By Electronic Mail

January 16, 2024

Ann E. Misback, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue NW.,
Washington, DC 20551

Chief Counsel's Office
Attention: Comment Processing
Office of the Comptroller of the Currency
400 7th Street, SW., Suite 3E-218
Washington, DC 20219

James P. Sheesley, Assistant Executive Secretary
Attention: Comments/Legal OES RIN 3064–AF29
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429

Re: Notice of Proposed Rulemaking, Regulatory Capital Rule: Amendments Applicable to Large Banking Organizations and to Banking Organizations with Significant Trading Activity; Federal Reserve Docket No. R–1813, RIN 7100–AG64; OCC Docket ID OCC-2023-0008; FDIC RIN 3064-AF29

Ladies and Gentlemen,

The Securities Industry and Financial Markets Association ("SIFMA")[1] and the Futures Industry Association ("FIA,"[2] together with SIFMA, the "Associations") appreciate the opportunity to comment on the Basel III endgame proposal issued by the Board of Governors of the Federal Reserve System ("Federal Reserve"), Office of the

[1] SIFMA is the leading trade association for broker-dealers, investment banks and asset managers operating in the U.S. and global capital markets. On behalf of our industry's nearly 1 million employees, we advocate for legislation, regulation, and business policy, affecting retail and institutional investors, equity and fixed income markets and related products and services. We serve as an industry coordinating body to promote fair and orderly markets, informed regulatory compliance, and efficient market operations and resiliency. We also provide a forum for industry policy and professional development. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association.

[2] FIA is the leading global trade organization for the futures, options and centrally cleared derivatives markets, with offices in Brussels, London, Singapore and Washington, D.C. FIA's membership includes clearing firms, exchanges, clearinghouses, trading firms and commodities specialists from about 50 countries, as well as technology vendors, lawyers and other professionals serving the industry. FIA's mission is to support open, transparent and competitive markets; protect and enhance the integrity of the financial system; and promote high standards of professional conduct.

Comptroller of the Currency ("OCC") and Federal Deposit Insurance Corporation ("FDIC," and collectively with the Federal Reserve and the OCC, the "Agencies").[3]

This letter is focused on the adverse effects on the U.S. capital markets arising from the intended treatment of fee-and commission-based services under the proposed operational risk capital framework. These adverse effects would arise because the proposal would require banking organizations to hold capital against fee and commission-based activities, effectively without limit. To avoid this excessive calibration, the Agencies should modify the proposed treatment of fee and commission-based services to mitigate the likely adverse effects on capital markets.

In addition, as proposed, the services component of operational risk would impact foreign banking organizations' ("FBOs") access to the U.S. capital markets through its treatment of inter-affiliate reimbursements for intermediate holding companies ("IHCs") of FBOs. The Agencies should therefore revise the proposal to exempt any reimbursement of an expense from a FBO parent entity to the same extent as a similar expense under the fee and commission-based services component calculation.

Although not discussed in detail in this letter, we also urge the Agencies to reduce the significant over-calibration of the broader operational risk framework, of which the services component is just one driver. Specifically, the Agencies should consider the recommendations set out in the comments submitted by the Bank Policy Institute ("BPI") and the American Bankers Association ("ABA") in response to the proposal.[4]

We urge the Agencies to carefully review our comments on the services component of operational risk as part of a broader evaluation of the U.S. bank capital framework. We also encourage the Agencies to proceed cautiously, after making an in-depth analysis available to the public, before making changes to the framework as significant as those contained in the proposal. We believe that, given the serious analytical gaps in the proposal, including as highlighted in this letter, the Agencies must make available their economic analysis justifying the proposed requirements and re-propose the rule in full with a new 120-day comment period. The re-proposal should explicitly define the specific capital problems that need to be addressed and how a proposed solution would address them. The re-proposal should also contain a robust economic analysis that convincingly demonstrates the net social benefit of the proposed changes in a data-based and transparent fashion.

I. Executive Summary

The proposal would require banking organizations to use a standardized approach to calculate operational risk capital requirements under the expanded risk-based approach

[3] See Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System and Federal Deposit Insurance Corporation, Regulatory Capital Rule: Large Banking Organizations and to Banking Organizations with Significant Trading Activity, 88 Fed. Reg. 64028 (Sept. 18, 2023).

[4] BPI and ABA joint comment letter at 7-8 and 86-101.

as a measure of three components.[5] The services component of the operational risk calculation would aim to capture fee and commission-based activities as well as "other operating" income and expenses associated with certain other banking activities. In particular, the proposal would impose capital charges based on the gross amount of income and expenses (whichever is larger) from, among other activities, retail brokerage, advisory services, custody, client clearing and similar fee-based businesses that rely on and are important to the functioning of the U.S. capital markets. In doing so, the proposal would result in an unnecessarily high calibration of required capital, which would be compounded by similar operational risks being capitalized under both the Stress Capital Buffer ("SCB") and the proposed standardized calculation for operational risk risk-weighted assets ("RWA") within the Enhanced Risk-Based Approach ("ERBA").

