Risk Management Association

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January 16, 2024

VIA ELECTRONIC SUBMISSION

Chief Counsel's Office
Office of the Comptroller of the Currency
400 7th Street SW, Suite 3E–218
Washington, DC 20219
Docket ID OCC–2023–0008

Ann E. Misback, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue NW
Washington, DC 20551
Docket No. R–1813, RIN 7100–AG64

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

Re: Regulatory Capital Rule: Large Banking Organizations and Banking Organizations With Significant Trading Activity

Ladies and Gentlemen:

This letter is submitted by the Bank Crisis Response Working Group (the "Working Group") of The Risk Management Association ("RMA"). The Working Group appreciates the opportunity to submit this letter to the Office of the Comptroller of the Currency ("OCC"), the Board of Governors of the Federal Reserve System ("FRB") and the Federal Deposit Insurance Corporation ("FDIC," and together the "Agencies") on their proposed rule (the "Proposal") to implement the final set of Basel III reforms.[1]

RMA is a member-driven professional association whose sole purpose is to advance the use of sound risk management principles in the financial services industry. RMA helps its members use sound risk principles to improve institutional performance and financial stability, and enhance the risk competency of individuals through information, education, peer-sharing, and networking. RMA has approximately 1,000 institutional members, including banks of all sizes as well as nonbank financial institutions. One of the most important components of RMA's mission is to provide independent analysis on matters pertaining to risk and capital regulation.

[1] Regulatory Capital Rule: Large Banking Organizations and Banking Organizations With Significant Trading Activity, 88 Fed. Reg. 64028 (Sept. 18, 2023).

The Working Group, a voice for the nation's regional banks, was formed in response to the spring 2023 bank failures. Members include domestic Category III and IV banking organizations, Category IV intermediate holding companies of foreign banking organizations as well as smaller banking organizations. As regional banks, our members are committed to providing a wide range of financial services to American consumers and are deeply invested in their communities.

Working Group members serve a critical role in the U.S. economy. As regional banks, we empower individuals in their pursuit of the American dream, strengthen the communities in which we are firmly rooted and support small businesses as they power the American economy. We believe the Proposal would impede these efforts and harm the real economy.

Moreover, Working Group members are robustly capitalized and have adequate capacity to continue lending to the real economy during a severe recession. Because of this fact, any proposal to raise capital levels, and thus raise the cost of lending and financial intermediation, requires a compelling justification. In releasing the Proposal, the Agencies offer no such justification. As such, the Proposal must be reconsidered.

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Here, we discuss the Proposal's most salient shortcomings. These shortcomings suggest that the Proposal should be withdrawn and re-proposed. To the extent the Agencies choose not to do so, we later offer certain specific recommendations that may mitigate the most harmful effects of the Proposal.

The Proposal Would Violate Section 165 of the Dodd-Frank Act

Congress passed the Economic Growth, Regulatory Relief, and Consumer Protection Act ("EGRRCPA" or "S. 2155") in 2018 requiring that the FRB tailor the application of enhanced prudential standards and, with respect to banking organizations with between $100 and $250 billion in assets, impose enhanced prudential standards only after considering the organizations' risk factors and after determining the standards are appropriate to promote financial stability or the organizations' safety and soundness. The Proposal is neither appropriately tailored in its application nor does it demonstrate that the FRB has made the necessary determinations after considering the factors required by the statute. Therefore, we believe that the Proposal would not comply with the statute.

The Proposal Would Raise the Cost of Credit for Everyday Americans

The Proposal would make credit more expensive for American individuals and small businesses. Specifically, the Proposal would impose inflated risk weights for retail exposures relative to the Basel Framework and fail to assign favorable risk weights to small businesses, in contrast to international norms and standards. In addition, the Proposal's approach to credit cards and home equity lines of credit would make these products more expensive and potentially lower consumers' credit scores and with that, their access to credit generally. As a result, the Proposal would drive consumers to less regulated or unregulated nonbank financial institutions. Moreover, in addition to raising the cost of credit, the Proposal's treatment of consumer lending is at cross-purposes with the Agencies' recently finalized rule on the Community Reinvestment Act (the "CRA").

The Operational Burdens Associated with the Proposal are Unjustified

The Proposal would create significant operational burdens on Category IV banking organizations by requiring costly buildouts related to its dual-stack approach and its operational and market risk frameworks. The costs that would be sunk into complying with the Proposal could instead be lent to customers to promote economic growth.

The Proposal Diverges from International Norms

Though the Proposal aims to promote consistency with international capital standards, it would do the opposite. Across many asset classes, the Agencies would impose higher risk weights than those set forth in the Basel Framework or proposed by key foreign jurisdictions. By doing so, the Agencies would harm the competitive position of American banks by making it more expensive for them to conduct business relative to their international competitors. Moreover, it would violate the spirit of the Basel process which seeks to promote the harmonization of capital standards and avoid materially divergent treatment across jurisdictions.

The Agencies have not Adequately Considered the Overall Calibration of the Capital Framework

The U.S. capital framework is made up of an amalgamation of requirements, including capital rules, stress tests, buffers, statutory floors and a separately proposed long-term debt requirement. Because each of these elements interacts with the others, regulatory design choices inform a bank’s overall capital requirements in more complex ways than simply summing each part of the framework. As a result, it is crucial to evaluate the Proposal in the context of the overall framework. Unfortunately, without releasing a holistic review of the capital framework for public comment, neither the Agencies nor the public can assess how each piece interacts with the others. Finalizing the Proposal under these circumstances would almost certainly lead to a miscalibrated capital framework – and that miscalibration would have real effects on the economy through reduced lending, increased costs of intermediation and slower economic growth.

* * *

For these reasons, the Proposal should be withdrawn and re-proposed.

Executive Summary

As discussed above, we believe the Proposal should be withdrawn and re-proposed. To the extent, however, the Agencies proceed with a final rule based on the Proposal, we present here certain key recommendations which would meaningfully improve the final rule.

- **The final rule should permit Category III and IV firms to make a one-time election to continue to exclude legacy accumulated other comprehensive income ("AOCI") related to reclassified held-to-maturity ("HTM") securities.** This transitional treatment is consistent with the Agencies' stated objectives of removing the AOCI opt-out and would level the playing field between Category III and IV firms and larger banking organizations.

- **The Agencies should retain the 25% deduction threshold for Category III and IV banking organizations** including for temporary difference deferred tax assets ("DTAs") that the organization could not realize through net operating loss carrybacks. Doing so is warranted in light of the adaptation of the Current Expected Credit Losses ("CECL") framework and the proposed removal of the AOCI opt-out, and would avoid a rapid and unjustified reversal in the Agencies' policy.

- **The Proposal's market risk and credit valuation adjustment ("CVA") frameworks should not apply to Category IV banking organizations without significant trading activities**. Consistent with decades of Agency precedent, we recommend that the Proposal's market risk framework not apply to Category IV banking organizations (other than those with significant trading activities). And because the CVA is designed to address risks arising from significant trading activities, we similarly recommend that the CVA not be applied to Category IV banking organizations without significant trading activities. Finally, Category IV banking organizations should not be required to use the Standardized Approach for Counterparty Credit Risk ("SA-CCR"), as the Agencies have not justified a shift away from their 2020 determination that doing so would be unduly burdensome for these entities.

- **The Proposal's operational risk framework should not apply to Category IV banking organizations.** Applying the operational risk framework to Category IV banking organizations is not justified in light of these entities' smaller size and simpler operations.

- **The Proposal's operational risk framework should be made more risk sensitive**. The Agencies should make the calibration of the operational risk framework more risk sensitive. In this respect, we endorse the recommendations made by the American Bankers Association and Bank Policy Institute in their joint comment letter to the Agencies on the Proposal (the "ABA / BPI Letter").

- **The Proposal's credit risk framework should be revised to increase risk-sensitivity**. By imposing inflated risk weights relative to the Basel Framework for retail exposures and through its treatment of credit cards and other unconditionally cancellable commitments ("UCCs"), the Proposal would make credit more expensive for American consumers. To ensure consumers have the adequate access to credit, we recommend that the risk weights for retail exposures and the credit conversion factor ("CCF") for UCCs be recalibrated based on the actual risk posed by these exposures. Specifically, risk weights for retail exposures should be set no higher than those provided for in the Basel Framework and the CCF for UCCs should be set no higher than 6.5.

We discuss these and other recommendations in greater detail below.

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I. The final rule should be scoped appropriately to comply with section 165 of the Dodd-Frank Act and prevent undue operational burdens.[2]

A. The final should comply with section 165 of the Dodd-Frank Act.

The Proposal would apply nearly identical capital requirements to all banking organizations with $100 billion or more in assets. In proposing to do so, the Proposal would violate the tailoring requirements found in section 165 of the Dodd-Frank Act as recently amended in 2018 by EGRRCPA.[3] This statutory deficiency is significant and therefore the Proposal should be withdrawn and re-proposed. To the extent the Agencies finalize the Proposal, the final rule should comply with the spirit of EGRRCPA's statutory mandate to appropriately tailor the capital regime by refraining from applying the same capital deduction framework applicable to Category I and II banking organizations to Category III and IV banking organizations and refraining from applying to Category IV organizations the Proposal's market risk, CVA and operational risk frameworks as well as the countercyclical capital buffer ("CCyB") and the supplementary leverage ratio ("SLR").

1. Challenges and Concerns.

As recently as 2019, the Agencies modified the thresholds for applicability for certain regulatory capital and liquidity requirements.[4] The Agencies explained that the modified thresholds were "consistent with considerations and factors set forth under section 165."[5] By reversing the 2019 rule and collapsing capital requirements for all banking organizations with $100 billion or more in assets, the Proposal, axiomatically, is inconsistent with section 165 of the Dodd-Frank Act.

The Agencies are aware that the Proposal is inconsistent with the Dodd-Frank Act because several Agency principals have pointed it out, as illustrated below:

- FRB Governor Bowman: "I am also concerned that today's proposal moves one step closer to eliminating the tailoring required by S. 2155 from the prudential capital framework."[6]
- FRB Governor Waller: "I am concerned that we are headed down a road where we would be no longer in compliance with section 165 of the Dodd-Frank Act . . ."[7]

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2 This section is responsive to Question 3.

3 12 U.S.C. § 5365.

4 Changes to Applicability Thresholds for Regulatory Capital and Liquidity Requirements, 84 Fed. Reg. 59230 (January 1, 2019).

