guaranteed to be incorporated into an IHC's capital requirements.[29] We do not see any rationale in the Capital Proposal as to why the allocation of global capital to the U.S. through the stress tests would not be sufficient to evidence an appropriate positioning of operational risk capital at the IHC.

If, notwithstanding our recommendations for a sensible solution to this issue that promotes international consistency, the Agencies do not provide a home country certification method for compliance with operational risk, then the operational risk elements of the Capital Proposal should be modified significantly to reduce international inconsistencies, burdens on international banks and divergences from statutory mandates. Based on a survey of certain of our members, the operational risk elements of the Capital Proposal would yield an average 23% increase in RWA for IHCs, and would be the single largest driver of RWA increases in IHCs—we do not believe that this result reflects the actual risk of the smaller and less risky IHCs. In particular, below we recommend (1) modifications to the ILM, (2) a recalibration of the operational risk elements of the Proposal or of stress testing or both, and (3) several modifications to the services inputs to the business indicator component.

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26 *See* 12 C.F.R. § 252.146(b) (an international bank may certify in Item 5(d) of the Form FR Y-7 that it is "subject on a consolidated basis to a capital stress testing regime by its home-country supervisor that meets the requirements of paragraph (b)(2) of this section; and [that it c]onduct[s] such stress tests or [is] subject to a supervisory stress test and meet[s] any minimum standards set by its home-country supervisor with respect to the stress tests"); § 252.158(b) (same for larger international banks in Item 5(e) of the Form FR Y-7); § 252.172(d) (same for single counterparty credit limits).

27 *See* Dodd-Frank Act § 165(b)(2) (when applying prudential standards to any "foreign-based bank holding company," the Federal Reserve "shall . . . take into account the extent to which the foreign financial company is subject on a consolidated basis to home country standards that are comparable to those applied to financial companies in the United States").

28 *See* Federal Reserve, *2023 Stress Test Methodology* 22 (June 2023). *See also* Section III.B.2 below regarding recalibration between the operational risk requirements and stress testing's inclusion of operational risk.

29 *See* data in relation to note 31 below and accompanying text.

1. *The Agencies should set the ILM at 1 and allow an IHC flexibility to use an ILM less than 1 if its parent would be permitted to do so under home country rules.*

If home country certification is not afforded to IHCs for compliance with the SMA, then the Agencies should set the ILM at 1 for IHCs and allow IHCs whose home country permits the ILM to go below 1 to opt into this treatment in the United States. Adopting this change would simplify the calculation for the sub-consolidated U.S. portion of a broader organization already applying operational risk capital charges on an enterprise-wide basis. First, no other country of which we are aware has used its discretion under the Basel III Endgame framework to create a floor at 1. Second, setting the ILM at 1 and giving certain IHCs optionality prevents IHCs that are already subject to a broader organization's operational risk charges from facing the operational burden of calibrating and calculating the U.S. ILM separately and additively, as this complexity would not have corresponding benefits for U.S. IHCs. Third, setting the ILM at 1 and giving certain IHCs optionality is much more likely to result in an internally efficient allocation of a portion (but not a skewed proportion, as may result from an ILM greater than 1) of the consolidated operational risk capital to the IHC's operations. Finally, allowing IHCs whose home country permits the ILM to go below 1 to opt into this treatment in the United States would avoid needlessly penalizing those IHCs that already have an ILM of less than 1 or that anticipate having an ILM of less than 1 in the future.

2. *To the extent that operational risk is included in both the risk-weighted assets calculation and in stress testing, recalibration is required.*

Stress testing already incorporates operational risk for IHCs above $100 billion. And the stress test already uses both a size indicator and historical loss events in the pre-provision net revenue calculation.[30] The Agencies do not sufficiently address why a separate operational risk component is needed if stress testing already considers and accounts for it, as all Category I-IV institutions are subject to stress-testing and annual capital plan submissions. In the United States, stress testing has a direct impact on required capital levels and the numerator of capital ratios through the stress capital buffer. The results of that test already flow back directly into a buffer *above* the ERBA general risk-based capital calculations, thereby making it a certainty that the operational risk charges will be *in addition* to each other.

In the 2023 Comprehensive Capital Analysis and Review ("CCAR"), the Federal Reserve estimated $185 billion of aggregate operational risk event losses across 23 institutions, out of a total aggregate loss of $540 billion—thus constituting more than one-third of all losses

[30] Federal Reserve, *2023 Stress Test Methodology* 22 (June 2023), https://www federalreserve.gov/publications/files/2023-june-supervisory-stress-test-methodology.pdf (the "model projects losses stemming from operational-risk events using information about the size and historical operational-risk losses of the firms and economic conditions defined in the Federal Reserve's supervisory stress test scenarios. Key firm characteristics that affect projected losses include the size of the firm measured by total assets and the firm's historical operational-risk losses by operational-risk event").

projected and resulting in such losses already being incorporated into every stress test institution's stress capital buffer.[31]

For IHCs specifically, operational risk is already counted once because the IHC's operational risk is incorporated into the parent's operational risk charges in the home country. Therefore, as recommended above in relation to the home country certification approach, for IHCs, the stress test can serve as an indicator of appropriate positioning of the international bank's global operational risk capital, without also applying the operational risk elements of ERBA. If the Agencies do not take this approach, IHCs could potentially be subject to *triple* layering of operational risk capital—once at the home country level, once in U.S. stress testing, and once in ERBA. Alternatively, the Agencies should recalibrate both the operational risk portion of the Capital Proposal and the operational risk elements of stress testing such that they are complementary. In other words, the Agencies should consider how to adjust operational risk in ERBA and operational risk in stress testing so they do not cover the same risks or apply cumulative capital charges for the same amount and types of risk. As noted in Section VII.A below, at a minimum this recalibration exercise should be conducted if there is to be any credibility in the U.S. capital framework from a "holistic" perspective. The advent of the stress capital buffer, which exists only in the United States, creates a very sophisticated capital requirement framework, and therefore modifications and additions must equally be subject to a sophisticated and robust calibration process.

3. *The Agencies should exclude income from intercompany services and transfer pricing for IHCs from the Business Indicator component.*

In the event the Agencies apply operational risk calculations to IHCs, the approach for determining the "Services" component of the "Business Indicator" of the operational risk calculation should be adjusted for IHCs of international banks to appropriately assess the capital requirements for transfer pricing frameworks at international banks. We believe, based on a quantitative survey of participating IIB members, that the Services component is the most significant source of Business Indicator exposure for IHCs (approximately 65% of the total Business Indicator component), and that this proportion is higher than domestic banking organizations' Services component.

The Proposal, as well as the Basel Framework, allow for certain exemptions of expense items, such as staff salary costs and infrastructure costs.[32] The Proposal, however, does not exempt reimbursement of these expense items from income. This is problematic because reimbursements of these administrative costs from a foreign parent or affiliate (including U.S. branches, agencies or representative offices) to its U.S. subsidiary in transactions in which the U.S. subsidiary provides a service to the foreign parent or affiliate will show up as income on the U.S. subsidiary's income statement. However, U.S.-headquartered top-tier bank holding companies would eliminate both such income in consolidation and the associated expenses under the Business Indicator exclusions in the Proposal. As proposed, the treatment of income from

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[31] *See* Federal Reserve, *2023 Federal Reserve Stress Test Results* (June 2023), https://www federalreserve.gov/publications/files/2023-dfast-results-20230628.pdf.

[32] *See* Capital Proposal at 64085; BCBS, Basel Framework, OPE 10.3(3) (administrative expenses) and 10.3(5) (premises and fixed assets).

inter-affiliate reimbursements would overstate the impact of arm's-length transfer pricing mechanisms for the IHC. Rather, under the final rule, to the extent that an expense is exempted from the Business Indicator and the Services component calculation, the associated reimbursement for that expense from a parent or affiliated entity under required transfer pricing mechanisms for services should be excluded as well.[33] Unlike the exclusions indicated in the Basel III Endgame framework, which exclude "recovery of administrative expenses" in addition to the exclusion of "administrative expenses",[34] the Proposal does not appear to make such an exclusion in the calculation of the Business Indicator component.[35] Making this change would ensure the consistent treatment of income and expense for these internal transactions and intercompany services, ensure common application of the rule, and avoid unduly penalizing IHCs based on their foreign banking entity structure.[36]

4. *The Agencies should amend the Services component of the Business Indicator to allow netting of income and expenses, particularly in relation to client clearing activity.*

Finally, the Capital Proposal's operational risk component would severely affect IHCs' fee-based businesses. This is despite the fact that fee-based businesses are relatively low in balance sheet usage and in risk. Lack of netting effectively penalizes diversification of products and services, and continuation of, or entry into, less volatile fee-based businesses. Other comment letters highlight this industry-wide problem in great detail, and here, we highlight how this issue especially affects international banks.

Generally, the Proposal's concept that fee, commission and operating income and expenses in the Services component are calculated as gross figures[37] (in contrast to the Interest, Lease and Dividend component and the Financial component, which are both net) serves to inappropriately and inordinately inflate the Services component of the Business Indicator. As noted above, this component also disproportionately affects IHCs in comparison to their domestic peers.

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33 Similarly, we note that "other operating expense" is defined to include only "expenses associated with financial services". Capital Proposal at 64186. However, "other operating income" does not include the same scope limitation. *Id*. For reasons similar to those above, we recommend that the same scope limitation apply to the "other operating income" component because, in addition to costs embedded in transactions with foreign parent or affiliates, there may be costs associated with corporate or shared services, not associated with a financial transaction or service, that could be allocated from the IHC to foreign affiliates and recorded as income to the IHC against those costs. We note that the Basel III Endgame framework includes a consistent use of the term "from ordinary banking operations" in both the income and expense definitions. *See* BCBS, Basel Framework, OPE 10.2.

34 *See* BCBS, Basel Framework, OPE 10.3(3), 10.3(4) and 10.3(5).

35 *See* Capital Proposal at 64216 (proposed § __.150(d)(3) on exclusions).

36 Transfer pricing on services is required by the Internal Revenue Service (*see* 26 U.S.C. § 482) and penalties for inaccurate transfer pricing may be assessed (*see* 26 U.S.C. § 6662). *See also* Organization for Economic Cooperation and Development, *United States Transfer Pricing Country Profile* (February 2022), at https://www.oecd.org/tax/transfer-pricing/transfer-pricing-country-profile-united-states.pdf.

37 *See* Capital Proposal at 64084.

As a specific example, but by no means the only example, the Services component of the Business Indicator stands to have disproportionately punitive effects on clearing member banks (and indirectly their customers) in the United States when compared to their global counterparts, in a divergence that is of particular concern to international banks. As proposed, the Services component does not offer a netting benefit for fees and commissions.[38] Under the Proposal, banking organizations that use U.S. Generally Accepted Accounting Principles ("GAAP") are required to report gross direct charges applied by the clearing member in the Business Indicator portion of the calculation (e.g., trade commissions, risk charges, spreads), plus any exchange and central counterparty ("CCP") clearing transaction fees, even though such fee payments by the clearing client are not income to the banking organization, but are passed through as payment to the exchange or CCP. However, under International Financial Reporting Standards ("IFRS") rules, exchange and CCP transaction fees that feed into the Business Indicator are net out. Under GAAP rules, therefore, the Business Indicator, and thus operational risk capital, could be overly punitive and potentially result in higher costs for clearing member banks' U.S. clients. In turn, this may create an incentive for clients to clear offshore rather than in the United States, where possible. For subsidiaries of IHCs that are clearing members, the divergence between the approach taken by GAAP and that taken by IFRS presents particularly severe problems, since the treatment of such fees would differ between the United States and the home country. To address this disparity and to ensure a unified and globally consistent approach for capturing fee income activity related to client clearing, the Agencies should allow for netting of income and expenses that are passed through in client clearing activity, consistent with IFRS treatment in the Business Indicator calculation.

We believe that there are other netting opportunities similar to this one, which suggests the need for a broad reconsideration of the elements of the Services component. Solutions to the inordinate inflation of this component of the Business Indicator could include:

- Incorporation of netting of income and expenses in the Services component, as permitted in both the Interest, Lease and Dividend component and the Financial component;

- A cap on the gross, unbound nature of the calculation of the Services component, similar to that applicable to the Interest, Lease and Dividend component;[39] and/or

- Application of risk weights to the elements of the Services component based on observed risk of the activity.

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38 *See id.*

39 *See* Capital Proposal at 64216 (proposed § __.150(d)(1)(i) (2.25% interest-earning asset cap in formula).

IV. Numerator Changes

A. The Agencies should not make the proposed changes to the numerator calculations for all Category III and IV institutions, except for the AOCI change.

IHCs are negatively and disproportionately affected by the proposed changes to the numerator calculations for Category III and IV institutions. These changes to the numerator include (a) the removal of the AOCI opt-out,[40] which reverses the change made in the 2019 Tiering Rules, and (b) a number of deductions from capital that mirror those currently required of Category I and II firms, including for mortgage servicing assets ("MSAs") and temporary difference deferred tax assets ("DTAs").[41] The Agencies estimate that IHCs in Category III will face a 13.2% increase in their CET1 requirements and 9.7% increase in leverage capital requirements as compared to 4.6% and 3.8%, respectively, for domestic firms in Category III.[42] For such IHCs, the Agencies noted that the "threshold deduction changes would dominate."[43]

In light of the extensive changes that the Agencies are proposing for the denominator, as described in Sections VI and VII of this letter, the Agencies should consider whether changes to the numerator are warranted. While we understand that changes to the denominator are part of the internationally agreed Basel III Endgame, the changes to the numerator have no justification other than to reverse the flexibility given to Category III and IV institutions just four years ago. The Agencies' only justification for changing the numerator is to "help ensure that the regulatory capital ratios of [Category III and IV] banking organizations better reflect their capacity to absorb losses,"[44] but standardizing the numerator across banking organizations without consideration for the size of the banking organization or, in the case of IHCs, the unique nature of having a foreign parent company and a home country jurisdiction also regulating capacity to absorb losses, imposes a burden on Category III and IV banking organizations that is not outweighed by any benefit to the stability of the economy. In fact, considering the dramatic increase in capital requirements the Capital Proposal would bring about without a commensurate policy justification, we posit that the changes to the numerator are not warranted.

We propose a simple tiering fix to leave the standardized approach numerator calculations for all Category III and IV institutions, except for the AOCI change which we agree is considerably more targeted to the March 2023 stress than other elements of the Proposal. Without such a change, there would be another significant element of the U.S. capital framework that lacks tiering, as required by statute, across banking organizations. At minimum, such a change needs greater analysis, data support and overall justification than a general reference to "creating alignment across all banking organizations subject to the [P]roposal."[45] Indeed,

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[40] Capital Proposal at 64036.

