United States Senate

WASHINGTON, DC 20510

December 6, 2023

The Honorable Jerome Powell
Chairman
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

The Honorable Martin Gruenberg
Chairman
Federal Deposit Insurance Corporation
550 17th Street NE
Washington, DC 20429

Mr. Michael Hsu
Acting Director
Office of the Comptroller of the Currency
400 7th Street SW
Washington, DC 20219

Dear Chairman Powell, Chairman Gruenberg, and Acting Director Hsu:

On November 13, 2023, you received a letter[1] outlining the concerns of thirty-nine U.S. Senators regarding the Notice of Proposed Rulemaking (NPR)[2] issued jointly by the Board of Governors of the Federal Reserve System (FRB), the Federal Deposit Insurance Corporation (FDIC), and the Office of the Comptroller of the Currency (OCC). This letter serves as a supplemental to that effort, specifically to outline our deep concerns with the operational risk portion of the NPR.

As you are aware, the NPR serves as the culmination of an interagency effort, commonly referred to as Basel III endgame, to adhere U.S. banking regulations to the Basel Committee on Banking Supervision (BCBS)'s international capital standards (the Basel III Framework or the Framework).[3] Revised following the 2008 Financial Crisis, the Basel III Framework functions as the global standards set for prudential regulation.

From its inception, the Basel III Framework was intended to harmonize global banking regulatory standards, not increase capital requirements. Speaking on the recently finalized Framework in 2017, then-Chair of the Group of Governors and Heads of Supervision (GHOS) and President of the European Central Bank Mario Draghi stated the goal of the Framework is "not to increase capital."[4] Similarly, in 2016, then-Governor of the Bank of England Mark Carney stated there was "...agreement of all the members of the G20 and the steering committee of the Basel Group, that there would be no significant increase in overall capital requirements as a consequence of finishing this process of Basel III."[5] Most explicitly, the very introduction of the Basel III Framework reads, "As a result of this assessment, the Committee focused on not

[1] https://www.banking.senate.gov/imo/media/doc/basel_iii_banking_gop_letter.pdf
[2] https://www.federalregister.gov/documents/2023/09/18/2023-19200/regulatory-capital-rule-large-banking-organizations-and-banking-organizations-with-significant
[3] https://www.bis.org/baselframework/BaselFramework.pdf
[4] https://www.bis.org/bcbs/b3/ghos_20171207_2.htm
[5] https://www.bankofengland.co.uk/-/media/boe/files/financial-stability-report/2016/transcript-november-2016.pdf

significantly increasing overall capital requirements."[6] This approach – bringing domestic banking regulations in line with the Basel III Framework without significantly raising capital requirements – is the path that financial regulators in both the United Kingdom (UK) and the European Union (EU) have largely adopted. Concerningly, the NPR issued by the FRB, FDIC, and OCC (the joint regulators) shows no similar restraint.

The changes contemplated to operational risk highlight the disparity between the Basel III Framework, as implemented by both the UK and EU, and the approach taken by U.S. regulators. Though various sources[7] have produced a range[8] of estimates[9] for the risk-weighted assets (RWAs) and corresponding capital levels necessary to meet the NPR's operational risk requirements, there is one undeniable theme – the total burden to the U.S. financial system for the operational risk component is expected to be between $1-2 trillion. In fact, the operational risk changes comprise close to 90% of the projected capital increase under the NPR.[10] Projections using economic research conducted by the BCBS indicate the operational risk requirements alone would diminish U.S. gross domestic product by nearly $90 billion every year.[11] Given these points, there is simply no way to view changes of such magnitude as anything but significant.

This push to aggressively increase capital requirements for operational risk would be understandable if operational risk was an unaccounted-for blind spot in U.S. financial regulation. However, that is simply not the case. The Fed's stress capital buffer (SCB), which is derived from supervisory stress tests that include operational risk losses as a component, already exists. As an institution-specific capital add-on, the SCB forces financial institutions to reserve capital, in part, for potential operational risk exposures, thereby incentivizing the management of these risks. Furthermore, the current U.S. standardized framework also covers significant components of operational risk through the calibration of credit and market risk capital charges. Barring any changes, the implementation of the NPR's operational risk component would thus require many U.S. financial institutions to reserve multiple, substantial capital stacks for the same potential exposure.