5 *Id*. at 59232.

6 FRB, Statement by Governor Michelle W. Bowman (July 27, 2023), https://www.federalreserve.gov/newsevents/pressreleases/bowman-statement-20230727.htm.

7 FRB, Statement by Governor Christopher J. Waller (July 27, 2023), https://www.federalreserve.gov/newsevents/pressreleases/waller-statement-20230727.htm.

- FDIC Vice Chairman Hill: “The proposal undoes almost all of the tailoring of the capital framework for large banks, and is a repudiation of the intent and spirit of S. 2155 . . . in defiance of Congressional directives . . .” [8]

- FDIC Director McKernan: “Does the proposal tailor or otherwise differentiate among banking organizations to the extent required by law?”[9]

We are deeply concerned that the Agencies released the Proposal for comment even as a significant number of Agency principals are not convinced of its legality, let alone its advisability.

It is even more concerning that the Proposal does not discuss at all how it complies with section 165. Particularly with respect to proposing enhanced prudential standards for Category IV banking organizations, the FRB must, as a matter of statute, (1) determine that the application of such standards are (a) appropriate to prevent or mitigate risks to U.S. financial stability; or (b) promote the safety and soundness of a particular bank holding company or group of bank holding companies; and (2) take into consideration the bank holding company’s or companies’ capital structure, riskiness, complexity, financial activities, size and any other risk-related factors.[10]

The Proposal does not explain how the FRB determined that capital standards applicable to larger banking organizations should be applied to Category IV banking organizations. Oblique discussions of recent regional bank failures does not amount to an analysis of specified factors as required by statute. The unique nature of those failed banks means that their capital structure, riskiness, complexity and financial activities are distinguishable from our member banks. And although the failed banks were similar in size to some of our members, the use of the conjunctive “and” in the list of factors the FRB must consider before applying enhanced prudential standards to Category IV institutions means that size alone is not a sufficient consideration in applying these capital standards to Category IV institutions. Moreover, the unique nature of those banks means that better management and appropriately focused supervision are better suited to address the failures of those banks, not a broad-brushed and rushed overhaul of the entire prudential framework without regard for statutory requirements.

Not only does the Proposal reverse the 2019 tailoring framework, in many places it is more punitive towards Category IV banking organizations than the initial U.S. implementation of the Basel III framework. By not only reversing the Agencies’ recently adopted tailoring regime but also proposing to adopt more punitive requirements than were imposed prior to the passage of S. 2155, the Agencies are attempting to nullify Congress’ express intent. Regardless of the prudential views of the slim majority of Agency principals, the Agencies must adhere to the will of Congress.

In addition to the Proposal’s statutory deficiencies, the Agencies’ whipsawing of regulatory practices in recent years impedes the safe and sound practice of banking by reducing consistency

8 FDIC, Statement by Travis Hill, Vice Chairman, FDIC, on the Proposal to Revise the Regulatory Capital Requirements for Large Banks (July 27, 2023), https://www.fdic.gov/news/speeches/2023/spjul2723b.html.

9 FDIC, Statement by Jonathan McKernan, Member, FDIC Board of Directors, on the Proposed Amendments to the Capital Framework (July 27, 2023), https://www.fdic.gov/news/speeches/2023/spjul2723c.html.

10 12 U.S.C. § 5365(a)(2)(C).

and transparency surrounding the Agencies' expectations and by imposing unjustifiably high compliance costs associated with building out new processes for new regimes every few years. While the industry has spent the last several years since 2019 adopting and adapting to the most recent changes, a significant change to the framework at this time would place banks back into a state of constant change and adaptation. Such a constant state of change undermines market transparency and the ability to understand expectations over a longer time frame, which may impair market function and confidence in the effectiveness of regulatory regimes.

2. Recommendations.

Though we believe the statutory deficiencies imply that the Proposal be withdrawn, we nevertheless provide certain recommendations which may bring the Proposal in compliance with statute.

(a) *The final rule should retain the 25% deduction threshold for Category III and IV banking organizations*.

As described in more detail below, the final rule should retain the 25% deduction threshold for Category III and IV banking organizations. The current 25% simplified deduction framework was the product of a multi-year review and a notice and comment process by the Agencies to simplify the unnecessarily burdensome capital deduction framework pursuant to the Economic Growth and Regulatory Paperwork Reduction Act ("EGRPRA"). The Agencies should not simply abandon their prior work without any reasonable justifications. In addition, as further described in Section II.B, the 10%/15% deduction thresholds, particularly as they apply to DTAs, are overly conservative given the CECL adoption and the proposed removal of the AOCI opt-out.

(b) *The Proposal's revised market risk framework should apply only to banking organizations with significant trading activities*.

For nearly three decades, the Agencies have recognized that only banking organizations with significant trading activities should be subject to market risk capital requirements. Specifically, when first promulgating a market risk rule in 1996, the Agencies adopted the market risk rule's current approach of scoping in firms "whose trading activity equals 10 percent or more of its total assets, or whose trading activity equals $1 billion or more."[11]

In so doing, the Agencies explicitly rejected the idea of applying the market risk rule based on "differential criteria based on total asset size," thus eschewing a bifurcated approach of applying the market risk rule to larger banking organizations with low levels of trading activities.[12] The Agencies explained that this was because "all institutions with significant market risk, regardless of size, should measure their exposure and hold appropriate levels of capital."[13]

We believe the principle underlying the Agencies' long-standing approach is sound. Only banking organizations with high levels of trading activities should be subject to market risk requirements.

11 Risk-Based Capital Standards: Market Risk, 61 Fed. Reg. 47358, 47361 (Sept. 6, 1996).

12 *Id*.

13 *Id*.

By contrast, banking organizations with minimal trading operations, regardless of their overall size, should not be subject to market risk requirements as the market risk related to their limited trading operations does not justify the significant operational costs associated with building compliance capabilities. Thus, we recommend the final rule not apply the Proposal's market risk framework to Category IV banking organizations without significant trading activities.

Though the principle is sound, it has been nearly 30 years since the $1 billion threshold was adopted, and as the Proposal recognizes, inflation and the ensuing growth in capital markets makes this threshold artificially low.[14] In that regard, we support the Proposal's approach of raising the threshold for applicability of the market risk rule to banking organizations with trading activity equal to or greater than $5 billion or 10% of the banking organization's total consolidated assets. Moreover, we agree with the Agencies that trading activity should be measured over the previous four quarters, as opposed to being based on the most recent quarter. Using a four-quarter average would reduce the risk of a banking organization being subject to onerous burdens for inadvertently crossing an asset threshold in one quarter, before returning to below the threshold.

Accordingly, we recommend that the final rule apply market risk requirements only to banking organizations with average trading activity over the previous four quarters equal to or greater than $5 billion or 10% of the banking organization's total consolidated assets. Doing so would be consistent with the Agencies' decades long precedent of applying market risk requirements to "all institutions with significant market risk, regardless of size."[15] At the very least, the final rule should not apply market risk requirements to Category IV banking organizations unless they have significant trading activity.

(c) *The final rule should not apply the Proposal's CVA framework to Category IV banking organizations not subject to the market risk capital rule*.

The Proposal states that its expanded CVA requirements would apply to "all large, complex banking organizations that, due to their significant trading activity, operational scale, and domestic and global presence, are subject to more stringent capital requirements."[16] This description does not extend to many Category IV banking organizations. Specifically, many Category IV banking organizations are not subject to the current market risk rule *precisely because they do not have significant trading activities*. The Agencies' rationale, then, for extending the CVA framework to Category IV banking organizations is not sound.

Accordingly, we recommend that, in line with the spirit of the current capital rule's market risk provisions, the final rule should refrain from applying the CVA framework to Category IV banking organizations without significant trading activity. We note that the CVA framework was never applied to Category IV organizations since the initial implementation of the Basel III framework in the United States – it was only applied to advanced approaches banking organizations. The Agencies' 2019 tailoring rules refined the scope of advanced approaches banking organizations

14 88 Fed. Reg. at 64095.

15 61 Fed. Reg. at 47361.

16 88 Fed. Reg. at 64150.

such that the current CVA rule only applies to Category I and II banking organizations. The Agencies have not provided any support for expanding the applicability now and, accordingly, should retain the current capital rule's scope with respect to CVA (or apply the CVA framework only to those firms with significant trading activity).

(d) *The final rule should not require Category IV banking organizations to use SA-CCR.*

The Proposal would require Category III and IV banking organizations to use SA-CCR. This represents a shift from the current rule, as finalized in 2020, which allows Category III and IV banking organizations to use either SA-CCR or the current exposures method.

The Agencies have not explained why, just a few years after finalizing the current rule on SA-CCR, they propose to expand the scope of its application so significantly. To the extent the Agencies wish to reverse their approach after such a short period of time, the Proposal should provide some justification as to why the change is needed. Such back-and-forth changes produce unnecessary regulatory uncertainty that hinder banking organizations' ability to adequately plan their strategic and risk management outlooks.

In adopting the current rule on SA-CCR, the Agencies explained that requiring Category III and IV banking organizations to use SA-CCR "would be inconsistent with the agencies' efforts to tailor the application of the capital rule to the risk profiles of banking organizations."[17] The Agencies appropriately recognized that adopting SA-CCR would "require[] internal systems enhancements and other operational modifications that could be particularly burdensome for smaller, less complex banking organizations."[18]

There is no evidence that Agencies got it wrong in 2020. Accordingly, we believe the final rule should not require Category IV banking organizations to use SA-CCR.

(e) *The Proposal's operational risk framework should not apply to Category IV banking organizations*.

The Agencies' impact analysis suggests that the Proposal's operational risk framework would, if finalized, represent the single largest driver of increased risk weighted assets ("RWA") under the expanded risk-based approach ("ERBA"). As detailed in Section III below, we believe the operational risk framework is flawed and significantly overstates operational risk. But as an initial matter, we do not believe Category IV banking organizations should be subject to the operational risk framework. Category IV banking organizations have relatively simple, low-risk operations. As such, the Proposal's operational risk charge and the attendant costs associated with building compliance capabilities would impose an unjustified burden on the entities.

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17 Standardized Approach for Calculating the Exposure Amount of Derivative Contracts, 85 Fed. Reg. 4362, 4367 (Jan. 24, 2020).

18 *Id*.