[41] Capital Proposal at 64036-37.

[42] Capital Proposal at 64171.

[43] Capital Proposal at 64171.

[44] Capital Proposal at 64031.

[45] Capital Proposal at 64037. Indeed, other than the "alignment" quote above, this section on the numerator deductions merely contains a description of the current rule and the proposal, with no other justifications.

creating alignment is contrary to the statutory requirement to make the rules less complex and less stringent for institutions in the lower categories.

B. The Agencies should retain the 100 percent risk weight for non-significant equity exposures in unconsolidated financial institutions.

A related modification is the Proposal's elimination of the 100 percent risk weight for non-significant equity exposures in unconsolidated financial institutions whose aggregate adjusted carrying value does not rise to the level of a deduction (i.e., does not exceed 10 percent of the banking organization's total capital).[46] A quantitative study among IIB members suggests that this change is likely to have a significant effect on risk-weighted assets, which the Proposal would impose without study or justification again. These equity exposures are already penalized through the possibility that their aggregate total may become significant, notwithstanding their individual non-significant nature. Apparently, this change was designed to "simplify" the equity exposures framework, but we do not understand how adding more and varied risk weights to an already penalized class of equities, simplifies the framework. We recommend retaining the 100 percent risk weight for these exposures.

V. The Agencies Should Reconsider the Unnecessary Complexity of the Structural Design of the Capital Proposal.

A. The Proposal requires IHCs to conduct regulatory capital calculations that are highly unlikely to serve as binding constraints, imposing unnecessary operational and administrative burdens and increasing inconsistencies with home country consolidated calculations.

Under the Capital Proposal, IHCs would be required to move from one U.S. regulatory capital calculation (the U.S. standardized approach) to four U.S. regulatory capital calculations (the U.S. standardized approach, the ERBA, modeled exposures for those trading desks that receive approval to use models for market risk, and another standardized market risk calculation to establish an "output floor" to these models for market risk).[47] The Proposal's three new calculations would be on top of the home country regulatory capital calculations with respect to their U.S. operations, which could be subject to modeled calculations and an output floor, as promulgated in the international bank's home country. Therefore, IHCs could be subject to at least six different calculations, when most were required to use only two or three calculation methods previously (and only one of which was imposed by the U.S. regulators). The serious burden this would pose may lead some IHCs to reduce their U.S. operations or exit certain business lines to reduce compliance costs, decreasing credit and liquidity provision in the United States.

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46 Capital Proposal at 64076.

47 Capital Proposal at 64030-31 (under the Capital Proposal, "a large banking organization would be required to calculate its risk-based capital ratios under both the new [ERBA] and the standardized approach (including market risk, as applicable), and use the lower of the two for each risk-based capital ratio"); *id.* at 64033-34 ("the [Capital] [P]roposal would introduce an 'output floor' to the calculation of expanded total risk-weighted assets . . . [t]he output floor would serve as a lower bound on the risk-weighted assets under [ERBA].").

Other host-country jurisdictions plan to implement Basel III standards while respecting the fact that local subsidiaries of international banks are regulated on a consolidated basis by their home country for capital purposes. For example, in the UK, the output floor will only be required of UK consolidated firms, not UK subsidiaries of non-UK firms.[48] The policy reason supporting this simplified approach assumes home country regulators will implement the output floor on a consolidated basis.[49] Therefore, the UK subsidiaries of U.S. firms would be required to calculate only one capital ratio in the UK. The Agencies, on the other hand, have decided that it is appropriate to impose three additional regulatory capital calculations on the IHCs of international banks, despite the fact that this is neither mandated by Basel III or by U.S. law.

The Federal Reserve has previously recognized that it is unnecessary and burdensome to impose multiple capital calculations on international banks. The 2012 proposed version of Regulation YY would have subjected IHCs to the advanced approaches rules.[50] However, in response to IIB comments highlighting this approach as duplicative, complicated, costly, burdensome and discriminatory,[51] the Federal Reserve decided not to subject IHCs to the advanced approaches rules, noting that "[t]he capital adequacy of a U.S. [IHC] will be addressed by standardized risk-based capital rules, leverage rules, and capital planning and supervisory stress testing requirements."[52] In contrast, the approach taken by the Proposal is at odds with these important concepts that the Federal Reserve recognized back in 2014 and completely contrary to statutory tiering requirements, which are addressed further in Section XI.A.

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48 Prudential Regulatory Authority, *Consultation Paper 16/22—Implementation of the Basel 3.1 standards*, at para. 9.3 (Nov. 30, 2022), https://www.bankofengland.co.uk/prudential-regulation/publication/2022/november/implementation-of-the-basel-3-1-standards ("The PRA proposes to implement the output floor as follows . . . to apply the requirement to UK firms that are not part of a group headquartered overseas").

49 *Id.* at para. 9.16 ("The PRA expects that the [output] floor would be applied to the overseas group or parent company on a consolidation level in its home jurisdiction.").

50 *See* Federal Reserve, *Enhanced Prudential Standards and Early Remediation Requirements for Foreign Banking Organizations and Foreign Nonbank Financial Companies*, 77 Fed. Reg. 76628 (proposed Dec. 28, 2012).

51 Letter from Sarah A. Miller, Chief Executive Officer, IIB to the Federal Reserve (Apr. 30, 2013), https://cdn.ymaws.com/iib.site-ym.com/resource/resmgr/imported/20130430IIB165NPRFinalLetter_CommentFile.pdf (commenting on the Regulation YY proposal).

52 *See* Federal Reserve, *Enhanced Prudential Standards for Bank Holding Companies and Foreign Banking Organizations*, 79 Fed. Reg. 17240, 17281 (Mar. 27, 2014) ("[C]ommenters asserted that requiring compliance with the home-country advanced approaches rule (as applicable), home-country Basel I rules, U.S. advanced approaches rules (as applicable), and the U.S. standardized approach was burdensome and unnecessary for systemic stability. In particular, commenters cited the need to create additional models for compliance with the U.S. advanced approaches rules that would be different from and inconsistent with home-country models. . . . In response to commenters' concerns regarding the burdens of implementing the U.S. advanced approaches rules, the Board has determined that the U.S. intermediate holding company will not be subject to the advanced approaches rules . . . A bank holding company subsidiary of a foreign banking organization that is subject to the advanced approaches rules may opt out of complying with the U.S. advanced approaches rules with the Board's prior approval.").

B. Because ERBA will practically always be the binding capital constraint, and because the Collins Amendment does not require that banking organizations undertake multiple capital calculations, the Agencies should take a different approach.

In light of the proposed additions to the capital adequacy requirements and the proposal of ERBA, the current market consensus is that ERBA will practically always be the binding constraint for those institutions subject to it after the phase-in period.[53] The Agencies themselves agree with this analysis, stating in the Capital Proposal that ERBA will "becom[e] the binding risk-based approach for most large banking organizations. As a result, the most commonly binding capital requirement would shift from the current standardized approach to [ERBA]."[54] Therefore, requiring banking organizations to calculate ERBA alongside the standardized approach, as well as additional market risk calculations, is a mere compliance exercise with no substantive benefit; it simply brings with it significant complexity and its own operational risk concerns.

The Agencies do not make it clear why they consider it necessary to subject banking organizations to so many redundant capital calculations. However, to the extent the Agencies believe the "Collins Amendment"[55] requires banking organizations to conduct multiple capital calculations, we submit that it does not.[56] The Collins Amendment requires only that the Agencies establish minimum risk-based capital requirements, which shall not be less than the generally applicable risk-based capital requirements the Agencies establish, and that they shall not be less than the generally-applicable risk-based capital requirements in effect as of July 21, 2010. Therefore, it is possible for the Agencies to "establish" capital requirements that simply are "not less" than the generally applicable requirements, or to determine that a capital requirement is "not less", rather than requiring institutions themselves to perform multiple calculations.

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53 *See, e.g.*, SIFMA, *Understanding the Proposed Changes to the US Capital Framework* (Aug. 28, 2023), https://www.sifma.org/resources/news/understanding-the-proposed-changes-to-the-us-capital-framework/ ("both the Collins Floor and the new standardized output floor effectively become compliance exercises that create unnecessary operational burdens for banks, while the binding capital requirement will almost always be the ERBA"); PwC, *Basel III endgame: Complete regulatory capital overhaul* at 8 (Aug. 2023), https://www.pwc.com/us/en/industries/financial-services/library/our-take-special-edition-basel-iii-endgame.pdf (noting that under the Capital Proposal, "the [standardized approach] and output floor are unlikely to create a binding constraint").

54 Capital Proposal at 64168.

55 *See* 12 U.S.C § 5371(b).

56 To the extent that the Agencies believe that they are constrained to propose multiple calculations to comply with a Collins Amendment that does not require such complexity, we do not understand why the Agencies do not believe that they are equally constrained by the provisions of the Dodd-Frank Act and EGRRCPA that require (i) differentiation and tiering of organizations above $100 billion, (ii) incorporation of the fact that international banks are subject to home country consolidated prudential standards similar to those existing in the U.S., and (iii) avoiding disproportionate effects on international banks in the name of national treatment and equality of opportunity.

This approach is consistent with the Agencies' past practice. In 2013, the Agencies adopted the standardized approach as "generally applicable",[57] even though it was new and different from the Basel I standards previously in effect. The Collins Amendment, of course, required that the standardized approach not be less than the generally applicable risk-based capital requirements in effect as of July 21, 2010. However, the Agencies did not require that banking institutions calculate their capital under the standardized approach and the July 21, 2010 requirements; instead, the Agencies simply determined that the standardized approach was indeed "not less" and was the new "generally applicable" approach.[58] This demonstrates the Agencies do not need to require banking institutions to perform calculations under both ERBA and the standardized approach under the Capital Proposal, and can determine that the new ERBA calculations are not less than the standardized approach calculations.

Furthermore, the Collins Amendment was intended to address the risk of banks using advanced approaches internal models for arbitrage,[59] so an approach such as ERBA—

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[57] *See* Agencies, *Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action*, 77 Fed. Reg. 52792, 52797 (proposed Aug. 30, 2012) ("Basel III NPR"); Agencies, *Regulatory Capital Rules: Standardized Approach for Risk-Weighted Assets; Market Discipline and Disclosure Requirements*, 77 Fed. Reg. 52888, 52892 (proposed Aug. 30, 2012) ("Standardized Approach NPR"); Agencies, *Risk-Based Capital Guidelines: Market Risk*, 77 Fed. Reg. 53060, 53069 n.16 (Aug. 30, 2012) ("Market Risk Final Rule"). The Agencies "proposed" a new "generally applicable" set of requirements: Standardized Approach NPR at 52892 ("The requirements proposed in the Basel III NPR and the Standardized Approach NPR are proposed to become the 'generally applicable' capital requirements for purposes of section 171 of the Dodd-Frank Act because they would be the capital requirements for insured depository institutions under section 38 of the Federal Deposit Insurance Act"); Basel III NPR at 52794 ("These proposals would *revise* the agencies' current general risk-based rules, advanced approaches risk-based capital rules (advanced approaches), and leverage capital rules") (emphasis added); *id.* at 52795 ("A second NPR (Standardized Approach NPR) *would revise the methodologies for calculating risk-weighted assets in the general risk-based capital rules*, incorporating aspects of the Basel II Standardized Approach and other changes") (emphasis added); *id.* at 52792 ("As discussed in the proposal, the revisions set forth in this NPR are consistent with section 171 of the Dodd-Frank Wall Street Reform and Consumer Protection Act").

See also Agencies, *Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Capital Adequacy, Transition Provisions, Prompt Corrective Action, Standardized Approach for Risk-weighted Assets, Market Discipline and Disclosure Requirements, Advanced Approaches Risk-Based Capital Rule, and Market Risk Capital Rule*, 78 Fed. Reg. 62,018, 62,021 (Oct. 11, 2013) (the "2013 Capital Rule") ("the minimum capital requirements in section 10(a) of the final rule, as determined using the standardized capital ratio calculations in section 10(b), which apply to all banking organizations, establish the 'generally applicable' capital requirements under section 171 of the Dodd-Frank Act").

[58] *See* 12 C.F.R. § 217.30(a) ("This subpart sets forth methodologies for determining risk-weighted assets for purposes of the generally applicable risk-based capital requirements for all . . . institutions").

[59] *See, e.g.*, Implementing the Dodd-Frank Wall Street Reform and Consumer Protection Act: Hearing Before the S. Comm. on Banking, Hous., and Urb. Affs., 111th Cong. 67 (2010) (statement of Sheila C. Bair, Chairman, FDIC) ("Section 171 states that the generally applicable capital requirements shall serve as a floor for any capital requirement the agencies may require. Without this provision, the Nation's largest insured banks and bank holding companies could avoid being held to higher capital standards, simply by using their own internal risk metrics under the agencies' rules implementing Basel II's 'advanced approaches' to compute the risk-weighted assets against which they hold capital."). *See also* Oversight of Basel III: Impact of Proposed Capital Rules: Hearing Before the S. Comm. on Banking, Hous., and Urb. Affs., 112th Cong. 24, 87 (Nov. 14, 2012) (statement by George French, Deputy Director, Policy, Division of Risk Management Supervision, FDIC) ("Section 171 of the Dodd-Frank Act known as the Collins

which "replac[es] current requirements that include the use of banking organizations' internal models for credit risk and operational risk with standardized approaches"[60]—is consistent with the policy rationale of the Collins Amendment and can stand alone without concern about using the ERBA to model or arbitrage lower risk weights.[61] The concerns animating the Collins Amendment (including model arbitrage) are not present when the Agencies have proposed, unlike other countries, to have an "expanded" standardized approach.

The Agencies should reconsider and simplify the approach to calculation of minimum capital requirements in the Capital Proposal such that IHCs do not have to conduct multiple capital calculations that have no clear objective and will never bind the banking organization. There are a number of ways this could be achieved. Potential approaches include:

1. Taking the approach suggested by FDIC Board Member Jonathan McKernan and give *all* banking organizations the option to conduct calculations under ERBA, thus making ERBA the generally applicable risk-based capital requirement in accordance with the Collins Amendment, but allow non-Category I-IV banks the ability to elect the current standardized approach.[62] This would eliminate the need for Category I-IV banks to be subject to both the standardized and ERBA

amendment . . . basically is sort of a horizontal equity-type provision in the law that . . . constrain[s] the potential benefits of those models", and "The FDIC has had a longstanding concern about the reliance in the Advanced Approaches rule on a bank's own models and risk estimates. Section 171 of the Dodd-Frank Act (the Collins Amendment) addresses this concern . . ."). *See also* 79 Fed. Reg. 70427 at 70428 ("Under section 171 of the Dodd-Frank Act, the generally applicable risk-based capital requirements serve as a risk-based capital floor for banking organizations *subject to the advanced approaches* risk-based capital rules . . . The lower ratio for each risk-based capital requirement is the ratio that will be used to determine an *advanced approaches bank*'s compliance with the minimum capital requirements . . .") (emphasis added).