To address the over-calibration of operational risk capital requirements for activities arising from the ILD component, the proposal would both net ILD-related income and expenses and cap the overall measurement of these activities relative to a bank's total assets.[6] In contrast, the proposal does not include any cap on or netting of the inputs to the services component, which the Basel Committee recognized as problematic in its 2014 and 2016 consultations. In its 2014 consultation, the Basel Committee stated that banking organizations specializing in providing fee-based financial services faced disproportionately high capital requirements due to the structure of the proposed framework.[7]

The committee went a step further in its 2016 consultation by explicitly recognizing that the manner in which the services component was calculated would subject "banks with a high fee component . . . [to] capital requirements that are too conservative relative to the operational risk faced by these banks."[8] One recent analysis expresses a similar concern as the Basel Committee, noting that "[l]arge businesses (as measured by the business indicator) would face significant Operational Risk RWA charges regardless of risk profile."[9] In its 2016 consultation, the Basel Committee proposed a solution to this problem for high fee-earning banking organizations,[10] but ultimately did not adopt it.. As

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[5] The proposal would measure three components that are intended to capture a banking organization's business volume: the interest, lease and dividend ("ILD") component; the financial component; and, as most relevant to this letter, the services component.

[6] The financial component would also net relevant income and expenses to avoid inappropriately high capital requirements.

[7] Basel Committee on Banking Supervision, *Consultative Document: Operational Risk – Revisions to the Simpler Approaches* (Oct. 2014) at 3-4, https://www.bis.org/publ/bcbs291.pdf. In the 2014 Consultative Document, the Basel Committee stated that: "A small number of banks that are highly specialised in fee businesses have been identified as facing a disproportionately high capital impact under the [business indicator]. The problem stems from the structure of the [business indicator], which was designed to capture the operational risk profile of a universal bank and does not lend itself to accurate application in the case of banks engaged predominantly in fee-based activities."

[8] Basel Committee on Banking Supervision, *Consultative Document: Standardised Measurement Approach for Operational Risk* (March 2016) at 4, https://www.bis.org/bcbs/publ/d355.pdf ("2016 Consultative Document"). In the 2016 Consultative Document, the Basel Committee also proposed a different approach to the calculation of the services component, which it did not end up adopting in the Basel framework.

[9] See Morgan Stanley Research and Oliver Wyman, "Into the Great Unknown," (Nov. 2023) at 11, https://elements.visualcapitalist.com/wp-content/uploads/2023/11/1700642580388.pdf.

[10] The Basel Committee specifically proposed that a banking organization with fee-based income or expenses that is greater than 50% of the firm's unadjusted business indicator would hold capital against 10% of the firm's fee-based income or expenses that exceeds

a result, the services component in the proposal remains overly conservative relative to the operational risks faced by banking organizations.

Given the potential significant impact that this proposal would have on retail customers and other market participants, it is concerning to us that the Agencies have not conducted a thorough economic analysis to evaluate how the proposal's increased capital requirements on the financial services provided by banks would impact access to financial services or affect the U.S. economy. The Agencies have acknowledged that the proposal would increase costs on banking organizations but claim that "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."[11] The Agencies, however, failed to substantiate this point with detailed economic analysis. The Agencies have also estimated that the proposal would increase RWAs for operational risk by $1.950 trillion but have only accounted for $952 billion of that total as operational risk resulting from lending and trading activities.[12] Thus, a significant portion of the $1 trillion shortfall is attributable to the services component of operational risk.

The treatment of fee-based income under the proposal could have adverse effects on the U.S. capital markets by over-calibrating relatively low-risk services, potentially impacting U.S. banking organizations' engagement in these activities. It would also contravene longstanding U.S. financial services policy. (Section II)

- The absence of netting, capping, or an equivalent mitigating mechanism for the services component would result in the over-calibration of the capital treatment of these business lines.
- U.S. banking organizations and FBOs operating in the United States are key players in the provision of fee-based services that rely on and are important to the functioning of the U.S. capital markets. The Agencies should not reflexively implement the Basel standards without considering the unique aspects of the U.S. markets, the importance of banking organizations' roles in these markets and the potential for adverse effects on financial markets and the economy writ large.
- The over-calibration of the services component could factor into banking organizations' decisions about the extent to which, and on what terms, to engage in relatively low-risk fee-based activities that provide healthy diversification benefits. This over-calibration could accordingly have a significant impact on end users, including both retail customers (whether directly or indirectly) and other market participants.

50% of its unadjusted business indicator. 2016 Consultative Document at 4. The Associations do not endorse the 2016 consultation's solution and have proposed our own approach to recalibrating the services component that we believe would better address the issues raised in this letter. However, we have included the Basel Committee's proposed solution here for illustrative purposes.

[11] 88 Fed. Reg. 64028, 64167.

[12] Bank Policy Institute, *The Trillion Dollar Omission in Vice Chair Barr's Cost Analysis* (Oct. 12, 2023), https://bpi.com/the-trillion-dollar-omission-in-vice-chair-barrs-cost-analysis/.

- The proposed approach to operational risk also would contravene decades of U.S. financial services policy, which has encouraged diversification in banking organizations' business models.

- The Agencies have not provided sufficient rationale in support of the proposed approach or conducted an economic analysis to justify the departure from established U.S. financial services policy goals.