More fundamentally, the Agencies have not explained why banking organizations should be required to separately capitalize for operational risk. As FRB Governor Waller pointed out, operational losses do not tend to materialize contemporaneously with losses on credit and market risk.[19]

In addition, as Governor Bowman has repeatedly pointed out, the Proposal's operational risk disincentivizes banking organizations' efforts to diversify their operations and revenue streams.[20] By doing so, the Proposal would actually *harm* the banking organizations' resilience, in direct opposition to its stated goals. At a time when the market and regulators are increasingly focused on regional banks' funding strategies, the operational risk framework is at cross-purposes with market expectations and other supervisory priorities. These mixed messages from regulators and the related uncertainty make it difficult for banking organizations to chart and implement their business strategies.

For these reasons and to take a step towards complying with section 165 of the Dodd-Frank Act, the Agencies should refrain from applying the Proposal's operational risk framework to Category IV banking organizations.

(f) *The final rule should not subject Category IV banking organizations to the CCyB or SLR.*[21]

The Proposal's approach of applying the CCyB and SLR to Category IV banking organizations is inconsistent with long-standing Agency precedent predating the 2019 implementation of the tailoring rules. In the initial U.S. Basel III implementation, the Agencies applied the CCyB and SLR only to advanced approaches banking organizations, generally those with $250 billion or more in assets.

At the time, the Agencies explained that they were applying the SLR only to advanced approaches entities because they "tend to have more significant amounts of off-balance sheet exposures" that were not adequately captured at the time.[22] The Agencies further explained that "[a]pplying the supplementary leverage ratio routinely [to smaller banking organizations] could create operational complexity for smaller banking organizations that are not internationally active, and that generally

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19 FRB, Statement by Governor Christopher J. Waller (July 27, 2023), https://www.federalreserve.gov/newsevents/pressreleases/waller-statement-20230727.htm.

20 FRB, Statement by Governor Michelle W. Bowman (July 27, 2023), https://www.federalreserve.gov/newsevents/pressreleases/bowman-statement-20230727.htm; Governor Michelle W. Bowman, Remarks on the Economy and Prioritization of Bank Supervision and Regulation (Nov. 9, 2023), https://www.federalreserve.gov/newsevents/speech/bowman20231109a.htm.

21 This section is responsive to Question 4.

22 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. 62018, 62031 (Oct. 11, 2013).

do not have off-balance sheet activities that are as extensive as banking organizations that are subject to the advanced approaches rule."[23]

Further, in initially proposing the CCyB, the Agencies refrained from applying it to what are now Category IV banking organizations by explaining that "large[r] banking organizations generally are more interconnected with other institutions in the financial system. Therefore, the marginal benefits to financial stability from a countercyclical buffer function should be greater with respect to such institutions."[24]

The Agencies reaffirmed their approach as recently as 2019 by continuing to refrain from imposing the SLR and CCyB to Category IV banking organizations. At the time, the Agencies explained that doing so would "maintain the risk sensitivity of the current capital regime and resiliency of [Category IV] banking organizations' capital positions."[25] Moreover, the Agencies recognized that Category IV banking organizations "have lower risk-based indicator levels relative to their larger peers."[26]

The Proposal would dispense with a decade's worth of precedent with a few short sentences about applying consistent standards across banking organizations and increasing resilience. This is not sufficient justification to depart from the existing practice with respect to the SLR and CCyB. Moreover, the limited justification is not convincing. Specifically, in an attempt to apply the same standards to banking organizations regardless of size, the Proposal would reduce the risk sensitivity of the capital rule and impose outsized operational costs on Category IV banking organizations. Further, it is not clear that subjecting Category IV banking organizations to the SLR and CCyB would increase the resilience of the financial system in any way. Especially with respect to CCyB, which has been set at zero for a decade, it is not clear what resiliency gains the Agencies expect.

For these reasons, we recommend the Agencies retain the current capital rule's approach to the SLR and CCyB.

B. The final rule should not apply the dual stack requirement to Category IV banking organizations.[27]

The Proposal begins with the assertion that it would "reduce complexity and operational costs."[28] This is not true, especially for Category IV banking organizations, as it would require Category IV organizations to expend significant resources to comply with the dual stack requirement, ERBA generally (including the new operational risk framework), an expanded market risk requirement,

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[23] *Id*. at 62032.

[24] 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, 52805 (Aug. 30, 2012).

[25] 84 Fed. Reg. at 59251.

[26] *Id*.

[27] This section is responsive to Question 2.

[28] 88 Fed. Reg. at 64030.

CVA and SA-CCR, among other parts of the Proposal. As FRB Governor Bowman noted, "applying a one-size-fits-all approach for [] smaller firms despite the variation in their risk, size, business models, and complexity, [would] likely result[] in costs that outweigh the benefits of this provision."[29]

In line with Governor Bowman's remarks, we believe that by requiring Category IV firms to expend significant resources to comply with the Proposal's operational requirements, the Agencies would necessarily divert resources away from lending and other activities that promote economic growth as well as from more meaningful risk management activities. Moreover, the dual stack approach may create needless uncertainty in Category IV organizations' capital planning processes as their binding capital requirements could shift between stacks. Accordingly, the Agencies should refrain from extending the dual stack approach to Category IV firms.

II. The Agencies should adopt a more considered approach to the calculation of capital ratios and the application of buffer requirements.

A. The final rule should permit Category III and IV firms that previously opted out of AOCI to make a one-time election to continue to exclude legacy AOCI related to reclassified HTM securities.

We recommend that Category III and IV banking organizations that previously opted out of recognizing AOCI in regulatory capital be permitted to make a one-time, transitional in nature, election to continue to exclude net unrealized gains and losses associated with debt securities that have been reclassified from available-for-sale ("AFS") to HTM on or before the effective date of any final rule ("HTM AOCI"). HTM AOCI is described in more detail below.

In addition, if such a one-time election were to be granted, the final rule should also permit electing Category III and IV firms to exclude any temporary difference DTAs or deferred tax liabilities ("DTLs") associated with the HTM AOCI (i) for purposes of determining whether a firm's DTAs exceed the deduction threshold and (ii) from the calculation of the firm's risk-weighted assets.

1. Challenges and Concerns.

Under the current capital rule, banking organizations subject to Category III or IV capital standards were provided an opportunity to make a one-time election to opt out of recognizing most elements of AOCI and related DTAs and DTLs. Under the Proposal, Category III and IV banking organizations would be required to include all AOCI components in common equity tier 1 capital ("CET1"), except for gains and losses on cash-flow hedges where the hedged item is not recognized on a banking organization's balance sheet at fair value.

As the Agencies explained in the preamble to the Proposal, this would mean that all net unrealized gains and losses on AFS debt securities from changes in fair value would flow through to CET1. In addition, although not discussed in the preamble to the Proposal, the proposed change also would have the effect of causing any HTM AOCI to flow through CET1.

29 Governor Michelle W. Bowman, Remarks on the Economy and Prioritization of Bank Supervision and Regulation (Nov. 9, 2023), https://www.federalreserve.gov/newsevents/speech/bowman20231109a.htm.

(a) *HTM AOCI*.

Under U.S. generally accepted accounting principles ("GAAP"), if a firm transfers or reclassifies debt securities from AFS to HTM, the unrealized gains or losses on those securities at the time of the transfer will be "crystallized," and continue to be recognized in AOCI, subject to amortization over time.

To elaborate, Financial Accounting Standards Board Accounting Standards Codification ("ASC") Topic 320-10-35-5 requires that each reporting entity reassess the appropriateness of the entity's classification of investments in debt securities at each reporting date, which reclassification may impact the reporting of unrealized gains and losses on such securities. In particular, ASC 320-10-35-10 provides that for debt securities transferred to the HTM category from the AFS category, unrealized holding gain or loss at the date of the transfer (which would have been reported in AOCI) should continue to be reported in AOCI, subject to amortization over the life of the security (as an adjustment of yield in a manner consistent with the amortization of any premium or discount). In contrast to unrealized gains and losses on AFS securities, continued inclusion of such items in AOCI (subject to amortization) does not appear to reflect the potential for such items to meaningfully contribute to income, but instead appears to be an accounting fiction intended to offset the effect of "amortization of the related premium or discount arising from the non-credit fair value adjustment in income" resulting from the reclassification.[30]

Since 2022, many banking organizations have been reevaluating their asset-liability management practices and updating their contingency funding plans in response to the current interest rate environment and to the recent bank failures. As a part of this reevaluation, a banking organization may consider reclassifying AFS securities as HTM for a variety of reasons, including to manage GAAP equity. But such reclassification does not impact the organization's liquidity position as it could still monetize the securities consistent with the intent to hold the security to maturity. For example, rather than relying on outright sales of AFS securities as a source of liquidity, the banking organization may use capital markets, secured funding sources or government sponsored funding facilities such as the discount window and Standing Repo Facility to monetize their HTM securities portfolios.

Despite the reclassification and a bona fide change of intent to hold these securities to maturity, any net unrealized gains and losses on such reclassified HTM securities as of the transfer date would remain in AOCI, and under the Proposal, would flow through CET1, resulting in an immediate increase or decrease to CET1.

2. Recommendations.

We recommend that Category III and IV banking organizations that previously opted out of AOCI be allowed to make a one-time election to continue to exclude HTM AOCI as of the effective date of the Proposal (as well as the associated DTAs or DTLs, as described above) for the following reasons:

[30] OCC Bank Accounting Advisory Series, Topic 1A., Question 2 (Aug. 2023).

(a) *This one-time election would level the playing field with Category I and II firms as Category III and IV firms transition into recognizing AOCI in regulatory capital*.

First, allowing a one-time opt-out would help to smooth the transition for affected firms and level the playing field between Category I and II firms, who have always been required to recognize such elements of AOCI in CET1, and Category III and IV firms, who have not. As the Agencies point out in the preamble to the Proposal, "the agencies have observed generally higher levels of securities classified as held-to-maturity (HTM) among banking organizations that recognize AOCI in regulatory capital."[31] These observations suggest that, if not for the AOCI opt-out, Category III and IV firms likely would have classified more securities as HTM immediately upon acquisition, rather than classifying securities as AFS and subsequently reclassifying such securities as HTM (thus avoiding any "locking in" of unrealized gains and losses on such securities). Requiring recognition for such HTM AOCI effectively penalizes Category III and IV firms for having relied on the AOCI opt-out to classify securities as AFS (which allowed them to use sales and other dispositions as a monetization strategy). These concerns are particularly acute for Category III firms who, prior to the 2019 revisions to the enhanced prudential standards categories, had been unable to make an AOCI opt-out election, and were later permitted to do so. The back-and-forth rule changes and their timing in the rate cycle creates a disadvantage to Category III firms (as compared to Category I and II firms). If the rules had not changed in 2019 for Category III firms, Category III firms would almost certainly have more securities classified as HTM securities (and would have avoided "locking in" HTM AOCI that has resulted from recent interest rate increases). This one-time election would mitigate the adverse impact to Category III firms by replicating the capital impact of securities as if the rules had remained consistent.