[60] *See* Capital Proposal at 64028. *See also id*. at 64082 (discussing the proposed elimination of internal models for calculating risk-weighted assets for operational risk to address agencies' concerns about the potential uncertainty, volatility, and lack of transparency that may result from reliance on such internal models); *id. at* 64032 ("Under the advanced approaches, banking organizations subject to Category I or II capital standards must develop and maintain internal modeling systems to determine capital requirements . . . Replacing the use of internal models with standardized approaches would reduce costs associated with maintaining such modeling systems and eliminate the associated submissions to the agencies.").

[61] Furthermore, the Capital Proposal would eliminate the option for IHCs to opt out of the multiple calculations, and would consequently subject IHCs to new advanced approaches elements (*e.g.*, operational risk and credit valuation adjustment) that are required under ERBA but are not reflected in the current standardized approach. These changes are not mandated by the Collins Amendment, which was intended to apply the dual stack approach only to advanced approaches organizations to address the potential risk of regulatory capital arbitrage through the use of internal models. While the revised market risk approach under ERBA would allow for the use of models, their use would be subject to enhanced requirements for approval and performance which sufficiently address the potential risk of model arbitrage that the Collins Amendment intended to eliminate.

[62] *See* Jonathan McKernan, Director, FDIC, Statement on the Proposed Amendments to the Capital Framework (July 27, 2023), https://www fdic.gov/news/speeches/2023/spjul2723c html# ftnref4 ("One alternative worth exploring is to make the expanded risk-based approach the generally applicable approach, but then give each smaller bank the option to keep its current standardized approach"). *See also id.* at n.20 ("My understanding is that the so-called Collins Amendment would not preclude this approach.").

requirements, as complying with ERBA should then satisfy the Collins Amendment; and

2. Issuing an interpretation or determination by the Agencies, as implied by the Collins Amendment, that the calculation under ERBA (with its operational risk, credit valuation adjustment ("CVA"), and mandated market risk charges) would "not be less" than the current standardized approach, and therefore banking organizations need only conduct the ERBA calculation, while non-Category I-IV banks may continue to apply the standardized approach. The Agencies could reserve the ability to require any particular banking organization to conduct the standardized calculation at their discretion. As noted above,[63] the Agencies have issued new or revised capital rules before and determined that they are "not less" than the generally applicable rules referenced in the Collins Amendment.

VI. Credit Risk

A. The Agencies should allow international banks to apply the current standardized treatment for bank exposures.

The proposed increase in risk weights for exposures to banks runs counter to the general thrust of the worldwide implementation of Basel III Endgame, which aims to make banks safer. Under the Capital Proposal, risk weights for credit exposures to U.S. domestic and international banks under ERBA are generally higher than under the current standardized approach used by IHCs. ERBA would increase the risk weights for exposures to banks from a fixed 20 percent for exposures to U.S. domestic banks[64] and a general range of 20 to 150 percent for exposures to international banks,[65] to a range of 40 to 150 percent for both domestic and international banks.[66] This is at least (and could be more than) a doubling of the risk weight for U.S. domestic banks and at least a doubling for low-credit-risk international banks and banks in OECD countries. These proposed changes do not receive sufficient support in the rulemaking, could lead to a more fragmented international regulatory landscape, and are unduly punitive to IHCs, which are inherently more likely to have exposures to a parent bank or banking affiliates.[67]

While the risk weights under the Capital Proposal reflect the Basel III Endgame framework's "Standardized Credit Risk Assessment Approach" ("SCRA") for countries that do not permit the use of credit ratings in determining risk weights,[68] the risk weights are generally higher than those permitted under the Basel III Endgame standards in jurisdictions that allow for

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63 *See* note 58 above and accompanying text.

64 12 CFR § 3.32(d)(1) (OCC); 12 CFR § 217.32(d)(1) (Federal Reserve); 12 CFR § 324.32(d)(1) (FDIC).

65 12 CFR § 3.32(d)(2) (OCC); 12 CFR § 217.32(d)(2) (Federal Reserve); 12 CFR § 324.32(d)(2) (FDIC).

66 *See* Capital Proposal at 64042.

67 Based on IIB's and its members' own analyses, the change to bank risk weights is the largest driver of credit risk capital increases.

68 *See* BCBS, Basel Framework, CRE 20.21.

the use of external ratings.[69] Risk weights for banks in jurisdictions that allow for the use of external ratings range from 20 percent to 150 percent, with investment grade rated banks generally receiving a 20 percent to 50 risk weight. Most investment-grade-rated banks land in the 20 percent to 30 percent categories. The Capital Proposal starts at a floor of 40 percent and only ratchets up. Indeed, the Proposal has a range of 40 percent (Grade A) to 75 percent (Grade B) specified for investment grade banks—weights that are 133% to 375% higher than those estimated for investment grade banks under the Basel III Endgame.[70] These discrepancies in risk weights in the Basel III Endgame standards, exacerbated by the Capital Proposal, stand to lead to a fragmented international landscape in which jurisdictions' credit risk regulations treat the same risks in different ways. Moreover, the justification for applying the proposed risk weights to bank exposures is not sufficiently explained by the BCBS[71] or in the Capital Proposal, which only provides a conclusory statement without a supporting rationale.[72] As FDIC Director McKernan noted in his statement on the Capital Proposal, "[w]here the Basel Committee has not articulated a convincing rationale, we should fill that gap by laying out our own well developed rationale. Where no convincing rationale is possible, we instead should consider our own approach that has a good grounding in theory and evidence."[73]

The Capital Proposal's treatment of risk weights for credit exposures to banks is one such area in which the Agencies should reconsider the approach. The Agencies should revert to risk weights under the current standardized approach, which was already crafted by the Agencies to be risk-sensitive.

Even if the Agencies were not to revert to the current standardized approach for all banks, IHC exposures to affiliated banks should be based on the current standardized approach (20% for most banks) and no higher. The Capital Proposal does not take into account the unique attributes of U.S. IHCs when it comes to exposures to affiliate banks.[74] For both

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[69] *See* BCBS, Basel Framework, CRE 20.18.

[70] *See* Capital Proposal at 64042.

[71] *See*, *e.g.*, lack of explanatory content regarding the proposed risk weights for bank exposures in BCBS, *High-Level Summary of Basel III Reforms* 2 (Dec. 2017), https://www.bis.org/bcbs/publ/d424_hlsummary.pdf; BCBS, *Basel III: Finalising Post-Crisis Reforms* 7-10 (Dec. 2017), https://www.bis.org/bcbs/publ/d424.pdf; BCBS*, Second Consultative Document: Standards: Revisions to the Standardised Approach for Credit Risk* 3-6 (Dec. 2015), https://www.bis.org/bcbs/publ/d347.pdf (providing relatively low levels of detail about the reasoning behind the proposal); BCBS, *Consultative Document: Standards: Revisions to the Standardised Approach for Credit Risk* 5-9 (Dec. 2014), https://www.bis.org/bcbs/publ/d307.pdf.

[72] Capital Proposal at 64041 ("The proposed treatment for bank exposures supports the simplicity, transparency, and consistency objectives of the proposal in a manner that is appropriately risk sensitive").

[73] *See* Jonathan McKernan, Director, FDIC, Statement on the Proposed Amendments to the Capital Framework (July 27, 2023), https://www.fdic.gov/news/speeches/2023/spjul2723c.html#_ftnref4.

[74] Indeed, there is a significant knock-on effect for derivatives, as most swap dealers are banks. Based on a study among participating IIB members, there would be a significant increase in bank derivative counterparty risk-weighted assets caused by interaction among different provisions of the Capital Proposal. We expect that this would negatively affect risk-mitigation efforts of banks—when banks face other banks, there is typically a beneficial effect on the financial system as a whole, since banks manage and allocate risks among themselves that were taken on from corporate clients that do not act as dealers.

enterprise-wide risk management and customer accommodation purposes, U.S. IHC operations are more likely than U.S. domestic institutions to have exposures to their parent bank or banking affiliates under derivatives, repurchase agreements, securities borrow/lend arrangements and credit extensions, because these affiliate exposures are eliminated in consolidation for U.S. domestic banks. This unique aspect of IHCs has been recognized by the Federal Reserve with respect to the counterparty default component of the supervisory severely adverse scenario,[75] as well as in other contexts. This treatment for IHCs would also be consistent with EGRRCPA's requirement for the Federal Reserve to "differentiate among companies on an individual basis or by category, taking into consideration their capital structure, riskiness, complexity, financial activities (including the financial activities of their subsidiaries), size, and any other risk-related factors that the Board of Governors deems appropriate."[76]

In addition, for all banks, the Agencies should implement the treatment of short-term exposures to banks under the Basel III Endgame. The Basel III Endgame framework provides for a 20% risk weight for short-term exposures to investment grade banks[77] *and* for exposures that result from the movement of goods across national borders (which may include off balance sheet exposures such as loans or self-liquidating trade-related contingent items) with maturities of six months or less.[78] In the Capital Proposal, the Agencies have "gold-plated" this standard by only allowing lower risk weights for the trade-related items, but even there the Agencies halved the maturity component.[79] This gold-plating stands to result in unnecessary divergences in international implementation of the Basel III Endgame and international fragmentation in short-term interactions among banks.

B. The Agencies should adopt the Basel III Endgame risk weighting standards for exposures to securities firms.

Under the Basel III Endgame framework, exposures to securities firms and other financial institutions may be risk-weighted as exposures to "banks."[80] As a result, exposures to these financial institutions are potentially subject to significantly lower risk weights than general corporate exposures if the entity is "subject to prudential standards and a level of supervision equivalent to those applied to banks (including capital and liquidity requirements)." National supervisors are empowered to make these equivalence determinations.[81]

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75 Federal Reserve, *2023 Stress Scenarios* at 13 n.14 (Feb. 2023), https://www federalreserve.gov/newsevents/pressreleases/files/bcreg20230209a1.pdf ("U.S. IHCs are not required to include any affiliate as a counterparty.").

76 Dodd Frank Act § 165(a)(2)(A) (as modified by EGRRCPA § 401(a)(1)(B)(i)).

77 *See* BCBS, Basel Framework, CRE 20.18 and CRE 20.21.

78 *See* BCBS, Basel Framework, CRE 20.31.

79 *See* Capital Proposal at 64041-42.

80 BCBS, Basel Framework, CRE 20.40.

81 *Id.*

We object to the Capital Proposal's position that securities firms (e.g., broker-dealers and investment advisers) should be risk-weighted as general corporate exposures.[82] Given the breadth and depth of regulation and supervision that securities firms are subject to, the rationale for treating them as corporate exposures is not at all clear. In addition, securities firms and other financial institutions are subject to a number of safety and soundness regulations and guardrails, such as capital and reporting requirements, and this is especially the case when such a firm is consolidated with a BHC or an international bank. By taking this blunt approach to these highly regulated entities, ERBA is not achieving the risk sensitivity that is supposed to be at its core.[83]

For all of these reasons, the final rule should clarify that, under both ERBA and the standardized approach, exposures to securities firms or other financial institutions that are subject to capital maintenance requirements and supervision on a consolidated basis, including by (but not limited to) being consolidated with a BHC or an international bank, will be subject to the *same* risk weight treatment applicable to U.S. domestic and international banks, and not the general corporate 100 percent. Extending this treatment to the standardized approach is key for consistency among the approaches and for logical implementation.

This issue is particularly important for IHCs, which face affiliated entities that are investment firms or broker-dealers on transactions that are not eliminated in consolidation, in contrast to the consolidation available to IHCs' domestic BHC counterparts. Therefore, to the extent that the final rule does not include our recommendation more broadly, *at least* IHCs should receive the more beneficial treatment provided in the Basel III Endgame framework with respect to exposure to *affiliated* securities firms and other financial institutions (that also are, by definition, subsidiaries of entities subject to capital, liquidity and other robust prudential requirements).

C. The definition of "collateral agreement" should be revised for the standardized approach and the ERBA.

We also request that the Capital Proposal clarify the requirements relevant to the simple approach to credit risk mitigation, as the opportunity is ripe to make this long-overdue change. We believe that, when the standardized approach was implemented in 2013,[84] these revisions inadvertently narrowed the scope of permissible credit risk mitigation in the generally applicable capital rules by importing a new definition of "collateral agreement" from the advanced approaches rules governing internal models. The ERBA does not correct this definition.

The simple approach for recognizing the risk-mitigating effects of financial collateral allows banks to substitute the risk weight of the counterparty with the risk weight of

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82 *See* Capital Proposal at 64041 n. 61.

83 *See* Capital Proposal at 64030 ("The proposal would strengthen risk-based capital requirements for large banking organizations by improving their comprehensiveness and risk sensitivity.").

84 *See* 2013 Capital Rule at 62107.

the collateral for portions of an exposure that are secured by the collateral.[85] However, the collateral must be subject to a "collateral agreement." Under 12 CFR § 217.2 and the corresponding definitions in OCC and FDIC rules, the definition of "collateral agreement" requires that the bank's exercise of rights not be stayed or avoided under applicable law in the relevant jurisdictions.

The reference to the risk of stays or avoidance was originally incorporated in the Agencies' 2007 rule implementing the Basel II Accord[86] solely in relation to qualifying financial contracts ("QFCs"), i.e. derivative contracts, eligible margin loans, and repo-style transactions and the internal models methodology. These transactions have appropriate U.S. Bankruptcy Code safe harbors. The simple approach in the generally applicable capital rules, however, is not restricted to QFCs and applies to a wider range of exposures, such as loans and letters of credit,[87] which may not be exempted from the automatic stay under the U.S. Bankruptcy Code.

Therefore, when the collateral agreement requirement was added to the generally applicable capital rules implementing the standardized approach in 2013, this revision disallowed the recognition of financial collateral for many exposures other than QFCs, in a divergence from the Basel framework and the prior U.S. Basel I rules. Neither the Capital Proposal nor ERBA fixes this issue,[88] and to ensure that the simple approach recognizes the actual credit risk mitigation benefits of financial collateral, we request that the Agencies remove the reference to a collateral agreement and instead condition the use of the simple approach on a bank's ability to ensure its right to liquidate or take possession of collateral in a timely manner and perfect its security interest. This revision would be consistent with the Basel framework's provisions governing credit risk mitigation.[89]

D. The applicability of SA-CCR to IHCs should be revisited.

The Proposal would require Category III and IV IHCs to use the standardized approach for counterparty credit risk ("SA-CCR") for derivative exposures; SA-CCR currently only applies to Category I and II banking organizations as part of the advanced approaches.[90]

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85 *See* 12 C.F.R. § 217.37(b) and corresponding OCC and FDIC rules.