The treatment of income from inter-affiliate reimbursements could have adverse effects on the U.S. capital markets by over-calibrating capital requirements for inter-affiliate services that provide FBOs with access to these markets. (Section III)

- Because of the scope of the operating income and expenses input, the services component would subject inter-affiliate reimbursements that a U.S. subsidiary of a FBO receives from its foreign parent to an over-calibrated capital charge. The reason for this over-calibration is that the proposal (as well as the international Basel standard) allows for certain exemptions of expense items, such as staff salary costs and infrastructure costs, but does not correspondingly exempt income, including inter-affiliate reimbursement income, from similar items. As a result, the services component's treatment of income from inter-affiliate reimbursements would overstate the impact of transfer pricing mechanisms for IHCs.

The Associations support the adoption of an alternative approach to the calculation of operational risk for services related income and an exemption of income from inter-affiliate reimbursements from the operational risk capital requirement. The Agencies should also address the broader over-calibration of operational risk in the capital framework. (Section IV)

- To address the excessive treatment of fee-based income under the proposal, we strongly urge the Agencies to consider the recommendations made in the letter submitted jointly by BPI and ABA in relation to the services component of the business indicator.[13] To address the punitive treatment on inter-affiliate reimbursements, we recommend that the Agencies exempt income received from the reimbursement of services provided by a U.S. subsidiary to a foreign parent from the scope of the services component to the same extent as a similar expense would be exempted from the services component calculation. This revision would ensure consistent treatment of income and expenses for these internal transfer pricing transactions and common application of the rule.

- The Agencies should also address other drivers of the broad over-calibration of operational risk capital requirements, including for banks with broad-based business models where the services component is not the primary driver of operational risk RWAs. Specifically, the Federal Reserve should modify its approach to stress testing of operational risk to reduce the over-calibration of risks that will occur through the combined effect of SCB and new minimum capital

[13] BPI and ABA joint comment letter at 87-97.

requirements. The Agencies should also consider the adjustments to the Internal Loss Multiplier ("ILM") and reductions in the coefficients within the Business Indicator Component ("BIC") that are outlined in the BPI and ABA letter.[14]

II. The treatment of fee-based income under the proposal could have adverse effects on the U.S. capital markets by over-calibrating the capital treatment of relatively low-risk services, which could factor into U.S. banking organizations' decisions of the extent to which and on what terms to engage in these activities. It would also contravene longstanding U.S. financial services policy.

A. The proposed approach to fee-based income i) does not accurately reflect the risks associated with asset-light capital markets fee-based businesses, ii) could disincentivize banking organizations from engaging in these beneficial activities in the future, and iii) consequently may impact access to, and raise costs associated with, capital markets services for both retail and institutional customers.

The proposal fails to account for the lower risks associated with many fee-based business lines that rely on and are important to the functioning of the U.S. capital markets, such as retail brokerage, advisory, clearing, and custody businesses. As a result, the proposed treatment of fee-based income may factor into decisions about the extent and type of involvement of banking organizations in these businesses, potentially reducing the benefits that banks derive from engaging in a diverse range of activities and impacting access for a wide range of market participants, including retail customers. Given the importance of the U.S. capital markets to corporate funding and the accumulation of retirement income relative to other jurisdictions, any impact on participant access would be problematic.

i. The services component is over-calibrated to the risks that asset-light fee-based businesses pose to banking organizations.

Many fee-based capital markets businesses are asset light. Brokerage, advisory, clearing, and custody services by definition involve acting on behalf of customers to buy, sell, and safekeep securities and other financial instruments, without assuming principal risk. In these business models, it is usually banking organizations' customers, not banking organizations themselves, that ultimately own the assets and bear the investment-related risk for the underlying asset. Thus, these fee-based business lines do not present significant credit or market risks to banking organizations.

Instead, the primary risk to banking organizations from fee-based business lines is operational risk. The operational risk resulting from these businesses, including those involving brokerage, advisory, custody, and clearing activities, is low or moderate for most banking organizations given their business models and/or the regulatory framework

[14] *Id.* at 86-87, 93-97.

to which these businesses are already subject.[15] The risks associated with each of these business lines vary to some extent, but are usually effectively managed.

The services component of the proposal, however, is calibrated as if the operational risk from these activities were a significant threat to banking organizations' stability. The proposal would use size and volume of fee-based businesses as the sole proxy to determine the appropriate operational risk capital charge, regardless of the risk posed. Unlike for the ILD and financial components of operational risk, the proposal would not implement any limiting principle, such as netting or capping, to the services component of a bank's activities. This approach is thus not appropriately calibrated to the actual operational risks posed by these business lines.

Moreover, other aspects of the prudential framework, such as the GSIB surcharge and leverage and supplementary leverage ratios, are more appropriate tools to account for the size and volume of activities of a banking organization from a capital perspective. Therefore, the proposed operational risk capital requirement, and in particular the services component, should be more closely linked to the risks posed by various activities, rather than just the size or volume of the business activity.

Below, we briefly describe each of these fee-based business activities to demonstrate the modest operational risks that they generally pose, which is further supported by a recent study comparing operational loss rates of banking organizations' different business lines, including retail brokerage, advisory, custody, and clearing.