(b) *The one-time election is limited to securities that would be held to maturity, and would be consistent with Agencies' stated objectives of removing the AOCI opt-out*.

Second, the Agencies note that the proposed removal of the AOCI opt-out would require "all net unrealized holding gains and losses on available-for-sale (AFS) debt securities from changes in fair value to flow through to common equity tier 1 capital, including those that result primarily from fluctuations in benchmark interest rates."[32] The Agencies further indicated that this treatment would better reflect the actual point in time loss-absorbing capacity of Category III and IV firms and better align regulatory capital with market participants' assessment of capital adequacy.[33]

This one-time election would be consistent with the Agencies' goal of having unrealized gains and losses of AFS securities to flow through to CET1 and the stated objectives described above. Since these securities have been reclassified from AFS to HTM (and by definition would be held to maturity),[34] any unrealized gains and losses "crystallized" in AOCI at the time of reclassification

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31 88 Fed. Reg. at 64036.

32 *Id*.

33 *Id*.

34 Generally, under GAAP, any sale of HTM securities would taint the entire HTM portfolio, resulting in the entire portfolio being reclassified as AFS and marked to market.

would never materialize. Accordingly, any such HTM AOCI does not reflect a firm's actual loss-absorbing capacity at any given point in time.

(c) *The one-time election is purely transitional in nature given the amortization of legacy HTM AOCI.*

Finally, we note that by construction, the recommended one-time election would be purely transitional in nature. It would only apply to legacy HTM AOCI as of the effective date of the final rule and would not apply to any future movement of securities from AFS to HTM, and thus would prevent any "arbitrage" issue. Over time, the impact on capital would be neutralized (relative to the Proposal as drafted) as any such legacy HTM AOCI would amortize over the life of the securities. To be sure, the overall impact of the proposed one-time election would be to put Category III and IV firms on an even playing field with Category I and II firms in this regard and, as noted above, Category III and IV firms that have previously opted out of AOCI likely would have classified such securities as HTM at the outset had the AOCI opt-out not been available.

In addition, we recommend that the Agencies provide Category III and IV firms a longer transition period during which to phase in AOCI components in CET1. As the discussion above demonstrates, the Agencies modified the treatment of AOCI for Category III firms relatively recently. Accordingly, we believe the Agencies should lengthen the phase-in period for Category III and IV firms to account for AOCI in their capital ratios to five years. Doing so would better allow our member institutions to adapt to the rapid reversals in the Agencies' approach to AOCI.

B. The final rule should retain the 25% deduction threshold for Category III and IV banking organizations.

We recommend that Category III and IV banking organizations be permitted to retain the 25% CET1 deduction threshold for temporary difference DTAs that the organization could not realize through net operating loss carrybacks, mortgage servicing assets ("MSAs"), and investments in the capital of unconsolidated financial institutions (collectively, the "Simplified Deductions"), minus certain deductions and adjustments.

1. Challenges and Concerns.

Prior to 2019, temporary difference DTAs, MSAs and investments in the capital of unconsolidated financial institutions were subject to a complex deduction framework that included a: (1) 10% CET1 capital deduction threshold that applied individually to holdings of MSAs, temporary difference DTAs and significant investments in the capital of unconsolidated financial institutions in the form of common stock, (2) 15% CET1 capital aggregate deduction threshold, (3) 10% threshold for non-significant investments in the capital of unconsolidated financial institutions, and (4) deduction for significant investments in the capital of unconsolidated financial institutions not in the form of common stock.

EGRPRA requires that regulations prescribed by the Federal Financial Institutions Examination Council and the Agencies be reviewed by these agencies at least once every 10 years. The second EGRPRA review began in 2014 and resulted in the submission of these agencies' second EGRPRA Report to Congress on March 21, 2017 (the "Report"), in which the Agencies indicated that they would develop a proposed rule to simplify the capital rule by considering amendments to, among other things, the Simplified Deductions in recognition of concerns surrounding the complexity of the regulatory capital rules.

On July 22, 2019, the Agencies finalized a rule (the "Capital Simplification Rule") implementing these commitments, providing that non-advanced approaches banking organizations would be subject to a simpler deduction framework with respect to the Simplified Deductions; only MSAs, temporary difference DTAs and investments in the capital of unconsolidated financial institutions that individually exceed 25% of CET1 would be deducted.[35] Particularly as relevant for many regional banking organizations, the Agencies noted that "[r]elative to the treatment in the current rule, the 25 percent common equity tier 1 capital deduction threshold in the final rule may also serve to mitigate the adverse effects of potential increases in temporary difference DTAs stemming from CECL or from changes to the tax code."[36]

2. Recommendations.

We recommend that the Agencies retain the Simplified Deductions for Category III and IV banking organizations. Retaining the Simplified Deductions would be consistent with the Agencies' conclusions from the multi-year EGRPRA review and would help to further smooth the transition resulting from CECL adoption and removing the availability of the AOCI opt-out.

(a) *The Proposal would eliminate the results of the Agencies' multi-year effort under EGRPRA to simplify unnecessarily complex and burdensome capital rules.*

As mentioned above, the Simplified Deductions were the result of a multi-year effort under the EGRPRA, and were adopted in an interagency final rule that had been through a thorough public notice and comment period. The Proposal would eliminate the results of this multi-year effort under EGRPRA by subjecting Category III and IV banking organizations to the unnecessarily complex and burdensome pre-2019 deduction framework. The Proposal does not offer an explanation for removing the Simplified Deductions framework, other than a desire for "alignment across all banking organizations subject to the proposal."[37] The Proposal also does not explain why the Agencies' objectives to simplify the capital framework as articulated in the Report and the Capital Simplification Rule no longer apply. In fact, we believe that the Simplified Deductions represent a well-considered response to concerns that the regulatory capital framework is too complex and burdensome for Category III and IV banking organizations, among others. Accordingly, the Agencies should not simply abandon the Simplified Deduction framework without any reasonable justification.

In the near term, replacing the Simplified Deductions with a more complex framework would create significant and undue burdens for Category III and IV banking organizations, particularly when

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35 Regulatory Capital Rule: Simplifications to the Capital Rule Pursuant to the Economic Growth and Regulatory Paperwork Reduction Act of 1996, 84 Fed. Reg. 35234 (July 22, 2019).

36 *Id.* at 35239.

37 88 Fed. Reg. at 64037.

considered in conjunction with the implementation of CECL and removal of the AOCI opt-out, as further described below. The combination of CECL and the AOCI opt-out would have the effect of drastically increasing DTAs across affected firms (and across the industry) in levels far exceeding those in effect in 2017, when the Agencies first proposed the Simplified Deductions. If adopted as proposed, the Proposal's removal of the Simplified Deductions would have a material "day one" impact, and could incentivize Category III and IV banking organizations to take on more interest rate risk to avoid "double counting" AOCI losses against capital.

(b) *Retaining the Simplified Deductions is warranted in light of the CECL adoption*.

Under CECL, banking organizations are required to use historical, current and forecasted information to estimate expected losses over the life of certain credit exposures, including loans. Adoption of the CECL framework has led to a significant increase in banking organizations' allowance for loan losses (or allowance for credit losses) (by about 37% based on data as of January 1, 2020).[38] As a general matter, an allowance for bad debts is not immediately deductible for tax purposes. Rather, the deduction is delayed until there is a charge off, resulting in a temporary difference DTA. By increasing allowances for loan/credit losses, CECL increases the associated DTAs. As mentioned above, the 25 percent threshold for Simplified Deductions was adopted in recognition of the potential for increases in temporary DTAs associated with CECL, whereas the pre-2019 deduction framework was calibrated in 2013, prior to finalization of the CECL standard in 2016. Moreover, as discussed below, the pre-2019 10% individual deduction threshold as it applies to DTAs is overly conservative and has unnecessarily procyclical impacts that threaten, rather than strengthen, the safety and soundness of banking organizations. Retaining the Simplified Deduction framework would mitigate these concerns.

(c) *Retaining the Simplified Deductions is also warranted in light of the proposed removal of the AOCI opt-out*.

Further compounding the difficulties are the impact on DTAs resulting from the proposed removal of the AOCI opt-out for Category III and IV banking organizations as the 25% Simplified Deduction framework was calibrated around the same time when Category III and IV banking organizations were given the option to opt out of AOCI. In general, increases in unrealized losses associated with a banking organization's investment securities result in increases in the banking organization's DTAs (representing potential reductions in deductions when those losses are realized). Currently, to the extent a Category III or IV banking organization elected to opt out of having AOCI flow through to CET1, the banking organization similarly would be permitted to exclude DTAs relating to such adjustments.[39] By removing the AOCI opt-out, the Proposal would also remove the banking organization's ability to exclude related DTAs from counting towards the deduction threshold and from the banking organization's risk-weighted assets. Lowering the deduction threshold at the same time when Category III or IV banking organizations' DTAs are

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38 The adoption of CECL resulted in a 37% increase in adopters' allowances as of January 1, 2020. See FEDS Notes, New Accounting Framework Faces Its First Test: CECL During the Pandemic (Dec. 3, 2021).

39 § 22(d)(1)(iv).

increasing due to factors outside of their control would further increase the capital requirement of the firm.

(d) *Overly conservative treatment of DTAs has unnecessarily procyclical impacts that would threaten, rather than strengthen, the safety and soundness of banking organizations*.

Moreover, we believe that an overly conservative treatment of DTAs has unnecessarily procyclical impacts that would threaten, rather than strengthen, the safety and soundness of banking organizations. DTAs typically increase during actual stress conditions when a banking organization realizes significant loan losses. Those stress conditions would also lead to a significant increase in allowances for credit losses (and associated DTAs), which would in turn create additional stress on the organization's capital levels. This procyclicality arises not only in an actual downturn, but as a practical matter impacts capital levels at banking organizations during normal economic times through the stress testing and capital planning processes. As noted above, the implementation of CECL exacerbates this concern.