86 *See* Agencies, *Risk-Based Capital Standards: Advanced Capital Adequacy Framework — Basel II*, 72 Fed. Reg. 69288 (Dec. 7, 2007).

87 *See* 12 C.F.R 217.37(b), and corresponding OCC and FDIC rules.

88 Indeed, the elimination of the advanced approaches exacerbates this issue, as the Capital Proposal applies the simple approach to all institutions and eliminates modeled approaches to incorporating collateral that were not reliant on the definition of collateral agreement.

89 *See* BCBS, Basel Framework, CRE 22 ("Standardized Approach: Credit Risk Mitigation") and CRE 22.26.

90 *See* Agencies, *Standardized Approach for Calculating the Exposure Amount of Derivative Contracts*, 85 Fed. Reg. 4362 (Jan. 24, 2020) at n. 115. *See also* Agencies, *Standardized Approach for Calculating the Exposure Amount of Derivative Contracts*, 83 FR 64660 at 64662 (proposed Dec. 17, 2018) ("While the agencies recognize that implementation of SA-CCR offers several improvements to CEM, it also will require, particularly for banking organizations with relatively small derivatives portfolios, internal systems enhancements and other operational modifications that could be costly and present additional burden. Therefore, the proposal would not require nonadvanced approaches banking organizations to use SA–CCR, but instead would provide SA-CCR as an optional approach.")

IHCs currently use the current exposure methodology ("CEM") given the ability to opt out of the advanced approaches and the application of SA-CCR only to advanced approaches. The Proposal provides little reasoning for this shift in position, and stands in sharp contrast to the tiered implementation of SA-CCR in the United States, which was subject to a robust, standalone notice and comment process.[91] The requirement to use SA-CCR imposes a number of unique burdens on Category III and IV IHCs, with global compliance implications, and is further evidence of inadequately tailored requirements. Such changes are not warranted for IHCs, particularly given the recent observation of the Federal Reserve and the FDIC that "most of the specified [foreign] firms have limited derivatives and trading operations compared to the U.S. GSIBs,"[92] and a risk-based and tailored solution is necessary.

Many nations have put SA-CCR into place in their capital frameworks, but, like the United States, have done so with national discretion. Therefore, the counterparty credit risk provisions applicable to an international bank on a consolidated basis may be different from the SA-CCR promulgated by the Agencies.

Based on the above, we recommend that Category III and IV IHCs should be permitted to (1) opt in to using SA-CCR, with the default being CEM, and (2) if SA-CCR is chosen, use their home country's SA-CCR methodology instead, which would be less costly and burdensome for the consolidated organization to implement at the IHC level.

VII. Market Risk

We support the recommendations related to the proposed revisions to the market risk capital framework in the joint letter of the International Swaps and Derivatives Association ("ISDA") and the Securities Industry and Financial Markets Association ("SIFMA"). Below we highlight several issues of particular concern to international banks.

A. The market risk revisions overlap significantly with elements of stress testing and the stress capital buffer, requiring recalibration.

The Capital Proposal would make major revisions to the market risk elements of RWA, but the Agencies have not sufficiently considered how these may interact with the other sweeping revisions they propose and the existing stress testing and stress capital buffer framework. We urge the Agencies not to tack on the market risk changes without a proper reevaluation of the entire capital framework, including recalibrating the different RWA elements in the denominator and reexamining elements that affect the numerator (such as the stress capital buffer). This reevaluation and recalibration should ensure the elements of the framework are not redundant or unnecessarily duplicative. We understand the Agencies were to have engaged in a holistic review of capital, but the existence of significant overlap (including those described below) suggests this was incomplete and needs further consideration.

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[91] *See* Agencies, *Standardized Approach for Calculating the Exposure Amount of Derivative Contracts*, 85 Fed. Reg. 4362 (Jan. 24, 2020).

[92] Federal Reserve and FDIC, *Guidance for Resolution Plan Submissions of Foreign Triennial Full Filers*, 88 Fed. Reg. 64641, 64647 (Sept. 19, 2023).

As Governor Bowman noted, the Capital Proposal "introduces new regulatory redundancies," particularly with respect to the market risk revisions and the stress testing requirements underlying the stress capital buffer.[93] These requirements already capture many of the risks that the market risk revisions seek to account for—something Governor Waller also emphasized in his statement on the Capital Proposal.[94] For example, the GMS subjects trading positions to a highly stressed environment (which is on top of the stress already incorporated into the severely adverse scenario). The "sensitivities-based" component of the market risk revisions, though, also subjects trading positions to regulatorily determined stress conditions.[95] It cannot be determined if the Agencies intend for GMS and the sensitivities-based component to capture different stresses, as the Agencies do not acknowledge the potential for overlap in the Capital Proposal. In addition, the LCPD scenario targets similar risks to those addressed by the standardized default risk component of the market risk revisions.[96] Both seek to capture the risk that a counterparty suddenly defaults. Yet, once again the Agencies fail to address this possible overlap.

The revised market risk approach thus takes into account trading position- and counterparty default-related stresses by incorporating them into the RWA denominator calculation *before* the GMS and LCPD components of the stress capital buffer captures those stresses again. It is therefore certain the capital charges in the stress capital buffer from the GMS and LCPD will be additive to the capital charges from the revised market risk approach (as well as the revised approach to operational risk[97] and CVA).

In light of this, a truly holistic recalibration of the capital framework is needed, such that each element addresses a particular risk supported by evidence from the Agencies without unnecessary overlaps. If the various elements cannot be made complementary, and instead remain additive, then certain elements should be eliminated. As an example, a recalibration could determine that the market risk revisions account for a degree of trading position stress in the base capital requirements, and thereby determine that GMS should only test for narrow additional types of trading position stress, such as a single scenario (e.g., a large increase in the price of oil) or a random sector-specific shock. In addition, the holistic recalibration should reexamine whether the portfolios of IHCs' U.S. operations give rise to a level of risk requiring the application of both GMS and the new stressed inputs to market risk. Removal of IHCs from the GMS would be warranted based on the material and evident differences between the risks in the trading books of the domestic institutions and the IHCs, as

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93 Michelle W. Bowman, Governor, Federal Reserve, Statement on the Proposals (July 27, 2023) ("Today's proposal is intended to improve risk capture, but in some circumstances, leaves in place and even introduces new regulatory redundancies, as with changes to the market risk capital rule, credit valuation adjustments, and operational risk that overlap with stress testing requirements and the stress capital buffer").

94 Christopher J. Waller, Governor, Federal Reserve, Statement on the Proposals (July 27, 2023) ("In total, staff estimate the proposal would require all large banks to increase capital by 16 percent. That would be in large part driven by an increase in the capital required for operational and market risks—risks that we have already been capturing in our stress testing for the past decade").

95 Capital Proposal at 64092.

96 *Id.*

97 *See* Section III above.

IIB has noted previously[98] and as has been acknowledged by the Agencies.[99] Another possibility is that the GMS and LCPD could be part of the additional exploratory market shocks that would not contribute to a firm's capital requirements or stress capital buffers.[100]

In any event, any holistic review of the various interconnected market risk elements of the capital framework should be fully explained and released with comparative data—something that was missing from the Capital Proposal.

B. The revised market risk approach should be revised to be more commensurate with the risk-profile of institutions by (i) only applying to Category III and IV organizations that have $20 billion in trading assets and liabilities ("TAL"); (ii) allowing Category III and IV institutions to apply market risk requirements at the firm, rather than desk, level; (iii) allowing IHCs to apply models approved by their home country regulators and certified to the Agencies; and (iv) allowing Category III and IV organizations to run monthly, rather than weekly, standardized market risk calculations

The Capital Proposal's revised market risk approach also continues the erosion of the statutorily required tiering of institutions. The trading books of most Category III and Category IV organizations are small, and under the Capital Proposal, organizations that were not previously subject to the market risk requirement would have to undertake intensive compliance exercises that have little or no apparent benefits. There should be an effort to tier the application of the market risk rules such that smaller institutions have the flexibility to apply models at the firm level, and apply desk-level requirements only for larger institutions. In addition, IHCs should be able to apply models approved by their home country regulators and certified to the Agencies. This would respect the fact that international banks are subject to consolidated supervision at the home country consolidated level, and would accord with the principles of national treatment and equality of competitive opportunity.

We appreciate that the Agencies have raised the threshold for application of the market risk capital rule from $1 billion in TAL to $5 billion to account for inflation and growth in capital markets since the $1 billion threshold was introduced in 1996.[101] However, we believe this threshold is still too low and somewhat arbitrary, and should instead be consistent with the threshold for "significant" TAL under the Volcker Rule—$20 billion.[102] We also disagree with

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[98] *See, e.g.*, Press Release, IIB, IIB Statement on the Federal Reserve's Tailoring Rule (Oct.10, 2019), https://cdn.ymaws.com/www.iib.org/resource/resmgr/weekly_bulletin/10-10-19tailoringstatement.pdf; Letter from Briget Polichene, Chief Executive Officer, IIB, to the Agencies 19 (June 21, 2019), https://cdn.ymaws.com/www.iib.org/resource/resmgr/2019_frb_tailoring_proposal/PDFFINALFBOTailoringLetter06.pdf (commenting on the tailoring proposals); *see also* data cited in Section XI.

[99] *See* note 92 above and accompanying text.

[100] *See* Federal Reserve, "Federal Reserve Board releases hypothetical scenarios for its 2023 bank stress tests" (Feb. 9, 2023).

[101] Capital Proposal at 64095.

[102] *See* Volcker Rule, Section __.2(ee); Agencies, Commodity Futures Trading Commission and Securities and Exchange Commission, *Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds*, 84 Fed. Reg. at 61974 (Nov. 14, 2019).

the Agencies' approach of automatically applying the market risk capital rule to Category III and IV institutions, and ask that the Agencies respect the tiering mandated by EGRRCPA by applying the market risk capital rule to a Category III or IV institution only if the institution meets this revised TAL threshold.

The Capital Proposal would require institutions to calculate the standardized measure for market risk weekly[103], which is inconsistent and more burdensome than that required by Basel III Endgame, which only requires a monthly calculation.[104] The Agencies do not justify why this departure is necessary or beneficial, even though it would impose a significant operational and reporting burden on institutions incommensurate with the risk—particularly for smaller firms with less complex trading portfolios. The Agencies should instead only require a monthly calculation for Category III and IV institutions.

C. The transition periods for the revised market risk approach should be clarified.

The Capital Proposal is not clear on the transition periods for the revised market risk approach. Market risk continues to be a component of the standardized approach, which will remain in place for smaller banks, as well as for larger organizations through the Collins Amendment floor (if the Agencies do not eliminate the second calculation under the standardized approach for Category IV and above firms, as we have recommended above). The Capital Proposal, however, makes no mention of when and how to incorporate the market risk revisions into the standardized approach. Any bank or BHC with $5 billion or more in trading assets or liabilities, or that is Category IV or above, would need to apply the new market risk rules under the standardized approach, but would lack clarity on when to start doing so. We suggest that, to simplify, the new market risk rules not be incorporated into the standardized approach at all during the three-year transition period, and instead become fully incorporated into the standardized approach only at the end of the three-year transition period.

D. The treatment of government-sponsored enterprise ("GSE") exposures should be broadly recalibrated so as to treat securities and related exposures deliverable by Fannie Mae and Freddie Mac as the same issuer, and a higher correlation between a number of GSE exposures should be implemented.

We support the recommendation of ISDA/SIFMA that the treatment of GSE exposures involving Uniform Mortgage-Backed Securities ("UMBS"), deliverable pools and UMBS securities in the to-be-announced market ("TBAs") should be revised to align with risk and market conventions to be treated as having the same obligor under the sensitivities-based method and default risk charge. The rules text should also provide that mortgage pools that are not UMBS-eligible issued by either Fannie Mae or Freddie Mac and UMBS issued by the same GSE likewise would be considered one "issuer." These revisions would reflect that market participants treat TBAs and pools as interchangeable exposures, regardless of the GSE, and that TBAs and pools are generally used by market participants to hedge positions in one another.

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103 Capital Proposal at 64112.

104 BCBS, Basel Framework, MAR 20.2.

Like ISDA and SIFMA, we believe that the proposed treatment of GSEs under the standardized measure for market risk would result in higher capital requirements for exposures involving UMBS and deliverable pools in a manner that would diverge from the actual economic risk of these exposures and would likely have adverse effects on the depth and liquidity of the Residential Mortgage-Backed Securities markets.

In addition, the Proposal would apply a 35 percent correlation between Fannie Mae and Freddie Mac debt issuances and between UMBS-eligible securities and Fannie Mae or Freddie Mac. This approach would not accurately reflect economic reality, does not reflect market treatment of the instruments and would overstate capital requirements for these positions. The correlation factor in this context should be much higher, and closer to 100 percent.

VIII. Agency Discretion

A. The Agencies should use a quantitative measure for determining which firms are exempt from CVA.

The Capital Proposal would give the relevant Agency the ability to exempt banking institutions from calculating CVA risk on a case-by-case basis.[105] While we appreciate that the Agencies acknowledge that "there may be unique instances where a banking organization . . . should not be required to reflect CVA risk in its risk-based capital requirements,"[106] we believe that a fully discretionary approach is inappropriate for such an important component of a firm's capital requirement. Instead, the Agencies should adopt an objective, quantitative threshold, similar to that for market risk, for exempting banking organizations from CVA risk.

We recommend that the Agencies exempt firms with aggregate notional amounts of non-centrally cleared derivatives exposure less than or equal to $100 billion from the CVA risk requirements, consistent with the Basel III Endgame.[107]

B. The Agencies should only apply ERBA and CVA to "Other Firms" after notice and response, and should only seek to exercise this discretionary authority in limited circumstances.

The Capital Proposal allows the relevant regulator to apply ERBA to any banking organization if the regulator "deems it necessary or appropriate to ensure safe and sound banking practices."[108] This places no guardrails on the Agencies' ability to apply ERBA more widely than would otherwise be allowed under any final rule and appears to give the banking organization no warning or opportunity to respond.

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[105] Capital Proposal at 64150.