- **Retail Brokerage.** Retail brokerage services generally involve the collection of customer assets, advice regarding asset allocation and diversification and the selection of securities, funds, and other vehicles in which customers invest their assets. In addition, retail brokers facilitate securities trades for their clients, and often rely on institutions providing clearing and custody services to settle and safekeep the underlying transaction and related assets. Given this business model, the operational risks posed by these brokerage services are modest and can be effectively managed by banking organizations.

- **Investment Advisory Services.** Investment advisory-based business lines, such as asset management or wealth management, involve low operational risks to banking organizations. When acting as asset managers, banking organizations are hired by investors to act as their fiduciary with respect to the allocation of capital on their behalf. Asset managers do so through an array of diversified investment strategies offered in a number of forms, including mutual funds, ETFs, private funds, and separately managed accounts. There is a clear legal separation between the assets of an asset manager and customer assets, which are often separately held by a custodian chosen by the customer, and asset management firms are not

[15] The 2016 Consultative Document supports the notion that these types of fee-based businesses may pose lower operational risks, given that it recognizes that "banks with a high fee component in respect to the overall [business indicator] amount have a very high [business indicator] value which results in capital requirements that are *too conservative relative to the operational risk* faced by these banks" (emphasis added). 2016 Consultative Document, *supra* note [•] at 4.

permitted to commingle the two.[16] Similar to asset managers, wealth managers work with customers to achieve their financial goals in the short and long term, but do so by providing a more comprehensive set of investment advisory services, including investment management, financial planning, tax advice or estate planning, in exchange for a fee. Given these business models, investment advisory services generally do not pose significant operational risk as they primarily deal in the provision of advice – a fact evidenced by the very low operational loss rates of such services relative to other business lines examined in the recent study by ORX highlighted below.[17]

- **Custody.** Custody services involve the settlement, safekeeping and reporting of customers' securities, cash and other assets for a variety of customers, including mutual funds, retirement plans, bank fiduciary and agency accounts, bank marketable securities accounts, insurance companies, corporations, endowments and foundations, and private banking clients. While custody services can be more susceptible to operational risk given the amount of information and transactions processed on a daily basis, "effective risk identification and controls can greatly mitigate these risks."[18] A limited number of banking organizations specialize in custody services, and accordingly, are heavily invested in maintaining the strong policies and procedures, control environment and technology that act as essential risk management tools for this business line. These factors effectively mitigate the operational risks associated with custody services.

- **Client Clearing.** The provision of derivatives, U.S. Treasuries, repurchase agreements, and equity clearing services by clearing members to clients provides access to central clearing, a key component of the global post-crisis financial services reforms, to those entities that cannot be or choose not to be clearing members. Clearing services are also a way for entities subject to the clearing mandate to meet their regulatory obligation. The current clearing models (1) aim to minimize credit exposure of the parties, (2) protect clients' initial margin contributions, (3) allow for prompt "porting" or close-out of a position if a clearing member defaults and (4) allow for prompt close-out of positions if a client defaults. While clearing members typically charge a fee for the provision of this service to clients, they also get charged a fee by the exchanges and central counterparties ("CCPs") for accessing their infrastructure and consuming their services. Not everyone can become a clearing member of a CCP, as CCP membership criteria are very strict, so only the most sophisticated and well-capitalized institutions act as clearing members. In addition, clearing members are subject to complex and detailed regulations which, together with the sophisticated

[16] See Securities Industry and Financial Markets Association, *The Asset Management Industry*, https://www.sifma.org/wp-content/uploads/2018/01/SIFMAAMGFactSheet-AssetManagers.pdf.

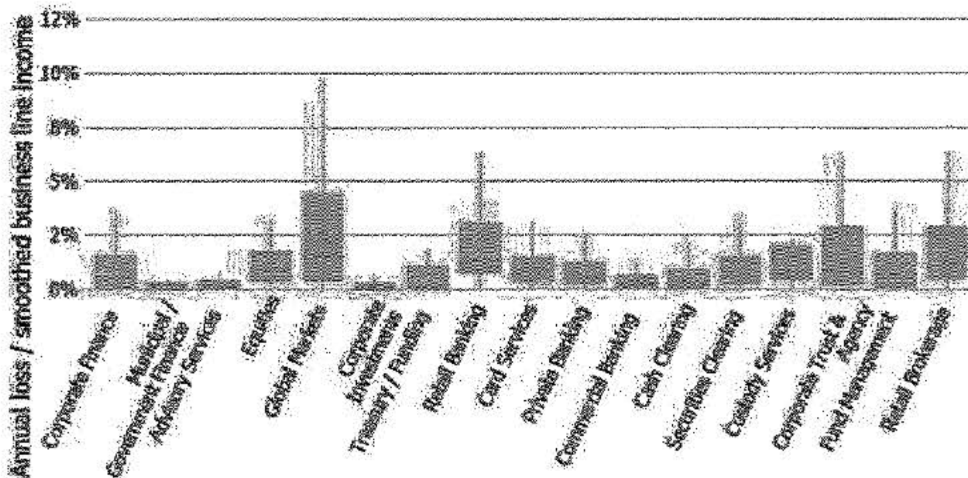
[17] ORX, "Basel III and Standardized Approaches to Capital: Analysis of ORX Global Banking Data in Response to Regulatory Capital Reforms," (Oct. 2023), https://orx.org/resource/basel-iii-and-standardised-approaches-to-capital-2023.