We recognize the Agencies historically have been concerned with the ability of banking organizations to realize DTAs against future taxable income, in particular the concern that an organization may not be able to realize the value of the DTAs under adverse financial conditions. We note however, the capital rules are premised upon banking organizations as going concerns, not failed entities, and therefore the concern that future taxable income would not exist against which DTAs could be used or realized should not be a driving consideration.

Additionally, DTAs on an organization's balance sheet are already subject to a "more-likely-than-not" to be realized valuation standard under GAAP with DTAs that are less than "more-likely-than-not" to be realized charged off to equity via a valuation allowance. Experience has shown that valuation allowances have been established with appropriate conservatism such that DTAs are valuable assets the inclusion of which in capital should not be overly constrained. As such, any deduction of the DTAs from regulatory capital is already conservative and overly restrictive, and further limiting it by lowering the deduction threshold from 25% to 10% is unwarranted and overly punitive.

Finally, we note that recent banking stress events have not changed the realizability of DTAs or the level of risks associated with temporary difference DTAs. As the Agencies previously noted in the preamble to the Capital Simplification Rule, "[a] banking organization's ability to realize its temporary difference DTAs is dependent on future taxable income; thus, the [25%] deduction threshold, together with a 250 percent risk weight for non-deducted temporary difference DTAs, will continue to protect banking organization capital against the possibility that the banking organization would need to establish or increase valuation allowances for DTAs during periods of financial stress."[40] There is nothing that suggests that the 25% threshold is no longer adequate to protect against such risk.

[40] 84 Fed. Reg. at 35239.

Even to the extent that the Agencies elect to remove the Simplified Deductions for Category III and IV banking organizations, the Agencies should, at a minimum, adjust the deduction framework as it applies to DTAs for Category III and IV firms. As described above, these concerns were articulated prior to finalization of the CECL framework, and certainly prior to the contemplated removal of the AOCI opt-out. It would be incongruous to include DTAs resulting from CECL and remove the AOCI opt-out without also considering whether the proposed deduction thresholds are appropriately calibrated for such institutions.

In light of these considerations, to the extent that the Agencies do not retain the Simplified Deductions, we then recommend that the Agencies increase the individual deduction threshold for temporary difference DTAs to 15% to account for the 37% increase in banks' allowances based on the FRB's estimated impact of CECL adoption (as of January 1, 2020).[41]

Alternatively, the Agencies could:

- Exclude DTAs associated with allowances for credit losses ("ACL DTAs") from the regulatory capital deduction limitation – ACL DTAs are recoverable DTAs and recognition of ACL DTAs occurs over a multi-year period, even during stress scenarios; during this multi-year period, ACL DTAs are recovered and more than offset by the associated loan interest income and fees of the portfolio;

- Provide a five year period for Category III and IV firms to phase-in the effects of the lowered deduction threshold; or

- Provide a higher deduction threshold for Category III organizations (relative to Category I and II organizations) and for Category IV organizations relative to Category III organizations, consistent with S. 2155.

Finally, in stress testing exercises, the FRB should also allow the assumption of a two-year net operating loss carryback for temporary difference DTAs (excluding net operating losses and credit carryforwards) for U.S. federal tax purposes under stress scenarios (which would be consistent with Congressional practice during periods of stress).

C. The final rule should retain a bifurcation in the CCB between the SA and ERBA.

Consistent with the current capital framework, the final rule should retain the bifurcated capital conservation buffer ("CCB") requirement. In particular, to the extent the Agencies retain the dual stack approach, the standardized CCB requirement for non-global systemically important bank holding companies ("GSIBs") should equal the sum of: (1) the applicable minimum standardized risk-based ratio; (2) the stress capital buffer ("SCB") requirement, calibrated based on supervisory stress testing using the standardized approach ("SA"); and (3) any applicable CCyB requirement.[42]

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41 FEDS Notes, New Accounting Framework Faces Its First Test: CECL During the Pandemic (Dec. 3, 2021).

42 We reiterate our recommendation that Category IV banking organizations not be subject to the CCyB.

A separate, expanded CCB requirement for non-GSIBs should equal the sum of: (1) the applicable ERBA ratio; (2) a fixed 2.5% CCB; and (3) any applicable CCyB requirement.

1. Challenges and Concerns.

Under the Proposal, Working Group members would be subject to a single CCB requirement, which would include the SCB requirement and applicable CCyB, and would apply to the lower of a banking organization's SA and ERBA ratios. Moreover, the SCB would be calibrated based on the binding CET1 ratio as of the final quarter of the previous capital plan cycle, regardless of whether it results from the SA or ERBA. This means that in any given quarter, the SCB could be calibrated based on one approach and apply to a binding ratio based on either approach. These concerns are amplified during the transition period in which the SCB could be calibrated on a lower phased-in (non-binding) percentage ERBA ratio, but would apply to a binding minimum ratio based on a more phased-in ERBA ratio.

Moreover, we note that both the supervisory stress test and ERBA (particularly the revised market risk capital framework) are intended to capture "tail-risks," such that it would be duplicative to require a firm to meet the requirements of ERBA on a post-stress basis.

Ultimately, this cherry-picking of ratios would increase the complexity and opaqueness associated with introducing the ERBA, result in potential duplicative requirements and exacerbate the impacts of the overly stringent implementation of the Basel Framework.

When the FRB proposed the SCB requirement in 2018, the FRB justified the (current) bifurcated approach to the CCB in part by observing that the FRB "has not used or required the use of the capital rule's advanced approaches in the supervisory stress test due to the significant resources required to implement the advanced approaches on a pro forma basis and due to the complexity and opaqueness associated with introducing the advanced approaches in supervisory stress projections."[43] The FRB further noted that both the supervisory stress test and the advanced approaches were "calibrated to reflect tail risks" and that "it could be duplicative to require a firm to meet the requirements of the advanced approaches on a post stress basis."[44]

This rationale continues to hold with the Proposal's introduction of ERBA, particularly as to revised market risk capital framework. In particular, the revised market risk capital framework was designed specifically to "improv[e] capture of tail risks and other features that are difficult to model,"[45] such that application of the SCB to an ERBA ratio would result in duplicative, overly complex requirements.

Since 2010, the U.S. regulatory framework already represents a patchwork of gold-plated Basel Committee on Banking Supervision ("BCBS") standards (including the Collins Amendment floor, SCB and U.S.-specific resolution planning requirements), not to mention an array of wide ranging

[43] Amendments to the Regulatory Capital, Capital Plan, and Stress Test Rules, 83 Fed. Reg. 18160, 18164 (Apr. 25, 2018).

[44] *Id.*

[45] 88 Fed. Reg. at 64169.

reforms encompassing standardized liquidity requirements, a separately proposed long-term debt requirement, single-counterparty credit limits, margin requirements, clearing requirements, enhanced governance standards, heightened risk management standards, enhanced reporting requirements, trading and activities restrictions and more stringent accounting for loan loss reserves, among others. By gold-plating the BCBS' SA, the already-convoluted U.S. regulatory framework would become untenably complex and conceptually incohesive, and run directly counter to the Agencies' stated objectives of decreasing "unwarranted variability" and improving consistency and transparency.

2. Recommendations.[46]

We reiterate our recommendation that the Agencies not subject Category IV banking organizations to the dual stack approach. For other banking organizations, we recommend the Agencies maintain separate capital conservation buffers as follows: (1) a standardized "stack" that includes U.S.-specific requirements, including the SCB and (2) an expanded "stack" based on ERBA, including a fixed 2.5% portion of the CCB. Doing so would greatly simplify the framework (including by making transition more intuitive) without compromising the Agencies' obligations under the Collins Amendment or their commitments to the BCBS, all while conceptually separating the BCBS ERBA framework from the U.S.-specific standardized framework.

III. Operational Risk: The operational risk framework should be revised and should not apply to Category IV banking organizations.

Banking organizations, like all companies, are exposed to operational risk and Working Group members currently manage and capitalize for their operational risks through ongoing risk management and through the inclusion of operational losses as part of the FRB's CCAR process. The Proposal, however, would impose a new, unprecedented "one-size-fits-all" approach capital charge for operational risk. To the extent the Agencies believe this operational risk framework is appropriate for the largest, most complex U.S. banking organizations, it is self-evident that the framework is *not* appropriate for smaller and simpler banking organizations, and especially Category IV banking organizations.

The Proposal's new operational risk framework would be the single largest source of RWA increase in the Proposal. Because the Proposal's operational risk calibration is extreme relative to its purpose of addressing base operational losses, and because banking organizations already account for stressed operational losses through CCAR, the Proposal would necessarily result in a framework-wide over-calibration of operational risk capital charges. Moreover, the Proposal does not provide a clear or convincing rationale for why this new requirement is necessary or why existing capital standards are insufficient to capitalize these risks. We reiterate Governor Waller's observation that operational losses do not tend to materialize contemporaneously with losses on credit exposures and market positions and therefore it does not make sense to require banking organizations to separately capitalize for operational risks.[47]

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[46] This discussion is responsive to Questions 7 and 8.

[47] FRB, Statement by Governor Christopher J. Waller (July 27, 2023), https://www.federalreserve.gov/newsevents/pressreleases/waller-statement-20230727.htm.

In addition, the Proposal's approach to operational risk fails to consider both the specific features and risk profiles of different banking organizations and business lines and the specific measures and controls that institutions have in place to mitigate operational risks. And unlike other aspects of the Proposal that are targeted to the risks of specific exposures, products or services, the operational risk capital requirements would impact the cost and availability of all financial products and services provided by banking organizations.

Accordingly, and as stated above, the final rule should not extend the operational risk framework to Category IV banking organizations. For other banking organizations that would be subject to the operational risk framework, including Category III banking organizations, we discuss below certain additional issues the framework poses. To address these and other issues related to the operational risk framework, we endorse the recommendations made in the ABA / BPI Letter.

A. The calibration for the services component should be improved.

A banking organization's operational risk capital charge would be a function of the organization's business indicator and an internal loss multiplier ("ILM"). The business indicator would be based on the sum of three components: (1) an interest, lease and dividend component; (2) a services component; and (3) a financial component. The services component is designed to capture fee and commission-based activities and other banking activities (such as those resulting in other operating income and other operating expenses) and would be a significant contributor to operational risk capital, which itself is the largest source of RWA increase in the Proposal.