[106] *Id.*

[107] BCBS, Basel Framework, MAR 50.9(1).

[108] Capital Proposal at 64183.

The Agencies have clearly recognized the importance of process elsewhere in the Capital Proposal—for example, the relevant regulator may only apply the revised market risk approach and CVA to a banking organization not otherwise subject to it after "notice and response procedures."[109] The Agencies should take the same approach to ERBA as they did in market risk and CVA, and only apply ERBA to "Other Firms" (generally less than $100 billion in total assets) after notice and response procedures to ensure fairness and due process.

Even with the protection of a notice and response process, the discretion given to the Agencies in applying ERBA and CVA to Other Firms would be considerable. The Agencies should explicitly commit to only applying ERBA and CVA to Other Firms in extremely limited circumstances, for example, if there is a serious safety and soundness concern that the Agencies demonstrate can only be remediated by application of ERBA or CVA. In addition, similar to our request in the immediately preceding subsection of this letter with regard to CVA, the Agencies should commit not to apply CVA to any firm that has lower than $100 billion in aggregate notional amounts of non-centrally cleared derivatives, which is consistent Basel III Endgame's threshold for opting out of CVA.[110] The Agencies could do this through a joint policy statement or a provision in the final rule to that effect.

Furthermore, no transition period is provided for Other Firms that the Agencies may at their discretion require to use ERBA, or the revised market risk approach and CVA. It would appear that such firms would be subject to these additional capital requirements immediately upon the Agencies' exercise of discretion, denying them the time needed to make necessary adjustments to business and operations. The Agencies should provide such firms the time necessary to make the changes needed to comply with the required capital regime by explicitly providing for a transition period in any final rule. The Agencies can address any safety and soundness concerns that may arise during the transition period using their respective reservations of authority.[111]

IX. Leverage Ratios

A. <u>The Agencies should (i) eliminate sovereign exposures that are risk-weighted at 0% and (ii) eliminate funds on deposit at any qualifying central bank from the supplementary leverage ratio ("SLR")</u>.

Currently, jurisdictions have implemented Basel's SLR in many different, inconsistent ways. Harmonization of the SLR would greatly level the playing field internationally, and we urge the Agencies to take the lead by revising the SLR denominator to (i) eliminate sovereign exposures that are risk-weighted at 0% and (ii) eliminate funds on deposit at any qualifying central bank. It is important to have *all* qualifying sovereign exposures and central bank deposits excluded from the SLR for harmonization purposes, rather than having

[109] Capital Proposal at 64229.

[110] *See* BCBS, Basel Framework, MAR 50.9(1).

[111] *See* 12 C.F.R. §§ 3.1(d), 217.1(d), 324.1(d).

different exclusions per jurisdiction just for that jurisdiction's sovereign securities or central bank.

If, however, the Agencies are unwilling to exclude all qualifying sovereign exposures and central bank deposits, they should at least exclude U.S. Treasuries and deposits at the Federal Reserve Banks. As demonstrated during the pandemic, the SLR can prove to be a constraint on banking organizations' ability to provide liquidity to the Treasury market, and to households and businesses generally. Of course, the Federal Reserve recognized this very problem by temporarily excluding Treasury and Federal Reserve Bank deposits from the SLR from April 2020 to March 2021.[112] Treasury markets are too critical to be put at risk by the artificial constraint of the SLR, and we urge the Agencies to consider our proposed revisions on a permanent basis.

X. Timing and Transitions

Banking organizations must receive adequate time to make changes necessary to comply with new capital requirements. Changes to capital regulations require operational overhauls and necessitate adjustments to business operations to efficiently allocate capital in accordance with the new regime.

A. The transition period for changes to the numerator calculations for Category III and IV institutions should be three years.

In particular, numerator modifications for Category III and IV institutions—namely the requirement to make deductions for threshold items, deductions for investments in unconsolidated financial institutions, deductions for investments in unsecured debt of GSIBs, and limits on the amounts of minority interests that currently only apply to Category I and II institutions—would appear to come into effect immediately upon effectiveness of a finalized Capital Proposal. The Agencies provide no reason for the lack of transition period for these items, despite generally recognizing that transition periods are necessary to "provide applicable banking organizations sufficient time to adjust to the proposal while minimizing the potential impact that implementation could have on their ability to lend,"[113] and providing transition periods for implementing ERBA and recognizing AOCI. The numerator changes, and the lack of a transition period, disproportionately affect IHCs. The Agencies estimate that IHCs in Category III will face a 13.2% increase in their CET1 requirements and 9.7% increase in leverage capital requirements (as compared to 4.6% and 3.8%, respectively, for domestic firms in Category III).[114]

Providing a transition period for AOCI recognition but not providing one for the other numerator modifications is another example of the Capital Proposal's unequal treatment of

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[112] Press Release, Federal Reserve, *Federal Reserve Board announces temporary change to its supplementary leverage ratio rule to ease strains in the Treasury market resulting from the coronavirus and increase banking organizations' ability to provide credit to households and businesses* (Apr. 1, 2020), https://www federalreserve.gov/newsevents/pressreleases/bcreg20200401a.htm.

[113] Capital Proposal at 64166.

[114] Capital Proposal at 64171.

international banks. The Agencies note that the threshold deduction changes dominate for IHCs, while AOCI recognition dominates for domestic banks.[115] Thus, domestic banks effectively get 3 more years to adjust to the capital definition changes than international banks get. To remedy this, we urge the Agencies to adopt a 3-year transition period for all of the numerator modifications.

B. More generally, the transition period for ERBA, operational risk, CVA and market risk calculations for Category III and IV institutions should be extended by an additional one year.

More generally, the transition period in the Capital Proposal for RWAs is inadequate for Category III and IV institutions, for whom the changes in the Proposal are particularly significant (as they have not previously applied operational risk and CVA capital requirements, and some have not previously applied market risk requirements), and who do not have as many resources devoted to regulatory change projects as the largest banking institutions. We request that the transition period for Category III and IV institutions be extended by an additional year.

C. As the Proposal would require the commencement of calculations even during the transition period, more time must be provided for Category III and IV institutions to be able to commence these calculations.

The Capital Proposal also does not give Category III and IV institutions enough time to make the necessary changes to calculate operational risk, CVA and, should IHCs opt in (see Section VI.D above), SA-CCR, even during the provided phase-in period. Currently, these firms are not required to calculate operational risk, CVA and SA-CCR, but the Capital Proposal would require them to use these methodologies immediately upon effectiveness to start calculating ERBA (as ERBA is phased in by percentages during the 3-year transition). Firms will only have the time between the publication of any final rule and its effective date to make the enormous operational and personnel adjustments needed to begin calculating operational risk, CVA and SA-CCR—time that is unlikely to be sufficient to do so robustly and effectively. We request that the Agencies give Category III and IV institutions an additional 6 months from the effective date of any final rule before requiring the use of the operational risk SMA, CVA and SA-CCR, even during the phase-in. For operational risk and SA-CCR, this transition time is particularly important if our recommendations in Sections III and VI.D regarding home country operational risk and SA-CCR frameworks are not accepted.

D. Additional time is necessary to obtain appropriate model approvals under the market risk framework.

The Capital Proposal does not acknowledge that it will take time for firms to obtain regulatory approval for models under the revised market risk approach and the revised criteria for models. Applying the new market risk approach without giving firms enough time to obtain approvals from regulators in time for an effective date would punish firms for something out of their control. Any final rule should permit firms to continue using the current market risk

[115] Capital Proposal at 64171.

approach for 6 months after the effective date, allowing time for regulators to approve models under the Proposal's new criteria.

XI. Foundational Issues with the Proposal

In this Section XI, we highlight broad themes that thread through all of our comments and that are of particular concern to international banks because of both (i) the disparate treatment international banks receive under the Proposals and (ii) the Proposals' lack of adherence to statutory requirements to take into account the subsidiary structure of IHCs (as well as parent support and the application of Basel III Endgame rules to the consolidated international bank organization by home country regulators) in comparison to domestic BHCs.

A. The Agencies have a statutory requirement to tier the application of prudential standards by risk, and the elimination of tiering under the Proposals is inconsistent with this requirement.

The Dodd-Frank Act and EGRRCPA require the Federal Reserve to "differentiate among companies on an individual basis or by category, taking into consideration their capital structure, riskiness, complexity, financial activities (including the financial activities of their subsidiaries), size, and any other risk-related factors that the Board of Governors deems appropriate."[116] The Agencies responded to EGRRCPA's new statutory requirements only four years ago, with a set of proposed rules, a robust notice and comment period, and eventually final rules revising the applicability of enhanced prudential standards (Federal Reserve) and capital and liquidity (the Agencies) (the 2019 Tiering Rules).[117]

The 2019 Tiering Rules—which, among other things, created the required tiering framework for categorizing and applying enhanced prudential standards to BHCs, IHCs and CUSOs—were a vital development in U.S. banking regulation. They kept in place important reforms from the Dodd-Frank Act while more appropriately calibrating these regulations to the relative size and risk profiles of banking organizations. As the Federal Reserve noted in 2019, the tiering "approach better aligns the prudential standards applicable to large banking organizations with their risk profiles, taking into account the size and complexity of these banking organizations as well as their potential to pose systemic risk. The [2019 Tiering Rules] also maintain[] the fundamental reforms of the post-crisis framework and support[] large banking organizations' resilience."[118]

EGRRCPA and the 2019 Tiering Rules were put in place after the BCBS finalized Basel III in December 2017. Therefore, the Basel III Endgame package was known to the Agencies at the time, and no mention was made that implementing Basel III Endgame would

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[116] Dodd Frank Act § 165(a)(2)(A) (as modified by EGRRCPA § 401(a)(1)(B)(i)).

See also Dodd Frank Act § 115(a)(1)(B) (recommendations of the FSOC regarding enhanced prudential standards are to "increase in stringency" based on a number of factors described in §§ 113 and 115(b)(3)); § 165(a)(1)(B) (the Federal Reserve "shall . . . establish prudential standards . . . that . . . increase in stringency based on" a number of factors described in § 165(b)(3)).

[117] *See* note 23 above.

[118] 2019 Enhanced Prudential Standards Rule at 59033-34.

somehow be inconsistent with the new U.S. statutory framework for prudential regulation. In our view, the Agencies are required to fit Basel III Endgame into the existing tiering structure, not knock down the tiering structure to accommodate Basel III Endgame.

However, the Capital Proposal effectively reverses these key developments from 2019 by making the standards applicable to Category II-IV banking organizations identical to each other and almost identical to the standards applicable to Category I banking organizations (*i.e.*, U.S. GSIBs).

To be clear, we believe that the tiering framework, in its current form, is in many cases not appropriately calibrated to the lower risks that IHCs pose.[119] However, the Capital Proposal moves far beyond the imperfections of the 2019 Tiering Rules, which were developed after a robust notice and comment period, and abandons them in favor of rules that cannot meaningfully be characterized as "tiered" because the rules make very few distinctions among the diverse characteristics of BHCs and IHCs that have over $100 billion in total consolidated assets in Categories I through IV. To name a few examples: As of the second quarter of 2023, IHCs had an average of $181.68 billion in total consolidated assets, whereas U.S. GSIBs had an average of $1.84 trillion in total consolidated assets.[120] As of the same date, there also were substantial differences between U.S. GSIBs and IHCs in terms of average total nonbank assets ($607.4 billion versus $78.5 billion); average total short-term wholesale funding ($325.63 billion versus $41.72 billion); average cross-jurisdictional activity ($1 trillion versus $28.37 billion); and average total off-balance sheet exposure ($353.56 billion versus $28.58 billion).[121] Notwithstanding these enormous differences, a disparity that is also the case for domestic non-GSIB banks relative to U.S. GSIBs, the Capital Proposal applies the same capital requirements to all banking organizations with over $100 billion in total consolidated assets, reserving only the GSIB surcharge and the enhanced supplementary leverage ratio ("eSLR") for Category I firms.

In addition, as part of larger organizations subject to global, enterprise-wide capital and liquidity planning, the U.S. operations of international banks benefit from the existence of their parent as a source of strength. International banks may manage and allocate capital and liquidity between their U.S. operations and other non-U.S. subsidiaries in a way that increases the strength of the group overall and reduces group fragility.[122] By contrast, distributions to public shareholders of domestic banking organizations leave the organization and do not promote group stability. In addition, strong home country resources can provide parent support that is not available to a standalone domestic banking organization. Unlike domestic banking organizations, the U.S. operations of international banks can receive support from parent organizations at a moment's notice without resort to the domestic capital markets. A parent

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119 *See* Press Release, IIB, *IIB Statement on the Federal Reserve's Tailoring Rule* (Oct. 10, 2019), https://cdn.ymaws.com/www.iib.org/resource/resmgr/weekly_bulletin/10-10-19tailoringstatement.pdf.

120 Data from Form FR Y-9C.

121 Available FR Y-15 data.

122 *See* Wilson Ervin, Brookings Center on Regulation and Markets, "Understanding 'ring-fencing' and how it could make banking riskier" (Feb. 7, 2018) (discussing the risks of ring-fencing, which impairs the ability of the parent bank holding company to allocate capital across subsidiaries by locking the capital within subsidiaries).

bank's capacity to provide support in stress has only been increased by the prudential standards and resolution-related requirements already implemented internationally over the last decade. Therefore, there are marked differences in risk and resolvability of IHCs. These differentiating and defining characteristics of IHCs is not appropriately incorporated into calibrations that should reduce the effects of U.S. prudential standards on IHCs.

Consequently, the Capital Proposal runs counter to foundational principles of the Dodd-Frank Act, particularly as modified by EGRRCPA, in several ways. First, it does not "differentiate among companies" in accordance with their various risk-based characteristics.[123] As we explain further in Section XI.C below, the Basel III Quantitative Impact Study ("QIS") that was used to inform the Capital Proposal does not take into account the effects of the Basel III changes on IHCs, something that seriously compromises the Agencies' ability to propose a rule that would "differentiate among companies." Second, the Capital Proposal does not reflect a risk-based approach to the development of prudential standards.[124] Third, with respect to the application of prudential standards to BHCs that have more than \$100 billion but less than \$250 billion in total consolidated assets, the Dodd-Frank Act as modified by EGRRCPA requires a special, more enhanced review of the imposition of such requirements (the "Dodd-Frank Act § 165(a)(2)(C) requirement").[125] Not only does the Capital Proposal insufficiently account for the lesser risks posed by these smaller organizations, but also it does not acknowledge the existence of, or make explicit the determination required by, the Dodd-Frank Act § 165(a)(2)(C) requirement. This approach stands in sharp contrast to the approach taken by the 2019 Enhanced Prudential Standards Rule, which explicitly took this requirement (and the other Dodd-Frank Act requirements) into account and worked to address them.[126]

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[123] *See* Dodd-Frank Act § 165(a)(2)(A), as modified by EGRRCPA § 401(a)(1)(B)(i) ("shall . . . differentiate among companies on an individual basis or by category, taking into consideration their capital structure, riskiness, complexity, financial activities (including the financial activities of their subsidiaries), size, and any other risk-related factors that the Board of Governors deems appropriate.")