Additionally, in drafting the proposed operational risk requirements, the joint regulators purposefully diverged from the standard present in the Basel III Framework as well as the methodology ultimately adopted by the UK and EU. Where the UK and EU opted to set their internal loss multiplier (ILM) – which functions as the scaling factor present in the operational risk calculation – equal to one, the NPR set forth by the joint regulators adopts a significantly more aggressive approach by setting a floor of one for the ILM.[12] Effectively, this forces the level of capital required to cover operational risks at U.S. firms to scale steeply upwards, while

---

[6] https://www.bis.org/bcbs/publ/d424.pdf
[7] https://fsforum.com/a/media/fsf_factsheet_b3e-oprisk-requirements_110923.pdf
[8] https://bpi.com/about-excessive-calibration-of-capital-requirements-for-operational-risk
[9] https://www.federalreserve.gov/newsevents/pressreleases/waller-statement-20230727.htm
[10] https://bpi.com/about-excessive-calibration-of-capital-requirements-for-operational-risk/#:~:text=Based%20on%20analysis%20released%20by.the%20banking%20agencies'%20Basel%20proposal
[11] https://www.bis.org/bcbs/publ/wp37.pdf
[12] https://www.pwc.com/us/en/industries/financial-services/library/our-take/basel-iii-endgame.html#content-free-1-5af8

similarly-performing institutions under the purview of the UK or EU regulatory regimes will see their requirements remain static. This places U.S. firms at an undeniable regulatory disadvantage.

In defending this decision, the U.S. federal banking regulators argue that the past operational losses which inform the ILM are themselves indicative of future operational risk exposure.[13] Yet the application of this logic is selective. By crafting an ILM floored at one, the joint regulators inherently ignore, rather than utilize, any operational loss history for a financial institution that would produce an ILM below one. Banks in this category, who have successfully avoided a history of significant operational risk costs, will be immediately forced to hold levels of capital that are detached from the very metrics the federal regulators claim to follow.

This concern also holds true when viewing the banking system as a whole. A careful examination of past operational losses, including those incurred during the worst of the 2008 Financial Crisis, reveals the operational risk requirements mandated under the NPR would result in capital requirements that vastly outstrip any previously-realized loss. Since 2003, the annual average loss continually remained less than 30% of the NPR's standard,[14] while nineteen of the twenty years within that same timeframe saw an average loss below 20% of the NPR's expected requirements. Given the consistency of this historical data, one can conclude the NPR seeks to enact a capital increase that reflects a premium of three-to-five times typical past operational losses. As such, it is unclear what future exposures the joint regulators are calibrating towards.

In addition, the NRP's methodology for calculating operational risk requirements also clearly disfavors certain revenue streams.[15] Diversification is a crucial strategy for maintaining safety and soundness in the U.S. financial system, so much so that the concept is an explicit component in assessing a firm's asset quality and liquidity as part of the well-known CAMELS rating system.[16] In fact, during previous economic downturns, the joint regulators encouraged financial institutions to seek out various fee-based revenue streams to provide counter-cyclical stability to their balance sheets.

Despite these clear supervisory preferences, the adoption of the operational risk requirements would result in significantly higher capital requirements for noninterest and fee-based revenue across all institutions and disparate and adverse treatment for firms that provide a high percentage of these products and services. Additionally, the NPR fails to distinguish between the levels of risk present in various forms of noninterest and fee-based revenue, such as deposit box fees and loan servicing portfolio income, instead treating them as co-equals. This blanket approach runs counter to the core logic behind Basel III endgame that capital requirements should reflect the granularity of the specific risk profiles of their RWAs. It remains unclear how the noninterest and fee-based methodology contained in the NPR will not ultimately disincentivize financial institutions from adopting the same diversification strategies the regulators themselves expressly wish to see.

---

[13] https://www.federalregister.gov/documents/2023/09/18/2023-19200/regulatory-capital-rule-large-banking-organizations-and-banking-organizations-with-significant

[14] https://orx.org/resource/basel-iii-and-standardised-approaches-to-capital-2023

[15] https://www.federalreserve.gov/newsevents/pressreleases/bowman-statement-20230727.htm

[16] https://www.federalreserve.gov/boarddocs/srletters/1996/sr9638.htm

Finally, certain aspects to the NPR's operational risk framework could incentivize the off-shoring of U.S. jobs. Certain institutions providing low-risk and non-financial services to their foreign-based affiliates or parents would see the reimbursement for these services captured and penalized under the currently proposed rule. Oddly, under the proposal, expenses for non-financial services are exempted from the operational risk requirement. Together, these provisions creating a concerning incentive to move these American jobs overseas.