[18] See the Office of the Comptroller of the Currency, Comptroller's Handbook on Custody Services (Jan. 2002), https://www.occ.gov/publications-and-resources/publications/comptrollers-handbook/files/custody-services/pub-ch-custody-services.pdf.

contractual arrangements and comprehensive regulatory oversight, all serve as mitigants for operational risks that exist in the clearing ecosystem.

The low or modest operational risks of these business lines are reflected in the results of a recent study that ORX completed in October 2023 investigating the relative riskiness of various fee-based business lines relying on twenty years of actual loss data for U.S. banks.[19] As shown in Figure 1 below, this study found significant variations in operational loss rates among services-related business lines, but advisory, custody and clearing services were determined to have low operational loss rates in the United States (with operational loss rates of advisory services being particularly low). While retail brokerage activities posed a higher risk based on its operational loss history, it remained lower than certain other banking activities.

Figure 1: Loss Over Annual Smoothed Income at Business Line Level 2 – U.S. Firms



Source: ORX, https:orx.org/resource/basel-iii-and-standardised-approaches-to-capital-2023.

Because retail brokerage, advisory, custody and clearing services are typically asset-light, the most effective way in which to regulate them is through a focus on customer protection mandates (which is largely achieved through existing securities, derivatives and commodities laws). These regulations protect end users and, in doing so, also lower the operational risks to market participants, reflected in the relatively low operational loss rates of these business activities in the figure above.

The Agencies' proposed approach to the services component, which penalizes fee-based income based on size or business volume without any limiting principle (such as the actual risks posed by the business activity, which varies as illustrated above), should therefore not be adopted as proposed.

ii. <u>Fee-based business lines offer a durable and diversified source of revenue for banking organizations, which may make these</u>

[19] ORX study at 6.

organizations less susceptible to the negative effects of market downturns.

Fee-based businesses offer durable, diversified sources of revenue to banking organizations that are less susceptible to significant variation when faced with market volatility. Banking organizations rely on these sources of revenue as a strategy to weather the lower-interest environments and market volatility more generally.[20] A recent study supports the view that banks that are diversified in a number of different ways, including in terms of their geographic footprint and diversity in certain business activities, have been able to lend more, reduce risk and stabilize their revenue streams, allowing them to maintain lending even during economic downturns.[21] As a result, maintaining a robust, diversified business offering, including fee-based businesses, can help to support the safety and soundness of banking organizations. This business mix in turn benefits banking organizations' customers by providing access to a broad array of services, including during times of financial instability. Engaging in certain fee-based capital markets-related business lines can therefore accrue benefits for banking organizations, their customers, and the financial system as a whole. The operational risk proposal should be revised to take this into account.

iii. The operational risk capital requirement may limit access and increase costs of brokerage, advisory, custody, and clearing services for both retail and institutional customers.

The proposal could make certain fee-based business lines within a banking organization less economic, which could result in a business composition that is relatively less stable. Although the proposed approach to fee-based businesses should seek to address relevant operational risks, it should do so without discouraging banking organizations' involvement in these activities. The proposal may cause banking organizations to reconsider the scale and scope of their brokerage, advisory, clearing, and custody activities. If that occurred, the proposal could limit access to core services that rely on and are important to the functioning of the U.S. capital markets for both retail and institutional investors.[22] Any reduction in the number of banking organizations that engage in certain business activities, such as clearing, may increase the potential for operational risk or exert pressure on the banking organizations that remain in the market. In this regard, the U.S. Commodity Futures Trading Commission noted, "[f]urther contraction of clearing members could increase systemic risk, and the associated reduction in the provision of clearing services is inconsistent with the fundamental

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[20] See, e.g., Speech by Luis de Guindos, Vice-President of the European Central Bank, *Challenges for Bank Profitability* (May 1, 2019), https://www.bis.org/review/r190502a.htm; Bank of International Settlements, Financial Stability Implications of a Prolonged Period of Low Interest Rates (July 2018), https://www.bis.org/publ/cgfs61.htm.

[21] See M. Gelman, I. Goldstein and A. MacKinlay, *Bank Diversification and Lending Resiliency* (Apr. 17, 2023), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4147790.

[22] For example, one recent analysis noted that "[t]he significant divergence in the impact [of the proposal] on specific products could redefine who participates in certain wholesale banking activities and the cost and quality of capital, liquidity, and broader services that corporate and institutional clients receive." See Morgan Stanley Research and Oliver Wyman at 11.

reforms in Dodd-Frank."[23] Reduced competition in the provision of fee-based services would thus increase risk in the broader financial system.

In addition, the increased capital requirements associated with the proposed operational risk rules could force banking organizations to pass on the associated costs to their customers for various fee-based services, including through increases to performance, management, retainer, administrative, and other fees. These cost increases could inhibit ordinary Americans access to these services and, therefore, create a barrier to achieving their financial goals. As a result of increased costs, small institutional investors may end up shifting their investment strategies to lower cost alternatives, which could harm their financial outlook. These types of cost increases or reductions in service offerings could also flow through to firms seeking to raise funds through the capital markets, inhibiting business growth.