[124] *See* Dodd-Frank Act § 165(a)(1)(B) (the Federal Reserve "shall . . . establish prudential standards . . . that . . . increase in stringency based on" a number of factors described in § 165(b)(3)).

[125] *See* Dodd-Frank Act § 165(a)(2)(C)(i) (the Federal Reserve "may by order or rule. . . apply any prudential standard established under this section to any bank holding company or bank holding companies with total consolidated assets equal to or greater than \$100,000,000,000 to which the prudential standard does not otherwise apply provided that the Board of Governors—(i) determines that application of the prudential standard is appropriate-- (I) to prevent or mitigate risks to the financial stability of the United States, as described in paragraph (1); or (II) to promote the safety and soundness of the bank holding company or bank holding companies. . ."). *See also* Dodd-Frank Act § 165(a)(2)(C)(ii) (the prudential standards for BHCs that have more than \$100 billion but less than \$250 billion must take "into consideration the bank holding company's or bank holding companies' capital structure, riskiness, complexity, financial activities (including financial activities of subsidiaries), size, and any other risk-related factors that the Board of Governors deems appropriate.").

[126] *See* 2019 Enhanced Prudential Standards Rule at 59037 ("The framework for application of enhanced prudential standards established in this final rule is consistent with section 165 of the Dodd-Frank Act, as amended by EGRRCPA. The framework takes into consideration banking organizations' risk profiles by applying prudential standards based on a banking organization's size, cross-jurisdictional activity, nonbank assets, off-balance sheet exposure, and weighted short-term wholesale funding. *By evaluating the degree of each risk-based indicator's presence at various thresholds, the framework takes into account concentrations in various types of risk***.** As explained below, the risk-based indicators were selected to measure risks to both financial stability and safety and soundness, including a bank holding company or

The GSIB Surcharge Proposal also erodes the principles of tiering in a different way. As explained further in our comment letter on that Proposal, the Federal Reserve suggested that changes to the CJA indicator would move seven CUSOs and two IHCs into Category II. That would have resulted in roughly equal numbers of international banks' U.S. operations in Category II as the number of domestic banks in Categories I and II, regardless of the material and obvious differences between Category I and II banks and the U.S. IHCs/CUSO. While we believe that projection to have been in error, the fact remains that the Federal Reserve appeared unfazed by applying Category II standards—which are similar to those applied to Category I U.S. GSIBs— to so many of the U.S. operations of international banks. Such an obvious disparity in size and risk, without taking that disparity into account in development of rules, is contrary to EGRRCPA and even the original Dodd-Frank Act language. Yet, as we explain further in the letter on the GSIB Surcharge Proposal, the Federal Reserve offers no supporting rationale for such a significant re-tiering of international banks and implies an outcomes-based targeting of international banks that is squarely at odds with the principles of national treatment and equality of competitive opportunity.

Beyond the Capital Proposal and the GSIB Surcharge Proposal, a de-tiering trend from the Agencies has become evident. The long-term debt proposal[127] and resolution planning guidance[128] proposals also propose undermining the statutorily required tiering of banking institutions, and of international banks in particular. An unintended consequence of this rollback may be the development of a "barbell" banking system in the United States, *i.e.*, an industry consisting of a small group of large institutions, all treated similarly even though each would be tagged to a Category, and a large group of much smaller institutions, with almost no one in between. Firms below the $100 billion threshold would be incentivized to stay there, as crossing the threshold would create a steep "cliff effect", massively increasing regulatory burdens practically to the level applied to U.S. GSIBs, or in the alternate, to compete with Category I-IV banks, they may be incentivized to merge with one another, leading to increased industry concentration. This lack of diversity would almost certainly make the banking system less robust, an outcome the Agencies should avoid.

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bank holding companies' capital structure, riskiness, complexity, and financial activities. Size is specifically mentioned in section 165(a)(2)(C)(ii). *By establishing categories of standards that increase in stringency based on risk, the framework would ensure that the Board's prudential standards align with the risk profile of large banking organizations, supporting financial stability and promoting safety and soundness*") (emphasis added).

[127] Agencies, *Long-Term Debt Requirements for Large Bank Holding Companies, Certain Intermediate Holding Companies of Foreign Banking Organizations, and Large Insured Depository Institutions*, 88 Fed. Reg. 64524 (proposed Sept. 19, 2023) (the "LTD Proposal").

[128] Federal Reserve and FDIC, *Guidance for Resolution Plan Submissions of Foreign Triennial Full Filers*, 88 Fed. Reg. 64641 (proposed Sept. 19, 2023) (the "International Bank Guidance Proposal").

B. The Agencies should not abandon the principles of international consistency, capital neutrality and equality of competitive opportunity for international banks.

1. *Maintaining a level playing field internationally should be a guiding principle of the Proposals.*

The Capital Proposal departs in a number of ways from internationally agreed Basel III Endgame standards, undermining the goals of international consistency and maintaining a level playing field among internationally active banks.[129] International consistency is crucial in ensuring that banks with global operations do not face different and potentially contradictory requirements across jurisdictions, which can lead to a more fragmented and brittle global financial system. Governor Bowman has noted that the Proposals would exacerbate existing issues through inconsistent implementation of capital standards across jurisdictions,[130] which is a particularly large problem for IHCs in relation to managing compliance with both home country and U.S. capital regimes. Governor Bowman has also noted the importance of international coordination in creating similar regulatory frameworks across jurisdictions,[131] but unfortunately, the Capital Proposal mostly ignores the issue of international consistency. As they progress towards final rules, the Agencies must consider the costs and risks associated with inconsistent capital standards across jurisdictions.

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[129] Press Release, Agencies, "U.S. banking agencies support conclusion of reforms to international capital standards" (Dec. 7, 2017), https://www.federalreserve.gov/newsevents/pressreleases/bcreg20171207b htm ("The reforms finalized today are intended to improve risk sensitivity, reduce regulatory capital variability, and level the playing field among internationally active banks"); Michelle W. Bowman, Governor, Federal Reserve, Remarks on Responsive and Responsible Bank Regulation and Supervision at the Salzburg Global Seminar on Global Turbulence and Financial Resilience: Implications for Financial Services and Society, Salzburg, Austria (Jun. 25, 2023), https://www federalreserve.gov/newsevents/speech/bowman20230625a htm ("While some deviation in standards is to be expected during local implementation of international capital requirements, policymakers should not ignore the underlying goal of promoting international consistency and parity. . . . We should be mindful of how such jurisdiction-specific deviations could impact international banking activities and cross-border competition."); Press Release, Agencies, "U.S. Banking Agencies Express Support for Basel Agreement" (Sept. 12, 2010) ("The U.S. federal banking agencies actively supported the efforts of the GHOS and the Basel Committee on Banking Supervision (Basel Committee) to increase the quality, quantity, and international consistency of capital.").

[130] Michelle W. Bowman, Governor, Federal Reserve, Statement on the Proposals (July 27, 2023), https://www federalreserve.gov/newsevents/pressreleases/bowman-statement-20230727.htm ("Many of the largest and most systemic banks operate internationally, and promoting international parity in capital standards applicable to global banks with international operations could help make the global financial system more resilient and competitive. Today's proposal deviates significantly from international standards and perpetuates differences in implementation across international jurisdictions").

[131] Michelle W. Bowman, Governor, Federal Reserve, Remarks on the Economy and Prioritization of Bank Supervision and Regulation, at the New York Banker's Association's Financial Services Forum, Palm Beach, Florida (Nov. 9, 2023), https://www federalreserve.gov/newsevents/speech/bowman20231109a htm ("International bodies and agreements can help foster the creation of similar regulatory frameworks across jurisdictions. Significant banking activities occur in the international and cross-border context, and we know that financial stability risks can spread throughout global financial markets. By engaging in international coordination, U.S. regulators can promote minimum standards across jurisdictions, and these minimum standards can improve competitive equity in banking markets and make the financial system safer").

The divergences of the Capital Proposal from Basel III Endgame, and its implementation in other jurisdictions, risk exacerbating existing issues in inconsistent implementation of capital standards across jurisdictions, further fragmenting liquidity, enterprise risk management and capital pools of banks. As just one example, the Capital Proposal would require, for all institutions above $100 billion in total assets, two separate RWA calculations—one under the new ERBA and a "backstop" calculation under the existing U.S. standardized approach. Most of, if not all, these institutions, are also likely to have to conduct two separate market risk calculations—one for desks that receive approval for models and one for those desks that do not. Furthermore, any desk that does have model approval is required to calculate the standardized market risk calculation as a backstop to the model approved for the desk. This complexity is unnecessary and not required by the internationally agreed-upon standards in the Basel III Endgame, which provides for a single backstop in the form of the output floor. [132] As discussed in Section V above, given that ERBA will almost always be the binding capital requirement, the purpose of these multiple backstops is questionable and would reduce the standardized approach and the market risk output floor to time-consuming compliance exercises that have few appreciable benefits.

This is of particular concern to IHCs, which must manage compliance with both home country (on a global basis) and U.S. capital regimes. It is important to recognize that we advocate for consistency not only because there does not appear to be any particular justification for departing from international standards agreed to by the Agencies in 2017, but because inconsistencies are a significant factor in the disproportionate impact on the U.S. operations of international banks arising from the Proposals. Requiring different systems, policies and procedures for unnecessary and unsubstantiated differences in the rules is both a burden and an operational risk in and of itself. In particular, differences from home country consolidated capital requirements is a specific and significant cause of costs and disincentives to operating in the United States and is inconsistent with the requirement that the Agencies "take into account the extent to which the foreign financial company is subject on a consolidated basis to home country standards that are comparable to those applied to financial companies in the United States."[133]

2. *The Agencies do not sufficiently justify their departure from the capital neutrality principles of Basel III Endgame, and have not shown that increasing capital requirements would increase resiliency.*

Members of the BCBS and the Group of Governors and Heads of Supervision ("GHOS") have indicated they intended the Basel III Endgame to be capital neutral, and that the goal was to increase risk sensitivity and reduce capital variability.[134] Previous statements from

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[132] BCBS, Basel Framework, RBC 20.4(2).

[133] Dodd-Frank Act § 165(b)(2)(B).

[134] *See* Stefan Ingves, Chairman, BCBS, "Reflections of a Basel Committee Chairman" (Nov. 30, 2016), https://www.bis.org/speeches/sp161130 htm; Mario Draghi, Chair, GHOS, and President, European Central Bank, Statement at the GHOS Press Conference (Dec. 7, 2017), https://www.bis.org/bcbs/b3/ghos_20171207_2.htm ("The focus of the exercise was not to increase capital. As a matter of fact, the GHOS almost a year ago endorsed this review by the Basel Committee, provided it wouldn't create a significant capital increase in the aggregate of the banking system"). *See also* Press

the Agencies also indicated that the implementation of the Basel III Endgame would be capital neutral in the aggregate.[135] However, the Capital Proposal is not capital neutral—instead, the Agencies estimate that the proposal would aggregate capital by 16%,[136] and we believe the effects to actually be higher than that. Despite such a dramatic increase in capital, the Agencies have provided little evidence that this would actually achieve their stated policy goals and increase resiliency.[137] Indeed, they have not even shown that such an increase in capital would actually make banks, let alone financial markets as a whole, safer. The Agencies give inadequate consideration[138] to the probability that increased capital requirements are likely to cause credit intermediation to migrate outside of the regulated sector into the shadow banking sector, which may increase systemic risk. The view that more capital is always safer is thus a myopic one, as it does not focus on the risks that may result if banks are forced to pull back on their lending activity. Furthermore, as highlighted in Section XI.B.3 below, in numerous areas modified by the Proposals, the impact on international banks is greater than that for domestic banks, also with no apparent or sufficient support.

Increasing capital requirements on the industry overall might be warranted if recent events had demonstrated that many banks showed weakness in times of stress. But that is not the case—banks have proven extraordinarily resilient in the face of recent stresses, especially the COVID-19 pandemic. Banks continued to provide a crucial source of liquidity and credit throughout the unprecedented uncertainty of the COVID-19 crisis, in part because existing capital requirements were <u>already</u> robust.[139] Further increases in capital, however, will inevitably make it more costly to extend credit, and could make banks less able or willing to do so in times of extreme stress. There is no systemic benefit to having banks that are strongly capitalized but that limit their lending or lose out on competitive financial opportunities to non-banks.

Release, Agencies, "U.S. banking agencies support conclusion of reforms to international capital standards" (Dec. 7, 2017), https://www.federalreserve.gov/newsevents/pressreleases/bcreg20171207b htm ("The reforms finalized today are intended to improve risk sensitivity, reduce regulatory capital variability, and level the playing field among internationally active banks."). This view is supported by the quantitative impact study released by the Basel Committee when it finalized the 2017 agreement, which concluded that the changes agreed to would actually reduce the risk-based capital requirements of all GSIBs in the aggregate. *See* BCBS, *Basel III Monitoring Report: Results of the cumulative quantitative impact study* (Dec. 2017), https://www.bis.org/bcbs/publ/d426.pdf.

135 Mark E. Van Der Weide, General Counsel, Federal Reserve, Statement at the Bank Policy Institute Annual Conference's Regulatory Agency General Counsel Panel (Nov. 2019), https://bpi.com/wp-content/uploads/2020/01/112019-BPI-REGULATORY-AGENCY-GENERAL-COUNSEL.pdf ("So, we're still kind of in the early days of working interagency, FDIC, Fed, OCC on figuring out how to implement the Basel three end game. We at the Fed at least are quite committed to doing it in a capital neutral way. And to also do it in a very thoughtful, comprehensive way, where we don't kind of finalize various pieces without thinking about the whole, and its accurate [sic] impact on the banking system and individual banks").

136 *See* Capital Proposal at 64169.

137 *See generally* Capital Proposal, "Impact and Economic Analysis," at 64167-71.

138 *See* Capital Proposal at 64169.

139 *See*, *e.g.*, Alice Abboud et al., Federal Reserve, *COVID-19 as a Stress Test: Assessing the Bank Regulatory Framework* (March 2021).