As a practical matter, through the services component, the Proposal would apply a capital charge to fee-generating services, including interchange and other credit card services, as well as to custody, securities brokerage and execution and cash management services, which traditionally have not been subject to separate capital requirements. This would penalize fee-generating activities and discourage banking organizations from increasing their resilience through diversification. And the increased capital requirements would likely be borne by consumers and end-users in the form of higher fees or reduced availability of services.

Neither the Proposal, nor the Basel Framework, adequately justify the calibration of the services component. In fact, as FDIC Director McKernan has pointed out, the Basel consultations on the operational risk framework identified that the services component was miscalibrated for banks with high fee incomes, proposed a fix to the issue, then declined to adopt the fix without explanation.[48] It is not clear why the Agencies, who propose to deviate from the Basel Framework in several other places, declined to propose an improved version of the services component.

Significantly, the Agencies provide no analysis in the Proposal of the impact of proposed RWA changes on banking organizations' credit card-related services, asset management, custodial, wealth management activities or other fee-generating activities. This is a critical oversight, particularly

[48] BCBS, Consultative Document, Standardised Measurement Approach for operational risk at ¶ ¶ 16(d), 20, https://www.bis.org/bcbs/publ/d355.pdf; FDIC, Statement by Jonathan McKernan, Member, FDIC Board of Directors, on the Proposed Amendments to the Capital Framework (July 27, 2023), https://www.fdic.gov/news/speeches/2023/spjul2723c.html.

because the introduction of the operational risk charges would change the RWA profiles of each of these categories of activities.

In addition, the Proposal's disparate treatment between interest income and fee-based income does not make conceptual sense. For example, in the case of the interest, lease and dividend component, operational risks are measured on a net basis with respect to net interest income, or revenues less costs. However, in the case of the services component, operational risks are measured on a gross basis with respect to the maximum of revenues and costs. Similarly, the interest, lease and dividend component is subject to a cap of 2.25% of the institution's interest income-generating assets, because as the Proposal explains, "operational risk does not necessarily increase proportionally to increases in net interest income."[49] The Proposal's logic for capping the interest component extends to fee-based income, but the Proposal does not provide a similar cap for services component. This treatment would result in an operational risk framework disconnected from the actual risk arising from different activities and would disincentivize banks from increasing their resiliency by diversifying their revenue streams.

B. The calibration of the internal loss multiplier should be improved.

Unlike proposals and near-final implementations in jurisdictions such as the United Kingdom and European Union, the Proposal would floor the ILM at 1. In so doing, the Agencies would neither exercise national discretion explicitly contemplated by the BCBS to set the ILM at 1 nor adopt the BCBS' recommendation to allow the ILM to be equal to a value less than 1, which would allow banking organizations with few losses to reduce their operational risk capital requirements. The Proposal's approach to the ILM would thus create divergence from, as opposed to harmonization with, international standards and so would harm the international competitiveness of U.S. banking organizations.

In considering their approach to the operational risk framework, other jurisdictions recognize that past loss observations (especially significantly old ones) do not mechanically predict future losses. Accordingly, in line with the considerations set forth by the UK's Prudential Regulation Authority in connection with the UK's proposed implementation of the Basel III endgame and relevant research on operational risk, the Agencies should consider that:

- The calculation of ILM is non-linear, so operational risk capital requirements increase slower than historical losses;
- The ILM calculation does not properly account for the "fat-tailed" nature of operational loss distribution, which is characterized by infrequent but very sizable losses;
- Low probability operational loss events that may be high-impact are heterogeneous and therefore are not good predictors of future losses;
- The information value of historic operational risk losses generally lessens over time, with loss history being informative for up to three years, per research by Federal Reserve

[49] 88 Fed. Reg. at 64084.

economists.[50] This may be in part because a banking organization's business models and lending activities may change;

- The 10-year window for calculating the average of past losses could be inappropriately affected by a banking organization's large historical operational risk losses near the start of the 10-year period, which might be a poor predictor of future losses. This, combined with the "fat-tailed" nature of losses, means that a firm that suffered an improbable but large loss would pay for it in its capital requirements for 10 years, even if there is no evidence that the loss is likely to be repeated;

- Evidence suggests that size, rather than the amount of past losses is the dominant differentiator of operational risk, making the ILM an unnecessary measure.[51]

The Proposal's approach would guarantee that any U.S. banking organization would have an ILM equal to or greater than a UK or EU firm. Finally, although the Basel Framework's formula does not explicitly set a floor, the natural log (ln) function in the ILM implicitly creates a floor[52] that provides the "robust minimum amount of coverage" the Agencies base their proposed floor on.[53] The Proposal's floor is thus a solely punitive measure and so the calibration of the ILM should be improved such as by setting it equal to 1, consistent with international practice.

IV. Credit Risk: The final rule's credit risk framework should be better aligned with actual risk.

As noted in the Appendix, the Proposal's credit risk framework would impose inflated risk weights for almost every asset class relative to the Basel Framework and/or international proposals to implement the Basel III endgame. This approach would harm the international competitiveness of U.S. banking organizations and runs counter to the BCBS' overarching goal of harmonizing capital standards across jurisdictions. More importantly, the Agencies have failed to justify these inflated risk weights which would result in artificially inflated capital needs for consumer products. This, in turn, would adversely impact the pricing and availability of these products. Reduced access to these products would also push more consumers into the less regulated shadow banking space.

Though the Proposal's credit risk framework raises a significant number of issues, we focus our comments here to certain key concerns. We also endorse and echo the recommendations made by the ABA / BPI Letter as well as by the Consumer Bankers Association.

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50 Filippo Curti & Marco Migueis, The Information Value of Past Losses in Operational Risk at 2, 21–25 (Jan. 2023), https://www.federalreserve.gov/econres/feds/files/2023003pap.pdf.

51 "Operational risk - Revisions to the simpler approaches" (Oct. 6, 2014), https://www.bis.org/publ/bcbs291.htm ("size is found to be a significant risk-driver").

52 This floor is ln(e-1) or about .54.

53 88 Fed. Reg. at 64086.

A. The Agencies should recalibrate risk weights for retail exposures to align with the risk posed by these exposures.

As part of the 2017 revisions, the BCBS revised capital requirements applicable to retail exposures to vary based on product type. The revisions differentiated between regulatory retail exposures, transactor exposures and other retail exposures, and assigned different risk weights to each.[54] The Proposal adopts the Basel Framework's differentiation, but unnecessarily and unreasonably assigns inflated, Basel non-compliant risk weights to these exposures.[55] This gold-plating is also inconsistent with international proposals to implement the Basel III endgame. For example, the UK and EU both propose to adopt the Basel Framework's risk weights without change.[56]

These inflated risk weights are not justified, and when combined with other aspects of the Proposal, including the new operational risk capital charge and the new CCF, would increase the capital needs for consumer products, which in turn would adversely impact the pricing and availability of these products. Moreover, as a conceptual matter, the Proposal's approach to retail exposures is at cross-purposes with the Agencies' recently finalized CRA rule. In particular, in his statement marking the adoption of the CRA rule, Vice Chair Barr noted the rule would "encourage banks to expand access to credit, investment, and banking services in low- and moderate-income [("LMI")] communities."[57] By contrast, the Proposal would have the opposite effect by making it more expensive for banking organizations to provide loans and other banking services to LMI communities. We are concerned that the Agencies considered impacts to LMI communities only as an "afterthought" in connection with releasing the Proposal.[58]

Accordingly, we recommend that the risk weights for retail exposures be recalibrated to align with the actual risk posed by these exposures as discussed further in the ABA / BPI Letter and be set no higher than the retail risk weights provided for the in Basel Framework.

1. Challenges and Concerns.

The Proposal's gold-plating of the Basel Framework risk weights for retail exposures is unnecessary, not supported by data and inconsistent with international standards. The Proposal asserts that gold-plating the risk weights for retail exposures is necessary "to mitigate potential competitive effects between U.S. banking organizations" as "marginal funding costs…for many

[54] BCBS, The Basel Framework, CRE ¶ 20.68.

[55] 88 Fed. Reg. at 64053.

[56] UK Consultation ¶ 3.139; Proposal for amending Regulation (EU) No 575/2013 as regards requirements for credit risk, credit valuation adjustment risk, operational risk, market risk and the output floor, COM/2021/664 (Oct. 27, 2021) ("EU Proposal") at Article 123.

[57] FRB, Statement on the Community Reinvestment Act Final Rule by Vice Chair for Supervision Michael S. Barr (Oct. 24, 2023), https://www.federalreserve.gov/newsevents/pressreleases/barr-statement-20231024.htm.

[58] FDIC, Statement by Jonathan McKernan, Member, FDIC Board of Directors, on the Proposed Amendments to the Capital Framework n.15 (July 27, 2023), https://www.fdic.gov/news/speeches/2023/spjul2723c.html..

large banking organizations could have [otherwise] been substantially lower than for smaller organizations not subject to the proposal."[59]

The concern about marginal funding costs is misplaced. Large banking organizations subject to the Proposal would be required to compute their capital requirements both under ERBA and under the current SA, with their capital requirements being based on the more punitive of the two calculations, consistent with the Collins Amendment. This floor would limit the benefit large banking organizations might see from implementing risk weights better aligned with the risks associated with retail exposures. Moreover, large banking organizations, unlike smaller banking organizations, would be required to capitalize for operational risk and are subject to the SCB and a separately proposed long-term debt requirement. These additional capital requirements increase marginal funding costs for these large banking organizations relative to smaller banks. Not only does the Proposal fail to consider these factors, it also fails to present any data supporting its contention regarding marginal funding costs.

Ultimately, the impact of the increased risk weights will be borne by American consumers, as the Proposal would raise their cost of borrowing and reduce their access to credit.

2. Recommendations.[60]

We recommend the final rule recalibrate the risk weights for retail exposures so that they are no higher than the Basel Framework's risk weights for retail exposures and are based on an empirical analysis of the actual risk posed by these exposures as discussed further in the ABA / BPI Letter. Doing so would increase the risk sensitivity of the final rule and mitigate any potential harm to consumers.