Given the breadth of our concerns with the operational risk proposal, we respectfully request each regulator provide independent responses to the following questions:

1. Do the joint regulators believe the adoption of the NPR, which is intended to bring the U.S. in line with the Basel III Framework, will require a significant increase to overall capital requirements? If not, please provide the threshold that the agency would consider the increase to be 'significant.'

2. Do the joint regulators believe the adoption of the operation risk component of the NPR, which deviates from both the Basel III Framework and the UK and EU implementation, will require a significant increase to overall capital requirements? If not, please provide the threshold that the agency would consider the increase to be 'significant.'

3. If the NPR, as currently written, is enacted, does the FRB believe operational risk requirements will be properly calibrated through both the SCB and Basel III endgame requirements? If not, does the FRB plan to make changes to account for the introduction of a new standardized operational risk capital charge?

4. Did the joint regulators conduct any impact or economic analysis into the effects on the U.S. banking system and the global competitiveness of financial institutions operating in the U.S. before pursuing the floored ILM, as opposed to an ILM set-to-one approach? If so, please share the findings of that analysis. If not, please explain why not.

5. Do the joint regulators believe an aggregate reduction in the utilization of noninterest and fee-based revenue across the U.S. financial system would improve or weaken safety and soundness across the U.S. banking system?

6. Are the joint regulators contemplating changes to the noninterest and fee-based calculations methodology contained in the NPR to reduce disincentives towards these revenue streams?

7. What specific policy purpose is served by requiring banks to capitalize for recharge income related to non-financial services while excluding similar expenses from the operational risk requirement?

The Basel III Framework's core mission is to harmonize international banking standards without significantly increasing capital requirements. Unfortunately, the operational risk components of the NPR put forth by the joint regulators appear poised to do the opposite. By implementing standards that notably deviate from other jurisdictions' and greatly increase required capital reserves, the joint regulators risk unduly penalizing U.S.-operating financial institutions while also pushing more banking activity into less regulated nonbank entities.

All banking systems require proper capitalization to function safely and efficiently and the U.S. financial system is no different. Financial institutions must also remain vigilant towards unforeseen risks and retain sufficient capital to meet these challenges when they occur. The validity of these points is well-settled. Yet efforts to gold-plate already-strong U.S. regulatory requirements will ultimately force resources away from the Americans who need financial services the most, curb U.S. growth prospects, put the U.S. financial system at a competitive disadvantage, and potentially impact underlying safety and soundness. For these reasons, we respectfully request the joint regulators engage in a thorough evaluation of stakeholder input throughout the NPR comment period and strongly consider relevant changes to the operational risk portions of the proposed rule.

Thank you for your timely consideration of these important issues. We respectfully request a response to our questions no later than Friday, December 22, 2023.

Sincerely,

[redacted]
Thom Tillis
United States Senator

[redacted]
Bill Hagerty
United States Senator

[redacted]
Mike Crapo
United States Senator

[redacted]
M. Michael Rounds
United States Senator

[redacted]
John Kennedy
United States Senator

[redacted]
Cynthia Lummis
United States Senator

[redacted]
Katie Boyd Britt
United States Senator

[redacted]
Kevin Cramer
United States Senator

[redacted]

Steve Daines
United States Senator

CC:

The Honorable Philip Jefferson
Vice Chair
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

The Honorable Michael Barr
Vice Chair for Supervision
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

The Honorable Michelle W. Bowman
Governor
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

The Honorable Lisa Cook
Governor
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

The Honorable Adriana Kugler
Governor
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

The Honorable Christopher Waller
Governor
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

The Honorable Travis Hill
Vice Chairman
Federal Deposit Insurance Corporation
550 17th Street NE
Washington, DC 20429

The Honorable Johnathan McKernan
Director
Federal Deposit Insurance Corporation
550 17th Street NE
Washington, DC 20429