Further, the composition of the U.S. market should be considered when evaluating the over-all impact of the over-calibration of the services component of operational risk on retail brokerage, advisory, custody, clearing, and other fee-based services. For example, in other jurisdictions, banking organizations are less prevalent providers of such services relative to in the United States.[24] Because the United States finances approximately 75 percent of corporate activity through the capital markets,[25] the negative impacts on access to capital markets that would result from the treatment of fee-based income in the proposal would be significantly more harmful to the availability of funding to the real economy than in other jurisdictions. For this reason, the Agencies should not reflexively implement the international Basel standards without considering these differences and the potential for significant long-term adverse effects on U.S. financial markets and the economy writ large.

B. The proposed approach to the services component of operational risk under the Basel III endgame contravenes decades of U.S. financial services policy, which has encouraged diversification in banking organizations' business models.

The proposed approach to the services component of operational risk may impact the extent to which, and on what terms, banking organizations engage in fee-based businesses that are important to the functioning of the U.S. capital markets. In addition to being harmful to banking organizations, retail investors, and other market participants, this potential result would contravene decades of U.S. financial services policy.

[23] See U.S. Commodity Futures Trading Commission, Comment Letter regarding Capital Adequacy: Standardized Approach for Calculating the Exposure Amount of Derivative Contracts (Feb. 15, 2019), https://www.cftc.gov/sites/default/files/2019-02/SA-CCRCommentLetter021519.pdf.

[24] See Securities Industry and Financial Markets Association, Blog Post, *Our Markets* (*citing* data from the New Financial Global Capital Markets Growth index), https://www.sifma.org/about/our-markets/ ; Securities Industry and Financial Markets Association, Press Release, *SIFMA Statement on Proposed Rule to Implement the Basel III 'Endgame' in the U.S.* (June 27, 2023), https://www.sifma.org/resources/news/sifma-statement-on-proposed-rule-to-implement-the-basel-iii-endgame-in-the-u-s/.

[25] *Id.*

Specifically, for decades U.S. financial services policy has recognized the benefits of business diversification, including through banking organizations' involvement in fee-generating capital markets activities, like asset management and retail brokerage activities. In fact, U.S. policymakers and banking regulators have long viewed expansion into these types of activities as a buttress to the safety and soundness of banking organizations and as one of the key drivers of growth, especially when navigating economically uncertain times. On this basis, prior to the adoption of the Gramm-Leach-Bliley Act ("GLBA"),[26] the Agencies recognized the benefit of, and tried to accommodate, the expansion into certain fee-generating business activities, such as asset management activities.[27] Subsequently, in the lead-up to the eventual passage of the GLBA, a key theme in debates and discussions was the benefit of diversification for banking organizations, including from a safety and soundness as well as an end-user perspective, as reflected below:

- In a 1987 report by the Congressional Research Services ("CRS"), which set forth the arguments for and against adopting the GLBA, the CRS highlighted that the additional securities activities "that depository institutions [were] seeking [to engage in] [were] both low-risk by their very nature, and would reduce the total risk of organizations offering them -- by diversification."[28]

- In testimony before the Senate Banking Committee on the GLBA in February 1999, then Comptroller of the Currency John Hawke stated that "[p]roviding banks - large and small - the opportunity to maintain strong and diversified earnings through a range of prudently conducted financial activities is [a] . . . critical component of safety and soundness. Historically, banks have been heavily dependent on net interest margins – generated through traditional lending - as a source of earnings. This makes banks particularly vulnerable to changes in economic conditions."[29]

- Similarly, during congressional debates relating to the GLBA, members of Congress highlighted the benefits of diversification of banking businesses, including "increase[ing] competition, promot[ing] innovation, lower[ing] consumer costs, and allow[ing] the United States to maintain its world leadership in the financial services industry."[30]

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[26] Among other things, the GLBA made it permissible for banking organizations to engage in a more diverse array of activities from which they had previously been barred.

[27] See, e.g., Board of Governors of the Federal Reserve System, Interpretive Letter to First Union Corporation, (June 24, 1999), https://www.federalreserve.gov/boarddocs/legalint/BHC_ChangeInControl/1999/19990624/.

[28] Congressional Research Service, Glass-Steagall Act: Commercial vs. Investment Banking (June 29, 1987), https://www.everycrsreport.com/files/19870629_IB87061_7206629ee76f98f929ca4286dd5388a9feb12635.pdf.

[29] Office of the Comptroller of the Currency, Statement of John D. Hawke Jr., Comptroller of the Currency before the Committee on Banking, Housing and Urban Affairs, United States Senate (Feb. 24, 1999), https://www.occ.gov/news-issuances/congressional-testimony/1999/pub-test-1999-13-oral.pdf.

[30] See United States House of Representatives, Conference Report on S. 900, Gramm-Leach-Bliley Act, Congressional Record Vol. 145, No. 154 (Nov. 4, 1999), https://www.congress.gov/congressional-record/volume-145/issue-154/house-section/article/H11513-8.