To the extent that the Agencies' decision to abandon capital neutrality is grounded in the March 2023 banking stress, the Proposals do not solve for the underlying factors that led to the failures of Silicon Valley Bank and Signature Bank, other than perhaps narrowly with respect to the proposed treatment of AOCI. Per the Agencies' own reports, the events of March 2023 were caused by many factors unrelated to capital.[140] Interest rate changes that had not been experienced over the last two decades were a leading factor, and arguably caused by the global governments themselves. The Agencies are statutorily mandated to not treat all risks the same, and are required by the Administrative Procedure Act to support the reasoning why significant capital increases across multiple organizations should be the right tool and the right outcome to address shortfalls in the management of certain banks.[141] More capital is not a substitute for intelligent risk and liquidity management, proactive supervision, and diversified business models.

The Agencies have not demonstrated that the changes to the capital rules in the Proposals, if in effect prior to 2023, would have addressed any one of these issues, much less prevented the March 2023 bank failures. As examples, among others:

- Requiring an additional three separate capital calculations for a number of domestic and international banks that previously were required to prepare only one does not appear to address any cause or risk evident from recently failed institutions; and

- The GSIB Surcharge Proposal's apparent raising of the categories of several international banks' IHCs and/or CUSOs, without raising the categories of any domestic institutions, is based on the unsupported assumption that international banks' activities are more systemically risky than previously thought, and does not focus on any of the still-surviving domestic banks that underwent stress in the months after March 10.

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[140] *See* Federal Reserve, *Review of the Federal Reserve's Supervision and Regulation of Silicon Valley Bank* (Apr. 2023) (the "FRB Silicon Valley Bank Report"), https://www federalreserve.gov/publications/2023-April-SVB-Key-Takeaways htm; FDIC, *FDIC's Supervision of Signature Bank* (Apr. 28, 2023), https://www fdic.gov/news/press-releases/2023/pr23033a.pdf; Government Accountability Office, *Preliminary Review of Agency Actions Related to March 2023 Bank Failures* (Apr. 28, 2023), https://www.gao.gov/assets/gao-23-106736.pdf; Office of Inspector General, Federal Reserve and Consumer Financial Protection Bureau, *Material Loss Review of Silicon Valley Bank* (Sept. 25, 2023), https://oig federalreserve.gov/reports/board-material-loss-review-silicon-valley-bank-sep2023.pdf.

While the Federal Reserve's report on Silicon Valley Bank points to the beneficial effects that increased capital requirements may have had, it is important to note that (i) Silicon Valley Bank was still in the process of transitioning to the full suite of capital requirements applicable to it following its rapid growth (*see FRB Silicon Valley Bank Report* at 12-13), suggesting more of an issue with the transition times to heightened requirements than with the actual requirements themselves, and (ii) the pro forma effects of pre-EGRRCPA capital requirements on Silicon Valley Bank are speculative at best (*see FRB Silicon Valley Bank Report* at 90).

[141] *See Motor Vehicle Mfrs. Ass'n of U.S., Inc. v. State Farm Mut. Auto. Ins. Co*., 463 U.S. 29 (1983) (stating that the agency's explanation must include an explanation of the rational connection between the evidence examined and rule).

Furthermore, as discussed in more detail immediately below, if the goal of the Proposals was to add more capital to regional banks that incurred disproportionate stress during March 2023, the net has been cast too wide and has captured the U.S. operations of international banks that did not undergo stress from market forces in March 2023.[142]

3. *IHCs are disproportionately affected by the Proposals, in a manner inconsistent with the internationally agreed principles of national treatment and equality of competitive opportunity.*

National treatment and equality of competitive opportunity are vital principles underpinning the international bank regulatory regime and the United States' framework for international banking. As early as the adoption of the original Basel framework in 1988, the BCBS noted, "the framework should . . . have a high degree of consistency in its application to banks in different countries with a view to diminishing an existing source of competitive inequality among international banks . . . "[143] Of particular concern to IIB is that the Proposals take little account of the clear Congressional mandates to respect the principles of national treatment and equality of competitive opportunity and to take into account comparable home country regulation.[144] National treatment and equality of competitive opportunity require treating international banks no less favorably than similarly situated U.S. banking organizations and creating a level playing field between international banks in the United States and domestic firms of a similar size and business model.[145]

The risk profile of the U.S. operations of international banks does not warrant the disproportionate treatment in the existing tiering structure of the enhanced prudential framework, nor the unbalanced treatment the Agencies are proposing to implement, both in terms of the effects of the Capital Proposal and potential IHC/CUSO categorizations reported by the GSIB

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[142] Furthermore, the evident targeting of international banks with the introduction of derivatives to the Form FR Y-15 CJA indicator undermines the claim that the Proposals are intended to address weaknesses at domestic regional banks. There is no support at all for the notion that including derivatives in the CJA indicator would have addressed the March 2023 stress.

[143] *See* BCBS, *International Convergence of Capital Measurements and Capital Standards* (July 1988), https://www.bis.org/publ/bcbs04a.pdf.

[144] Dodd-Frank Act § 165(b)(2) (in particular, when applying prudential standards to any "foreign-based bank holding company," the Federal Reserve "shall . . . take into account the extent to which the foreign financial company is subject on a consolidated basis to home country standards that are comparable to those applied to financial companies in the United States").

As we have noted before, the post-Dodd-Frank-Act standards have already failed to recognize this principle, have paid only limited attention to the place of the U.S. operations in the broader regulated organization, and have placed international banks' U.S. operations in unwarranted tiers for purposes of enhanced prudential standards.

[145] Federal Reserve, *Prudential Standards for Large Bank Holding Companies and Savings and Loan Holding Companies*, 83 Fed. Reg. 61408, 61411 n.27 (proposal, Nov. 29, 2018) ("The Dodd-Frank Act requires the Board to give due regard to national treatment and equality of competitive opportunity, which generally means that [international banks] operating in the United States should be treated no less favorably than similarly situated U.S. banking organizations and should generally be subject to the same restrictions and obligations in the United States as those that apply to the domestic operations of U.S. banking organizations.").

Surcharge Proposal. On the contrary, the categorization of international banks and calibration of capital requirements for IHCs should take into consideration the reduced risks of and broader consolidated regulatory frameworks applicable to such institutions. Simply applying the same capital standards to international banks and domestic banking organizations does not comport with this statutory requirement—as noted in Section XI.A above, there are large and obvious differences between international banks and domestic banking organizations that simply are not taken into account or incorporated into the Proposals.

The Agencies must also consider that FBOs' U.S. operations are part of a broader, supportive organization and must acknowledge that international banks are already subject to comprehensive home country capital requirements applied on a consolidated basis.[146] Categorization of international banks and calibration of capital requirements for IHCs should take into consideration the reduced risks of such institutions and the latent support that could be provided on a moment's notice without resort to the fickle capital markets. Furthermore, disproportionate requirements in the United States could lead to similar demands by other host-country supervisors. For example, in 2019, the European Union finalized a rule requiring that certain non-EU banks establish an intermediate parent undertaking ("IPU").[147] This rulemaking has been characterized as a retaliatory response to the United States' rule requiring international banks to establish IHCs.[148] This continued pattern of escalating regulatory requirements by host-country regulators could, in turn, lead to increased fragmentation of internationally-active banking organizations, making such organizations less resilient on an enterprise-wide basis and increasing financial stability risks in both home and host jurisdictions.[149]

In apparent disregard of the reasons why capital and enhanced prudential requirements for IHCs and the U.S. operations of international banks should be calibrated at levels less than those applicable to domestic BHCs, international banks are, in fact,

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[146] International banks' U.S. operations are part of larger organizations in which capital may be allocated among IHCs and other non-U.S. subsidiaries as part of an international banks' global, enterprise-wide capital planning designed to maintain the capital strength of all subsidiaries and avoid gaps that could lead to group fragility. *See, e.g.,* Randal K. Quarles, Vice Chair for Supervision, Federal Reserve, "Trust Everyone—But Brand Your Cattle: Finding the Right Balance in Cross-Border Resolution" (May 16, 2018) ("Brand Your Cattle Speech"), https://www.bis.org/review/r180522a htm (noting that "adequate flexibility for the parent to deploy resources where needed is likewise in the host regulator's interest."); Wilson Ervin, Brookings Center on Regulation and Markets, "Understanding 'ring-fencing' and how it could make banking riskier" (Feb. 7, 2018) (discussing the risks of ring-fencing, which impairs the ability of the parent bank holding company to allocate capital across subsidiaries by locking the capital within subsidiaries).

[147] Council of the European Union, "Proposal for a Directive Of The European Parliament And Of The Council amending Directive 2013/36/EU as regards exempted entities, financial holding companies, mixed financial holding companies, remuneration, supervisory measures and powers and capital conservation measures," February 14, 2019, https://data.consilium.europa.eu/doc/document/ST-6289-2019-INIT/en/pdf.

[148] See Alex Barker et. al., "EU to retaliate against US bank capital rules," *Financial Times* (Nov. 21, 2016), https://www ft.com/content/26078750-b003-11e6-a37c-f4a01f1b0fa1.

[149] *See e.g.*, Ervin, note 146 above (finding that for a hypothetical bank with four equally sized subsidiaries, the risk of group failure could increase by 5x or more if extensive ring-fencing were required); Institute of International Finance, *Addressing Market Fragmentation: The Need for Enhanced Global Regulatory Cooperation* (Jan. 2019) (noting the risks posed by market fragmentation); Financial Stability Board, *Report on Market Fragmentation* 9-10 (June 4, 2019) (discussing the threat that fragmentation of capital and liquidity regimes across borders poses to financial stability).

disproportionately affected by the Proposals with the inclusion of, ironically, more stringent requirements than applicable to their peer domestic banks. The Agencies' own estimated effect of the Capital Proposal on Category III and IV IHCs is closer to the effect on U.S. GSIBs than the effect on Category III and IV domestic firms.[150] The Capital Proposal estimates a 19% increase in common equity Tier 1 ("CET1") requirements for domestic banking organizations in Categories I and II; a 14% increase for IHCs in Categories III and IV; and just a 6% increase for domestic banking organizations in Categories III and IV.[151] A quantitative study among participating IIB members suggested that the effect on IHC CET1 could actually be much worse, and could be in the range of a 28% increase to CET1 requirements for IHCs.

The Proposal's impact is notwithstanding IHCs' already higher capital ratios, smaller sizes overall and reduced risk profiles as part of global banking organizations. As of the end of the second quarter of 2023, while IHCs had an average CET1 ratio of 16.01%, U.S. GSIBs and Category II BHCs had an average CET1 ratio of 12.61% and domestic BHCs in Categories III and IV had an average CET1 ratio of 10.60%.[152] Similarly, while IHCs had an average Tier 1 capital ratio of 17.56%, U.S. GSIBs and Category II domestic BHCs had an average Tier 1 ratio of 14.28% and domestic BHCs in Categories III and IV had an average Tier 1 ratio of 12.22%.[153] IHCs had, on average, approximately $181.7 billion in total consolidated assets, whereas U.S. GSIBs and Category II BHCs had, on average, approximately $1.7 trillion in total consolidated assets, and Category III and IV domestic BHCs had, on average, $323.7 billion in total consolidated assets.[154]

Removing the AOCI opt-out and requiring Category III and IV firms to make deductions from capital ratio numerators that mirror required deductions of Category I and II firms also negatively and disproportionately affect IHCs. The Agencies estimate that IHCs in Category III will face a 13.2% increase in their CET1 requirements and 9.7% increase in leverage capital requirements, as compared to 4.6% and 3.8%, respectively, for domestic firms in Category III.[155] Again, this effect is not warranted given the already higher capital ratios and the lower risk profile of IHCs generally.

The Capital Proposal's requirement that firms calculate RWAs under the standardized approach, ERBA, and the market risk output floor also disproportionately affects IHCs and their bank subsidiaries. IHCs would move from having to undertake one U.S. regulatory capital calculation under the current framework to being required to calculate three or four sets of U.S. regulatory capital RWAs, on top of measuring their U.S. operations' contributions to an international bank's home country capital requirements. These changes subject IHCs to increased complexity and administrative burden in the United States without any

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[150] In the next Section of this comment letter, we explain how the methods through which the Agencies have been collecting data to inform any analysis underlying the Proposals have substantial flaws, per the Agencies' own admission.

[151] *See* Capital Proposal at 64169 n. 464.

[152] Weighted averages based on data from Form FR Y-9C.

[153] Weighted averages based on data from Form FR Y-9C.

[154] Form FR Y-9C data.

[155] *See* Capital Proposal at 64171.

commensurate benefit. Indeed, the purpose of these additional calculations is unclear, given that the standardized approach will effectively never be binding.

Finally, the GSIB Surcharge Proposal's inclusion of derivatives in the calculation of CJA is particularly concerning to international banks. By their nature, IHCs tend to have more cross-jurisdictional derivatives activity than domestic firms, as they are part of global banking organizations and generally play a supporting role to the parent's international operations as well as to the international financial system more generally. But that does not make them any riskier; indeed, as explained, IHCs generally have a lower risk profile than domestic banking organizations.[156] Including derivatives in CJA makes IHCs look riskier than they are, and punishes IHCs simply for not being able to eliminate inter-affiliate derivatives in consolidation. Therefore, mere inclusion of derivatives is blunt and insufficiently nuanced, as our recommendations in our comments on the GSIB Surcharge Proposal indicate. As with so many other changes in the Proposals, this change would be inconsistent with principles of national treatment and equality of competitive opportunity.

C. The Proposals lack sufficient cost-benefit and impact analysis.

The Agencies have not provided sufficient information to the public with respect to the Proposals' cost-benefit analyses to allow meaningful comment.[157] Along with other industry organizations, on September 12, 2023, IIB called for the Agencies to re-propose the Capital Proposal in order that a re-proposal may provide all evidence and analyses the Agencies relied upon in proposing the Capital Proposal.[158] The Proposals rely on nonpublic and unreleased information, a reliance that is not consistent with the requirements of the APA.[159] The Agencies have still not provided the information needed for informed public comment. In addition, the Agencies issued the Proposals without completed (and still ongoing) data collection and QIS. The Proposals stated that information was still being analyzed, and yet the Federal

[156] *See* 88 Fed. Reg. 64641 at 64647 (stating that "most of the specified [foreign] firms have limited derivatives and trading operations compared to the U.S. GSIBs [. . .]".)