B. The final rule's approach to CCFs should be recalibrated to reduce negative impacts to consumers.

1. Challenges and Concerns.

The Proposal would change the treatment of off-balance sheet items in a number of ways including by increasing the CCF for UCCs from 0% to 10% and establishing a methodology for estimating a hypothetical maximum for commitments with an express contractual maximum (such as certain charge cards).

The CCF increase from 0% to 10% for UCCs, including the unused portion of credit cards is not appropriate as, by definition, a bank can unconditionally cancel these commitments. Moreover, this increased CCF would make it more expensive to extend credit to or increase credit limits for consumers. To the extent the Proposal would lead to banks reducing or holding constant credit lines, consumer utilization rates would increase, thus potentially leading to lower credit scores. In turn, these lower credit scores would make it more difficult for consumers to access any kind of financing, including mortgages, student loans and auto loans.

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59 88 Fed. Reg. at 64170.

60 This section is responsive to Question 34.

Moreover, the 10% CCF for UCCs would put pressure on credit card banks to more frequently cancel unused cards with pre-set credit limits (thereby reducing consumers' access to emergency funds), even though undrawn accounts are not likely to implicate the financial stability risks the Proposal aims to address. In addition, the Proposal suggests a methodology to calculate the off-balance sheet notional exposure amount for charge cards with no pre-set limit. This methodology involves multiplying the average total drawn amount of the commitment over the prior eight quarters by 10. In proposing this multiplier of 10, as with the rest of the methodology, the Agencies provide no justification for its calibration. Based on industry analysis, we believe the calibration of the CCF and the parameters to calculate off-balance sheet notional exposure are inappropriately stringent and accordingly should be revised.[61]

Finally, as the examples in the Proposal's preamble indicate, the UCC portions of many credit cards and charge cards would be assigned retail exposure risk weights. As discussed above, the Proposal would apply inflated risk weights to retail exposures, and credit cards and charge cards that generate both interest income and fee income would also receive an additional operational risk capital charge under ERBA. Together, the inflated retail risk-weight, the over-calibration of the operational risk framework and the new CCF charge would significantly increase the capital requirements for credit cards and charge cards. It is therefore important that the Agencies consider the impact of various aspects of the Proposal (and for that matter, the capital framework) as a whole, rather than considering each aspect individually. To that end, we reiterate our recommendations that the Agencies recalibrate the risk weights for retail exposures based on actual risk and address the over-calibration of the Proposal's operational risk framework.

2. <u>Recommendations</u>.

The Agencies should ensure that they do not inappropriately hamper consumers' access to credit and reduce consumer credit scores. Accordingly, we recommend that the final rule:

- **Recalibrate the CCF based on empirical data and set it no higher than 6.5%.** Though we do not believe UCCs should be subject to any capital charge as they are unconditionally cancellable, based on industry analysis we believe the Agencies could improve the risk sensitivity of the final rule while still maintaining a conservative CCF by recalibrating the CCF for UCCs based on empirical data and setting it no higher than 6.5%.

- **Eliminate capital charges for accounts with pre-set limits with no funds drawn for 8 quarters.** Under the Proposal, charge cards with no pre-set limit with no drawn funds for 8 quarters would not be subject to a capital charge. We believe this treatment should be extended to cards with pre-set limits.

- **Revise the multiplier to calculate off balance sheet notional exposures.** Industry analysis and experience suggests that multiplier of 10 for off balance sheet notional exposures is excessive. Accordingly, the Agencies should revise the multiplier based on an analysis of these exposures.

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[61] This analysis is discussed in greater detail in the ABA / BPI Letter.

Adopting these recommendations will improve the risk sensitivity of the final rule and reduce the impacts of the Proposal on American consumers.

C. The final rule should provide for an 85% risk weight for exposures to corporate SMEs.

As part of the 2017 revisions to the Basel Framework, the BCBS included a separate, 85% risk weight for unrated exposures to corporate small or medium-sized entities ("SMEs").[62] Inconsistent with the Basel Framework, the Proposal does not include a separate risk weight for corporate SMEs, instead subjecting such exposures to general corporate risk weights.[63] Excluding this separate classification means that exposures to such entities would almost always be subject to a 100% risk weight (assuming the public listing requirement is retained), which would be inconsistent with the Basel Framework and proposals in other major jurisdictions such as the EU and UK.[64] The effect of this omission would be to favor lending to large, publicly listed corporations, and reducing lending from banking organizations to corporate SMEs. Accordingly, we recommend that the 85% risk weight carve-out for corporate SMEs be included in the final rule in line with the Basel Framework.

1. Challenges and Concerns.

The Proposal's omission of a separate category of corporate SMEs with a lower risk weighting will reduce corporate SMEs' ability to access credit, and could stifle the growth and development of SMEs that are critical to fueling innovation that powers the American economy. Additionally, the lack of differentiation in risk weights could lead corporate SMEs to borrow from largely unregulated non-bank financial institutions instead of borrowing from banking organizations, encouraging the buildup of leverage outside of the regulated financial sector.

This omission also represents a significant and unexplained departure from the Basel Framework and international practice. For example, the UK proposed to adopt the 85% risk weight. Similarly, the EU provides SME support factors to reduce the cost of lending to SMEs. Accordingly, the Proposal would put U.S. banks at a competitive disadvantage relative to their foreign competitors.

2. Recommendations.[65]

We recommend that the final rule assign an 85% risk weight to exposures to corporate SMEs in line with the Basel Framework. Doing so would promote lending to American small businesses, harmonize U.S. capital standards with other major jurisdictions and improve the risk sensitivity of the final rule.

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[62] Basel Framework, CRE ¶ 20.47.

[63] 88 Fed. Reg. at 64054.

[64] UK Consultation ¶ 3.127; EU Proposal at Article 501.

[65] This section is responsive to Question 40.

D. The final rule should assign a 65% risk weight to any exposure to a company that is investment grade without regard to whether the company, or its parent, has publicly traded securities outstanding.

Under the Proposal, a banking organization would assign a 65% risk weight to a corporate exposure that is both (1) an exposure to a company that is investment grade and (2) where that company, or a parent that controls that company, has publicly traded securities outstanding. While we are supportive of distinguishing between investment grade exposures and other exposures, there is no merit in the public listing requirement – it arbitrarily imposes an unnecessary cost on small and medium businesses, large companies that choose not to access public markets and institutional investors and regulated entities that do have access to or do not access public markets in the regular course of business. Accordingly, we recommend removing the public listing requirement and assigning a 65% risk weight to any exposure to a company that is investment grade.

1. <u>Challenges and Concerns</u>.

The Agencies do not explain why a public listing requirement would justify the significant and unnecessary costs it would impose on lending to creditworthy private companies, or whether there are credible alternatives that accomplish the Agencies' objectives.

In particular, the Agencies justify the public listing requirement by asserting that (i) the requirement is simple and objective, so it would provide consistency between organizations, and (ii) publicly-traded companies are subject to enhanced transparency and market discipline.

While consistency is a defensible objective, consistency cannot be evaluated in a vacuum. Rather, consistency implies: (i) the presence of some quality to be assessed (creditworthiness) and (ii) that such assessment is performed in the same way over time, resulting in similar outputs for similar inputs. In other words, the criteria used to create consistency must bear some reasonable relationship to the underlying quality being measured. In jurisdictions outside of the United States and under the Basel Framework, external credit ratings provide a standardized set of external criteria that help to evaluate creditworthiness (the underlying quality being assessed).

In contrast, while a public listing requirement would provide some measure of consistency, the dimensions across which such consistency is manufactured only bears a tenuous relationship to creditworthiness.[66] Whether a company is publicly listed depends on meeting the listing criteria for an exchange, which requirements vary from exchange to exchange. In many cases, these criteria are aimed at ensuring a baseline of information to retail investors and do not bear a reasonable relation to how sophisticated banking organizations evaluate credit risk. In this regard, it is unclear how the New York Stock Exchange's listing requirements (to take an example) have a meaningful or consistent bearing on the creditworthiness of a company. In other words, there is no evidence or analysis to suggest that a public listing requirement would result in an increase in consistency

[66] In fact, in the banking context, one study published in the FRBNY Economic Policy Review stated, "risk between publicly held and privately owned banking companies—whether measured by loan portfolio quality or earnings variability—is statistically indistinguishable." Simon H. Kwan, "Risk and Return of Publicly Held versus Privately Owned Banks," FRBNY Economic Policy Review (Sept. 2004), *available at* https://www.newyorkfed.org/medialibrary/media/research/epr/04v10n2/0409kwan.pdf.

across banking organizations' assessments of creditworthiness, or that any statistical effect demonstrating such increase represents something meaningful given that public listing requirements vary from exchange to exchange, and across jurisdictions.

Moreover, consistency can be achieved through other means – such as borrowers being subject to regulatory requirements that promote prudent risk taking. This form of consistency would actually be pertinent to creditworthiness – a prudently managed entity is less likely to default relative to a thinly capitalized one.

With respect to transparency and market discipline, we agree those factors may be important for a banking organization to determine the riskiness of corporate exposures. However, many unlisted entities provide greater transparency than publicly listed entities. For example, pension funds are subject to extensive regulation promoting high levels of both transparency and market discipline, even though they do not, in the usual course of business, access public markets. In fact, through requirements such as daily net asset value calculation requirements and disclosure requirements under the laws of several jurisdictions, pension funds often disclose information comparable to or, in some cases, greater than publicly listed entities.

Accordingly, apart from having no bearing on creditworthiness, a public listing requirement does not have merit even based on the Agencies' justification. Moreover, the inflated risk weights are inconsistent with other major proposals to implement the Basel III endgame and undermine the Agencies' goals of harmonizing capital standards across jurisdictions.

2. Recommendations.[67]

A public listing requirement would increase the cost of lending to private investment grade entities and increase borrowing costs for these entities. These private entities include many high-quality, low risk corporate exposures, such mutual funds and pension funds that do not typically list securities on an exchange but are subject to supervision and regulation, and stringent activities and prudential limitations, comparable to or exceeding exchange listing requirements.[68]

We therefore recommend that the Agencies remove the public listing requirement and permit banking organizations to assign a 65% risk weight to corporate exposures that are investment grade, regardless of whether they are publicly listed. The Agencies have not presented any compelling reason to justify a public listing requirement and such a requirement would impose an unnecessary cost to private investment grade entities. Moreover, the requirement would put U.S. banking organizations at a competitive disadvantage relative to banks in most other jurisdictions with no public listing requirement.