Since the adoption of the GLBA, banking regulators—both in the United States and abroad - have echoed and reinforced the basic policy imperatives underlying the GLBA. As reflected below, policymakers recently have underscored the benefits of banking organizations having a diversified business mix, in a similar manner to the debates of over 20 years ago. For example:

- In response to questioning regarding the benefits of diversification of business lines among regional banks at a 2019 Brookings Institution event, then-FDIC Board member Martin Gruenberg stated that he believed "diversification is overall a plus, especially if it's true diversification and you aren't dealing with asset types or business lines that have a correlation with one another."[31]

- In 2019 remarks, the European Central Bank Vice-President Luis de Guindos stated that: "Developing sustainable revenue streams beyond net interest income – such as fee and commission income – remains vital in order to buttress profitability [for banking organizations] in the coming years." De Guindos further highlighted that "bank profitability matters for financial stability" and that "banks with poor structural profitability can face higher funding costs and may be tempted to take on more risk."[32]

- Finally, in recent remarks regarding the Basel III endgame proposal, Federal Reserve Governor Michelle Bowman similarly spotlighted these benefits and highlighted the downside of increased capital charges targeting fee-generating businesses: "Diversification in revenue streams can enhance the stability and resilience of a bank, and excessive capital charges for these revenue-generating activities could create incentives for banks to roll back the progress they have made to diversify revenues."[33]

The Agencies have not provided any rationale in support of the proposed approach to justify this departure from established U.S. financial services policy goals. Nor have they conducted a robust economic analysis aimed at fully understanding the impact that the proposed approach would have on the banking sector or the U.S. economy.[34] For example, the proposal does not account for approximately $1 trillion of estimated increase in operational RWAs, a significant portion of which will be driven by

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[31] See The Brookings Institution, Transcript from *Recession Preparation: What Happens When a Big Domestic Bank Fails?* (Oct. 16, 2019), https://www.brookings.edu/wp-content/uploads/2019/10/es_20191016_recession_banks_transcript.pdf.

[32] See, e.g., European Central Bank, Speech by Luis de Guindos, Vice-President of the European Central Bank, *Challenges for Bank Profitability* (May 1, 2019), https://www.ecb.europa.eu/press/key/date/2019/html/ecb.sp190501~7733ecc1a9.en.html.

[33] See Board of Governors of the Federal Reserve System, Statement by Governor Michelle Bowman on the Proposed Amendments to the Capital Framework (July 27, 2023), https://www.federalreserve.gov/newsevents/pressreleases/bowman-statement-20230727.htm .

[34] In a joint trade association letter, SIFMA, BPI and other trade associations specifically highlighted the dearth of data and analyses exhibited in the Basel III endgame proposal to advocate for its re-proposal. See Securities Industry and Financial Markets Association, Bank Policy Institute, et al., Comment Letter regarding Request for Re-Proposal of Regulatory Capital Rule to Remedy Administrative Procedure Act Violations (Sept. 12, 2023), https://bpi.com/wp-content/uploads/2023/09/Letter-to-Agencies-Re-Missing-Information-2023.09.12-vF.pdf.

the proposed treatment of services related income[35] The proposal also does not analyze the effect that the proposed services component would have on retail and other market participants' access to capital markets-based and related products and services, the limitations that the proposal could place on Americans' ability to save, or the impact that the resulting costs of the proposal could have on wealth creation and upward mobility for Americans.

III. The treatment of income from inter-affiliate reimbursements could have adverse effects on the U.S. capital markets by over-calibrating capital requirements for inter-affiliate services that provide FBOs with access to U.S. capital markets.

The proposed approach to the services component also would inappropriately include certain reimbursements of expenses that U.S. affiliates receive from their foreign parent within the scope of the "other operating income" element of this component. The result of this approach would be to subject IHCs to an over-calibrated capital charge on these reimbursements to the U.S. subsidiary. These reimbursements may be tied to the provision of ancillary services to better enable the foreign parents' access to the U.S. capital markets. Therefore, imposing this kind of charge on IHCs of FBOs may disincentivize their U.S. capital markets activities. In this regard, the effect that a broadly scoped "other operating income" element would have on capital markets activities of banking organizations could be similar to the impact of an uncapped and un-netted "fee income" element of the services component, as described above. The Agencies should accordingly adjust the approach to the services component so that IHCs can appropriately assess the capital requirements for internal transfer pricing frameworks.

As currently proposed, the services component would result in the inconsistent treatment of income and expenses for similar transactions involving a foreign parent and U.S. affiliate. The proposal, as well as the international Basel standard, allow for certain exemptions of expense items, such as staff salary costs and infrastructure costs, from the "other operating income and expenses" element of the services component.[36] In stark contrast, the proposal does not exempt income from similar items, including income received as part of a reimbursement from a foreign parent to a U.S. subsidiary, from the same element of the services component. So, for example, if a U.S. subsidiary provided services to a foreign parent, any income it received as reimbursement would be subject to a capital charge. If, on the other hand, the transaction was reversed and the U.S. subsidiary outsourced services to the foreign parent, expenses from this transaction could be excluded from the operational risk RWA calculation. This result makes little sense.