[157] *See* Michelle W. Bowman, Governor, Federal Reserve, "The Role of Research, Data, and Analysis in Banking Reforms" (Oct. 4, 2023), https://www federalreserve.gov/newsevents/speech/bowman20231004a htm ("My insistence upon being guided by evidence does not imply that I am opposed to regulatory reforms, but rather that policymakers should be expected to show their work. The banking system is not perfect, and policymakers should continually ask themselves if there are ways to improve regulation and supervision. I am always open to considering evidence-based proposals that address known deficiencies and shortcomings in our regulatory and supervisory framework, but any such proposals must stop short of interfering with or stepping into the role of managing the financial institution. . . . Our call to action coming from this conference, in my view, is to resist the urge to act in a reactionary way when addressing policy matters. Instead, policymakers should choose to exercise restraint and patience, consider the evidence, and strive for well-calibrated policies that fully incorporate the costs, benefits, and impacts of reform and complement, rather than complicate or contradict, the existing regulatory framework.").

[158] *See* Letter from the Bank Policy Institute, American Bankers Association, Financial Services Forum, IIB, SIFMA and U.S. Chamber of Commerce to the Agencies (Sept. 12, 2023), https://bpi.com/wp-content/uploads/2023/09/Letter-to-Agencies-Re-Missing-Information-2023.09.12-vF.pdf (requesting re-proposal of regulatory capital rule to remedy Administrative Procedure Act violations).

[159] *See, e.g., FBME Bank Ltd. v. Lew*, 125 F. Supp. 3d 109, 121 (D.D.C. 2015) (stating that agencies must make public all data the agency used to develop its rule).

Reserve made additional requests for information, on October 20, 2023, *during the comment period*. Furthermore, the Federal Reserve's data collection effort will end on the *same day* the Capital Proposal's comment period ends (January 16, 2024), making it impossible for firms to comment on how that data informs the Capital Proposal.[160] The Agencies' incomplete data collection contributes to the lack of sufficient information to address the possible effects on subject institutions, levels of lending and capital markets activity, and the U.S. economy more generally. This method of introducing the Proposals is inconsistent with the Agencies' previous commitments to transparency.[161] Worse, this opacity makes the reasoning in the Proposals conclusory, and overall makes it far more difficult for banking organizations to provide meaningful feedback that could improve aspects of the Proposals.

The impact estimates in the Capital Proposal are, by the Agencies' own admission, subject to "several caveats."[162] One is that the impact estimates rely partly on a limited number of banking organizations' Basel III QIS submissions, which were prepared based on these organizations' *assumptions* about how the Agencies could implement Basel III.[163] The Basel QIS did not include all banking organizations, and does not specifically consider the impact of Basel III on IHCs. For IHCs, the Agencies claim to rely on regulatory filings which the Agencies admit "do not include sufficient granularity for precise estimates."[164] For all these reasons, the Basel III QIS submissions are a highly inappropriate basis upon which to make an impact estimate for the specific provisions (which are not consistent with the Basel III Endgame) of the Capital Proposal.

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160 Press Release, Federal Reserve, "Federal Reserve Board launches data collection to gather more information from the banks affected by the large bank capital proposal it announced earlier this year" (Oct. 20, 2023), https://www federalreserve.gov/newsevents/pressreleases/bcreg20231020b.htm.

161 Jerome H. Powell, Chairman, Federal Reserve, Financial Stability and Central Bank Transparency, at the Sveriges Riksbank Anniversary Conference, Stockholm, Sweden (May 25, 2018), https://www federalreserve.gov/newsevents/speech/powell20180525a.htm ("[T]he case for enhanced transparency is not just about being accountable; it is also about providing credible information that can help restore and sustain public confidence in the financial system"); Randal K. Quarles, Vice Chair for Supervision, Federal Reserve, Spontaneity and Order: Transparency, Accountability, and Fairness in Bank Supervision, at the American Bar Association Banking Law Committee Meeting, Washington, D.C. (Jan. 17, 2020), https://www federalreserve.gov/newsevents/speech/quarles20200117a.htm ("transparency is intended to prevent arbitrary, capricious, and thus ineffective regulation by inviting broad public participation and mandating a deliberate public debate over the content of proposed rules . . . Transparency is central to our ability to assert that our rules are fair."); Jelena McWilliams, Chair, FDIC, Trust Through Transparency, at the Community Banking in the 21st Century Research and Policy Conference, https://www fdic.gov/news/speeches/2018/spoct0318.html (Oct. 3, 2018) ("transparency is pivotal to maintaining trust in the safety and soundness of the entire banking system. It helps to bridge information gaps and allow analysts and investors to monitor the buildup of risk and limit it to acceptable levels through market discipline . . . Because we are an independent agency, the FDIC is keenly aware of the need for transparency and accountability to the public, and that we must work even harder to promote the public's trust.").

162 Capital Proposal at 64168.

163 BCBS, *Basel III Monitoring Report* 1 (Sep. 2022), https://www.bis.org/bcbs/publ/d541.pdf. *See also* Capital Proposal at 64168.

164 Capital Proposal at 64168.

We also note that the regulatory impact analysis fails to consider the costs of cumulative regulations (particularly, the quantitative impact from this summer's resolution-related proposals and other regulatory requirements that cross-reference the regulations affected by the Capital Proposal), and accordingly is not consistent with the APA or the spirit of Executive Orders 12866, 13563, and 14094.[165]

Imposing significantly higher capital requirements should come with a commensurate examination of the potential effects on economic activity, particularly bank lending and market liquidity. But by the Agencies' own admission in the Capital Proposal, "existing empirical studies on the relationship between capital requirements and market liquidity are limited."[166] This ought to lead the Agencies to conduct such studies before imposing a double-digit percentage increase in capital requirements, particularly on top of a decade of increasingly stringent capital, stress test, liquidity and related requirements that have already boosted capital requirements. The Agencies, however, make an imprecise statement that "this increase in requirements could lead to a modest reduction in bank lending" that would be outweighed by "the benefits of making the financial system more resilient to stresses that could otherwise impair growth," supported by outdated studies that are not even specific to the Capital Proposal itself. [167] There is also no attempt to quantify the reduction in bank lending that could result from the Capital Proposal—indeed, there is no support for the assertion that the reduction would only be a "modest" one.[168]

The Agencies also provide no empirical evidence that the supposed resiliency benefits would outweigh the reduction in lending activity. The sum total of the evidence provided is the truism that capital helps banks absorb losses and continue lending in times of stress.[169] But the real question is not about capital's purpose, but about the potential effects of *more* capital, given the already lofty heights of capital required by original Basel III and the Dodd-Frank Act rulemakings. Even if more capital might make an individual bank more resilient, that does not necessarily mean the entire financial system would become more

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[165] *See*, *e.g.*, Exec. Order 14094, 88 Fed. Reg. 21879 (Apr. 11, 2023) ("Regulatory analysis should facilitate agency efforts to develop regulations that serve the public interest, advance statutory objectives, and are consistent with Executive Order 12866, Executive Order 13563, and the Presidential Memorandum of January 20, 2021"). *See also* Exec. Order 13563, 76 Fed. Reg. 3821 (Jan. 21, 2011) ("This order is supplemental to and reaffirms the principles, structures, and definitions governing contemporary regulatory review that were established in Executive Order 12866 of September 30, 1993 [stating that] . . . to the extent permitted by law, each agency must, among other things, . . . tailor its regulations to impose the least burden . . . taking into account . . . the costs of cumulative regulations"). *See also Metlife, Inc. v. Fin. Stability Oversight Council*, 177 F. Supp. 3d 219, 223 (D.D.C. 2016) ("focus[ing] exclusively on the presumed benefits . . . and ignor[ing] the attendant costs . . . is itself unreasonable under the teachings of Michigan v. Environmental Protection Agency").

[166] Capital Proposal at 64170.

[167] Capital Proposal at 64169 n. 470. *See also id.* at 64167 ("Although a slight reduction in bank lending could result from the increase in capital requirements, the economic cost of this reduction would be more than offset by the expected economic benefits associated with the increased resiliency of the financial system.").

[168] Capital Proposal at 64169.

[169] *See* Capital Proposal at 64169-70 ("The banking organizations that experience an increase in their capital requirements under the proposal would be better able to absorb losses and continue to serve households and businesses through times of stress.").

resilient—especially given costs of decreased bank lending, lower economic growth, and potential migration of activity into the shadow banking sector, none of which the Agencies sufficiently consider. In other words, the Agencies cannot make the mistake of thinking that increasing stringency at the microprudential level necessarily means increasing macroprudential resiliency.[170]

The Capital Proposal's impact analysis is insufficiently robust with respect to international banks in particular. First and foremost, the Basel III QIS on which the Agencies rely did not contain any specific information on the impact of Basel III on IHCs.[171] Furthermore, the Agencies note that they estimate the average total-loss absorbing capacity ("TLAC") and long-term debt ("LTD") requirements for Category I firms would increase by 15.2% and 2.0%, respectively, based simply on the increase in RWAs from the Capital Proposal. The Agencies do not do a similar analysis for IHCs and instead just state that "the RWA changes under the proposal could also increase the TLAC and LTD requirements for [IHCs] of some globally systemic important foreign banking organizations."[172] It is not possible for the Agencies to make an informed decision on the costs and benefits of the changes to RWA calculations, or to even comply with their statutory constraints to provide national treatment and equality of competitive opportunity, if the Agencies do not actually understand what the costs (and relative costs) are to international banks.

The Proposals also do not grapple with the problems associated with holding smaller institutions to the same standards as larger ones, problems experienced in the aftermath of the passage of the Dodd-Frank Act. When smaller institutions are held to the same standards as larger institutions, whether through direct regulation, the treatment by supervisory or exam teams, or the elevation of "best practices" expectations on smaller banks, the result is dislocations in resources, unwarranted and disproportionate increases in costs, pull-back from certain businesses, and the merger and acquisition of smaller institutions that are unable to keep up with unwarranted expectations (with the resulting negative effect on concentration and competition).[173]

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[170] *See*, *e.g.*, Jacek Osiński, Katharine Seal, & Lex Hoogduin, *Macroprudential and Microprudential Policies: Toward Cohabitation* (Int'l Monetary Fund Staff Discussion Note 13/05, June 2013), https://www.imf.org/external/pubs/ft/sdn/2013/sdn1305.pdf (discussing the differences between macro- and microprudential supervision and tools, and the dangers of conflating the two); Frederic Boissay & Lorenzo Cappiello, *Micro- versus Macro-prudential Supervision: Potential Differences, Tensions, and Complementaries*, *in* Eur. Cent. Bank Fin. Stability Rev. 135, 140 (May 2014) (suggesting that tighter capital requirements may require banks to shed assets at low prices, which may cause capital erosions at other banks).

[171] BCBS, *Basel III Monitoring Report* 1 (Sept. 2022), https://www.bis.org/bcbs/publ/d541.pdf.

[172] Capital Proposal at 64171.

[173] See, *e.g.*, Daniel Tarullo, Governor, Federal Reserve, A Tiered Approach to Regulation and Supervision of Community Banks, at the Community Bankers Symposium (Nov. 7, 2014), https://www federalreserve.gov/newsevents/speech/tarullo20141107a.htm (discussing the importance of tailored regulation); Letter from David A. Perdue, Senator, et al., to Randal Quarles, Vice Chairman for Supervision, Federal Reserve (Aug. 17, 2018), https://dlbjbjzgnk95t.cloudfront.net/1074000/1074755/letter%20to%20vc%20quarles%20re%20401-%20final.pdf (stating that, with EGRRCPA, "Congress acknowledged faults with the existing post-financial crisis laws that swept non-systemic firms into advanced regulatory categories and further

While the tiering required by EGRRCPA did not eliminate these problems, it went some way to reduce them. Unfortunately, the Agencies do not provide sufficient support for, or analysis of the effects of, undermining tiering via the effective elimination of capital differentiation across Categories I-IV. The Agencies should conduct a holistic review of any tiering rollback, particularly with respect to cost increases on Category III and IV firms. Indeed, subjecting Category III and IV firms to the same capital requirements as Category II and even Category I firms imposes costs beyond those associated with the capital increases themselves, namely, being subject to heightened expectations not commensurate with the business mix, size and overall risk of these institutions and that are far better suited for larger, riskier institutions. Another tiering rollback that lacks evidentiary support is the GSIB Surcharge Proposal's inclusion of derivatives in CJA, which the Federal Reserve suggested would raise the tiering category of several Category III and IV international banks. The Federal Reserve troublingly did not attempt to conduct a cost-benefit analysis of the change in tiering, and simply stated that it would happen.[174] The CJA indicator was originally set in 2019, and it is not clear what has changed in the intervening four years to justify a different calculation, other than a general preference to apply increasingly stringent standards to international banks.

Given the lack of cost-benefit analysis and empirical support, the Proposals evince the troubling impression that the Agencies' policy goal is simply to increase capital requirements and stringency on international banks. But as we have explained, raising capital is not an end in itself—it is merely one tool to increase resiliency. The Agencies must not make changes that the evidence does not clearly support in a narrow mission to increase capital requirements. Instead, they should conduct targeted empirical analyses to support the particular changes across the Proposals, examining whether the changes would increase macroprudential stability, what the impact would be on economic growth and credit intermediation, and what the particular costs and benefits on international banks and their IHCs would be. If the analysis does not support a particular change, the Agencies should not make it.

XII. Conclusion

We are commenting on the Proposals because they stand to have a material effect on our members, the international financial regulatory system and financial stability for years to come. Following this comment period, the Agencies have a vital window of opportunity to make changes necessary to better align the capital framework with U.S. statutory mandates; to remain consistent with internationally agreed principles that respect the roles of home- and host-country supervisors of international banks; and to provide the public with sufficient data and time to assess the impact of the Proposals.

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empowered the Fed to tailor the regulations to address individual risk-profiles of financial companies"); News Release, Mike Crapo, Senator, *Senate Passes Crapo's Economic Growth, Regulatory Relief and Consumer Protection Act* (March 14, 2018) ("absent excessive regulatory burden, local banks and credit unions will be able to focus more on lending, in turn propelling economic growth and creating jobs"); Michael D. Bordo & John v. Duca, *The Impact of the Dodd-Frank Act on Small Business* (Nat'l Bureau of Econ. Rsch., Working Paper No. 24501, Apr. 2018) (finding that the passage of the Dodd-Frank Act reduced smaller banking organizations' loans to small businesses).

[174] GSIB Surcharge Proposal at 60397-98.

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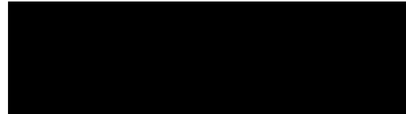
We appreciate your consideration of our comments on the Proposal. If we can answer any questions or provide any further information, please contact me at 646-213-1147, bzorc@iib.org or Stephanie Webster, General Counsel at 646-213-1149, swebster@iib.org.

Very truly yours,



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