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[67] This section is responsive to Questions 38 and 39.

[68] Registered investment companies, for example, report certain census information annually to the Commission on Form N–CEN. 17 CFR § 270.30a-1. Registered investment companies also are required to report monthly portfolio-wide and position-level holdings data to the Commission on Form N–PORT. 17 CFR § 274.150. This includes information regarding repurchase agreements, securities lending activities, and counterparty exposures, terms of derivatives contracts, and discrete portfolio level and position level risk measures to better understand fund exposure to changes in market conditions.

Alternatively, the final rule should allow a banking organization to assign a 65% risk weight to an investment grade exposure to: (i) a company with publicly listed securities outstanding (or that is controlled by a company with publicly listed securities outstanding); (ii) highly-regulated entities (including mutual funds and business development companies registered under the Investment Company Act of 1940; pension funds such as employee benefit plans and government plans as defined in the Employee Retirement Income and Security Act of 1974, and foreign equivalents; investment advisors; insurance companies; broker-dealers; swap dealers; security-based swap dealers and foreign equivalents); and (iii) a company with audited financial statements, unaudited interim financial statements and, where relevant, the fund's prospectus.

V. Equity Risk: The final rule should retain the 100% risk weight for non-significant equity exposures and assign a 100% risk weight for equity exposures pursuant to nationally legislated programs.

We recommend that the final rule retain the 100% risk weight for non-significant equity exposures which, in aggregate, do not exceed 10% of the banking organization's total capital. In addition, we recommend that the Agencies allow banking organizations to assign a 100% risk weight to equity exposures pursuant to a nationally legislated program. Working Group members currently use the "bucket" for non-significant equity exposures to entities such as small business investment companies ("SBICs"), as required by the current capital rule, venture capital funds, to promote the capital formation and innovation, and equity exposures related to nationally legislated tax equity investments such as renewable electricity production tax credits and renewable energy investment tax credits. Retaining the 100% risk weight bucket for non-significant equity exposures and allowing a 100% risk weight for all nationally legislated programs would align with the Basel Framework which allows banking organizations to assign a 100% risk weight to exposures related to nationally legislated programs up to 10% of the banking organization's total capital. [69]

1. Challenges and Concerns.

In line with the Agencies' current capital rules, banking organizations assign a 100% risk weight to exposures that qualify as community development investment under the National Bank Act and investments and to non-significant equity exposures up to 10% of their total capital to SBICs, tax equity investments provided for by the Internal Revenue Code, non-significant exposures to venture capital funds and similar investments.

The Proposal would eliminate the 100% bucket for non-significant equity exposures up to 10% of the organization's capital, and instead assign a 100% risk weight to community development investments and SBIC investments. As a practical matter, this would raise the capital requirements on many nationally legislated programs, venture capital investments and other similar investments. This outcome would restrict banking organizations' ability to invest in national priorities and their ability to provide funding to small businesses, thus hindering economic growth in areas of national concern.

[69] Basel Framework, CRE ¶ 20.59.

Moreover, the Proposal's treatment of non-significant equity treatment is neither internally consistent nor is it consistent with the Basel Framework. For example, while the Proposal allows for a 100% risk weight for SBIC exposures, it effectively disallows the same treatment for venture capital funds. However, underlying policy considerations suggest both asset classes should be eligible for similar treatment. Specifically, the statutory framework establishing SBICs provides that:

> [i]t is declared to be the policy of the Congress and the purpose of this chapter to improve and stimulate the national economy in general and the small-business segment thereof in particular by establishing a program to stimulate and supplement the flow of private equity capital and long-term loan funds which small-business concerns need for the sound financing of their business operations and for their growth, expansion, and modernization, and which are not available in adequate supply.[70]

The same rationale is evident in the Agencies' approach to qualifying venture capital funds in the Volcker Rule. Specifically, the Agencies excluded venture capital funds from the definition of a covered fund (and the attendant investment restrictions) because the Agencies believed that banking organizations' investment in venture capital funds would "support capital formation, job creation, and economic growth, particularly with respect to small businesses and start-up companies."[71]

We agree that banking organizations' investments in venture capital funds, like their investments in SBICs, support small businesses and thereby promote economic growth and job creation. As such, we do not believe it is appropriate for the Agencies' to effectively raise capital requirements for these investments by removing the non-significant equity bucket.

Similarly, the Proposal would allow banking organizations to assign a 100% risk weight to community development investments, including tax equity exposures to low-income housing tax credits[72] and new market tax credits,[73] in part because these investments "generally receive favorable tax treatment and/or investment subsidies that make their risk and return characteristics different than equity investments in general."[74] This rationale comports with the Basel Framework which allows for a 100% risk weight to "national legislated programmes that provide significant subsidies for the investment to the bank and involve government oversight and restrictions on the equity investments."[75]

The Agencies' and the Basel Framework's rationale extends equally to other forms of tax equity investments and nationally legislated programs including renewable electricity production tax credits and renewable energy investment tax credits. These exposures "receive favorable tax

70 15 U.S.C. § 661.

71 Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, 85 Fed. Reg. 46422, 46444 (July 31, 2020).

72 12 CFR 24.6(a)(4).

73 12 CFR 24.6(c)(3).

74 88 Fed. Reg. at 64077.

75 Basel Framework, CRE ¶ 20.59.

treatment . . . that make their risk and return characteristics different than equity investments in general."[76] Moreover, as part of statutorily established programs, both "involve government oversight and restrictions on the equity investments."[77] For example, the allocation of tax credits associated with these tax equity investments is subject to Internal Revenue Service interpretation.[78]

2. Recommendations.

As demonstrated above, the Proposal's removal of the non-significant equity bucket results in an inappropriately punitive treatment for non-significant equity exposures, including investments in venture capital funds and tax equity investment exposures. Moreover, its failure to extend the 100% risk weight to all nationally legislated programs is inconsistent with the Basel Framework and with U.S. policy goals.

Accordingly, **we suggest the Agencies retain the 100% risk-weight for non-significant equity exposures**. Banking organizations have been assigning a 100% risk weight to non-significant equity exposures for nearly a decade now. The Agencies have not justified a shift from that approach, nor has our experience suggested this bucket should be removed. Moreover, retaining the bucket would allow banking organizations flexibility as they make investments to strengthen their communities and the economy. In addition, **we recommend the Agencies allow a 100% risk weight for all equity exposures pursuant to nationally legislated programs**. Doing so would promote consistency both with international capital standards and within the U.S. capital framework.

Alternatively, we recommend the Agencies:

- **Allow a 100% risk weight for exposures to venture capital funds.** As discussed above, banking organizations' investments in venture capital funds address the same policy goals as investments in SBICs. Accordingly, we believe investments in venture capital funds should receive the same 100% risk weight as investments in SBICs. For similar reasons, we suggest the Agencies allow banking organizations to assign a 100% risk weight to direct investments in certain small businesses.

- **Allow a 100% risk weight for an initial investment period.** We recommend allowing banking organizations to assign a 100% risk weight to a non-significant equity exposure for an initial investment period. This approach would be analogous to the Volcker Rule's provisions for a seeding period.[79]

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76 88 Fed. Reg. at 64077.

77 Basel Framework at CRE 20.59.

78 Internal Revenue Service, Rev. Proc. 2007-65; Mark P. Keightley et al., Tax Equity Financing: An Introduction and Policy Considerations, Congressional Research Service at 8 (Apr. 17, 2019).

79 12 CFR 248.12(a)(2)(i).

Thank you for considering these comments. Should there be any questions concerning the comments reflected above, kindly contact Edward J. DeMarco, Jr., at edemarco@rmahq.org or at 215 446-4052 with any questions.

Very truly yours,

Edward J. DeMarco, Jr.

Edward J. DeMarco, Jr.
General Counsel

APPENDIX

Deviations from International Standards

In the FRB meeting to consider releasing the Proposal for notice and comment, FRB staff, in response to questions from governors, noted that the Proposal "is broadly consistent with [] international standards."[80] However, as the tables below illustrate, the Proposal's credit risk treatment of almost every asset class is more punitive than the Basel Framework and/or international proposals to implement the Basel III endgame. These are not the only examples of the Proposal's gold-plating of international standards, but rather are illustrative of the overall way in which the Proposal is misaligned with international standards. To the extent the Agencies wish to harmonize capital requirements across jurisdictions, the final rule should be revised.

Table A.I: Retail Exposures

	Regulatory Retail	Transactors	Other
Basel Framework	75%	45%	100%
Proposal (Basel +10 p.p.)	**85%**	**55%**	**110%**

80 FRB, Transcript of Open Board Meeting at 17 (July 27, 2023), https://www.federalreserve.gov/mediacenter/files/open-board-meeting-transcript-20230727.pdf.

Table A.II: Residential real estate exposures							
LTV bands	50% or below	50% to 60%	60% to 70%	70% to 80%	80% to 90%	90% to 100%	above 100%
General residential real estate exposures							
Basel Framework	20%	25%	30%		40%	50%	70%
Proposal (Basel +20 p.p.)	**40%**	**45%**	**50%**		**60%**	**70%**	**90%**
Income-producing residential real estate							
Basel Framework	30%	35%	45%		60%	75%	105%
Proposal (Basel +20 p.p.)	**50%**	**55%**	**65%**		**80%**	**95%**	**125%**

Table A.III: Corporate Exposures			
	Corporate SMEs	IG Corporate without Publicly Listed Securities	Certain Highly Regulated Financial Institutions
Basel Framework	85%	100%	100%
EU/UK Proposals	EU: 100% reduced by SME Support Factor UK: 85%	65%	Often treated as bank exposures (subject to risk weights as low as 30%)
Proposal	**100% (Higher than Basel Framework and UK Proposal, effectively higher than EU Proposal)**	**100% (Higher than EU and UK Proposals)**	**100% (Typically higher than Basel Framework and EU and UK Proposals)**

Table A.IV: Bank Exposures			
	Exposures to well-capitalized* Grade A Banks	Short-term exposures** to Grade A Banks	Short-term exposures** to Grade B Banks
Basel Framework	30%	20%	50%
Proposal	**40%**	**40%**	**75%**

* Grade A banks with a CET1 ratio of 14% or more and a Tier 1 leverage ratio of 5% or more.
** Exposures to banks with an original maturity of three months or less, as well as exposures to banks that arise from the movement of goods across national borders with an original maturity of six months or less.