This inconsistent treatment is particularly problematic for IHCs because reimbursements from transactions between a foreign parent and its U.S. subsidiary show up as income on the U.S. subsidiary's income statement. This income would then be

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[35] Bank Policy Institute, *The Trillion Dollar Omission in Vice Chair Barr's Cost Analysis.*

[36] The scope of "operating income" sweeps broadly and aims to capture "rent and other income from other real estate owned . . . [and] all other income items not currently itemized in the regulatory reports, which are not included in other business indicator items and are not specifically excluded from the business indicator." 88 Fed. Reg. 64028, 64084 n.186.

factored into the operational risk RWA calculation through the "other operating income" element of the services component, without benefiting from an exclusion. Meanwhile, these reimbursements would not affect the calculation of the services component for U.S. banking organizations because they are eliminated from domestic banks' balance sheets upon consolidation. As proposed, the treatment of income from inter-affiliate reimbursements under the services component would therefore overstate the impact of transfer pricing mechanisms for IHCs.

Moreover, attributing a capital charge to a U.S. affiliate of a FBO is inconsistent with the risks posed to the U.S. affiliate. When a U.S. affiliate provides services to a FBO to help the FBO access U.S. capital markets, it is often the FBO - not the U.S. affiliate - that bears the risk from the transaction, including for operational losses. The U.S. affiliate acts merely as a conduit and does not provide financial services to the client.

Not only is this treatment of income from inter-affiliate reimbursements illogical for the reasons described above, it could also have implications for the capital markets activities of FBOs since U.S. subsidiaries, at times, provide services to foreign affiliates to facilitate access to the U.S. capital markets. Reimbursements for these services would be subject to an operational risk capital charge under the proposal. This capital treatment could curtail FBOs' involvement in the U.S. capital markets as they may seek alternative - and potentially more expensive - mechanisms to access such markets. FBOs are an essential part of maintaining the competitiveness and strength of U.S. markets and should not be unduly impacted in their access to these markets.[37]

IV. The Associations support the adoption of alternative approaches to the calculation of the services component of operational risk capital requirement and an exclusion of inter-affiliate reimbursements. The Agencies should also address the broader over-calibration of operational risk in the capital framework.

For the reasons articulated above, the Agencies should not adopt the operational risk capital requirements for services-related income as proposed. Instead, the Agencies should adopt the following alternative approaches to the calculation of the services component:

A. The Agencies should adopt an alternative approach to the calculation of the services component of operational risk.

As proposed, the services component is not sufficiently calibrated to the modest risks associated with many of the fee-generating businesses that rely on and are important to the functioning of the U.S. capital markets in which banking organizations engage. It further fails to recognize the benefits that accrue to banking organizations, retail consumers (whether directly or indirectly) and other markets participants through banking organizations' involvement in fee-based businesses and activities. We therefore strongly encourage the Agencies to consider the proposed modifications to the

[37] Katie Kolchin, CFA and Carter McDowell, 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.

calculation of the services component of the operational risk capital framework laid out in the BPI and ABA comment letter.[38]

B. The Agencies should revise the services component calculation to largely exempt income from the reimbursement of an expense from a parent entity.

In addition to the above changes, the Agencies should revise the services component so that, to the extent that an expense is exempted from the services component calculation, the associated reimbursement for that expense from a parent entity would be excluded as well. Making this change would ensure the consistent treatment of income and expenses for internal transfer pricing transactions and common application of the rule, as well as avoid unduly penalizing IHCs based on their foreign banking entity structure. From a practical perspective, subjecting these inter-affiliate reimbursements to a capital charge could impact FBOs' participation in the U.S. capital markets, curtailing access, both in the United States and abroad, to these globally important markets. This alternative approach may help to mitigate these potential negative impacts.

C. The Agencies should address the broader over-calibration of operational risk by modifying the approach to the stress testing of operational risk and making other changes to the proposal.

As noted above, the Agencies should also address other drivers of the significant over-calibration of operational risk capital requirements, particularly for banks with broad-based business models where the services component is not the primary driver of operational risk RWAs. Specifically, the Federal Reserve should modify its approach to stress testing of operational risk to reduce the over-calibration of risks that will occur through the combined effect of the SCB and new minimum capital requirements. The Agencies should also consider the adjustments to the ILM and reductions in the coefficients within the BIC that are outlined in the BPI and ABA letter.[39]

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[38] BPI and ABA joint comment letter at 87-97.

[39] *Id.* at 86-87, 93-97.

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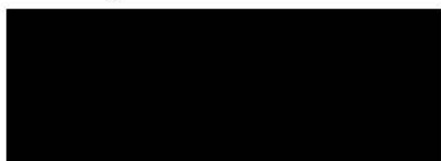
SIFMA and FIA appreciate the Agencies' consideration of these comments and would be pleased to discuss our views in greater detail if it would assist with their deliberations on the Basel III endgame proposal. Please contact Peter Ryan at pryan@sifma.org or at (202) 962-7452 and Jacqueline Mesa at jmesa@fia.org or at (202) 772-3040 if you wish to discuss the points raised in this letter further.

Sincerely,



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