


January 16, 2024

Via Electronic Mail
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Secretary
Board of Governors of the Federal Reserve System
20th Street & Constitution Avenue NW
Washington, D.C. 20551
Docket No. R-1813; RIN 7100-AG64

Federal Deposit Insurance Corporation
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Washington, DC 20429
Attention: James P. Sheesley, Assistant Executive Secretary
RIN 3064–AF29

Office of the Comptroller of the Currency
400 7th Street SW, Suite 3E-218
Washington, DC 20219
Attention: Chief Counsel's Office, Comment Processing
Docket ID OCC–2023–0008; RIN 1557–AE78

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

Ladies and Gentlemen:

Capital One Financial Corporation, The PNC Financial Services Group, Inc., Truist Financial Corporation, and U.S. Bancorp (collectively, the "**Banks**" or "we") appreciate the opportunity to comment on the notice of proposed rulemaking issued by the Board of Governors of the Federal Reserve System (the "**Federal Reserve**"), the Office of the Comptroller of the Currency and the Federal Deposit

Insurance Corporation (the "**Agencies**") to amend the U.S. Basel III capital rules on July 27, 2023 (the "**Proposed Rule**").[1]

We are Category III banking organizations with total consolidated assets between approximately $470 billion and $668 billion as of September 30, 2023. Collectively, we play an important role in the United States economy—our retail and commercial bank or retail brokerage business models focus on the banking and other financial services needs of American consumers, small businesses, middle market companies, large corporations and institutions and state and municipal governments. We recognize the importance of robust capital requirements in the United States as a part of the broader regulatory framework applicable to U.S. banking organizations. We support efforts to make the U.S. Basel III capital rules more risk-sensitive and comparable to those adopted in other countries whose banking organizations we compete against in the United States, while at the same time allowing the U.S. banking sector to continue to grow and support the broader U.S. economy without driving more banking activity into other, less regulated or unregulated sectors of financial services.

The Banks are concerned, however, that the Proposed Rule suffers from a number of serious deficiencies, including:

(1) the Proposed Rule would impose stricter requirements than the standards that the Basel Committee on Banking Supervision published in December 2017 to finalize the Basel III reforms (the "**Basel Framework**"),[2] without compensating for the fact that the existing U.S. Basel III capital rules, initially finalized by the Agencies in 2013, (the "**U.S. Capital Rules**") are already designed to produce higher capital requirements than the Basel Framework, including through the stress capital buffer ("**SCB**") requirement, thus putting U.S. banking organizations with $100 billion or more in total consolidated assets at risk of becoming less competitive compared to non-U.S. banking organizations and the U.S. shadow banking sector;

(2) the Proposed Rule would make it more expensive for large U.S. banking organizations to engage in fundamentally important consumer financing and

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

[2] Basel Committee on Banking Supervision, *Basel III: Finalising Post-Crisis Reforms* (Dec. 2017), available at https://www.bis.org/bcbs/publ/d424.pdf.

credit activities such as credit cards and residential mortgage lending and servicing, due to a combination of (i) increased deductions from capital for mortgage servicing assets ("**MSAs**") and temporary difference deferred tax assets that the banking organization could not realize through net operating loss carrybacks ("**DTAs**"), (ii) increased risk-weighted assets ("**RWAs**") for credit risk, and (iii) the structure of the new standardized approach for operational risk, which punishes fee-earning services and provides no relief for banking organizations that experience relatively lower operational losses relative to their volume of business;

(3) the Proposed Rule would make it more expensive for U.S. banking organizations to extend credit to, or invest in, small and medium-sized enterprises ("**SMEs**"), projects that advance important national interests, and even their own employee benefit plans; and

(4) as the Federal Reserve has itself implicitly acknowledged by launching a data collection initiative on October 20, 2023, there was insufficient data to support the Proposed Rule. The Agencies, nevertheless, have compounded this fundamental flaw by cutting off the extended comment period for the Proposed Rule on the same day as the due date for the data to be submitted to the Federal Reserve by the affected U.S. banking organizations.

In this comment letter the Banks draw the Agencies' attention to specific aspects of the Proposed Rule that the Banks believe will have a material negative impact on our businesses, our ability to serve our clients, and the broader U.S. banking sector, along with recommendations for how to correct these deficiencies.

I. Executive Summary

The Banks support the Agencies' efforts to make the U.S. Basel III capital rules more risk-sensitive and to align the capital rules more closely with those adopted in other countries. The Banks, however, have identified a number of deficiencies with the Proposed Rule and we recommend changes to the proposal that would allow the Banks to better serve their communities. In aggregate, the Agencies' proposal would require U.S. banking organizations to hold significantly more capital than required by the Basel Framework or other foreign jurisdictions. This would impose a punitive measure on U.S. banking organizations, making it more challenging for them to continue to provide the same level of credit and related banking services to clients and to compete against both nonbank financial institutions ("**NBFIs**") and non-U.S. banking organizations.

The Agencies have estimated that the Proposed Rule would increase total RWAs for affected bank holding companies by 20%, with the largest effects being from operational risk capital requirements and market risk capital requirements. Although the Agencies estimate that, in the aggregate, RWAs for credit risk under the Enhanced Risk-Based ("**ERB**") Approach would decrease under the Proposed Rule as compared to the existing standardized approach, overall capital requirements would increase for many types of credit exposures that are important to the customers and communities served by the Banks and to the broader U.S. economy.

As discussed in greater detail in subsequent sections of this comment letter, the Banks have the following primary concerns with the Proposed Rule:

Negative Impact on Mortgage Lending. The combined effect of several aspects of the Proposed Rule would increase the cost of mortgage lending and have a material negative impact on our ability to provide residential mortgage and home equity loans at a reasonable cost to consumers, including low- to moderate-income ("**LMI**") and minority borrowers. These negative impacts would arise primarily due to the Proposed Rule's:

- Establishment of risk weights for residential mortgages that are 20 percentage points higher than the Basel Framework, with the highest capital charges applied to mortgage loans with smaller down payments, which are frequently issued to first-time homebuyers or LMI borrowers;

- Unnecessary restrictions on the amount of MSAs that Category III and IV banking organizations may include in Common Equity Tier 1 ("**CET 1**") capital;

- Punitive capital requirements for banking organizations that provide both first-lien and second-lien mortgages to the same borrower, thereby disincentivizing banking organizations from engaging in the type of relationship banking that is fundamental to our business models and helpful to borrowers facing financial hardship;

- Introduction of a new standardized capital requirement for operational risk, which would require banking organizations to hold additional capital based on the amount of fees they earn from servicing mortgages; and

- Introduction of a new standardized approach for calculating RWAs for securitization exposures ("**SEC-SA**"), which is expected to materially increase

the capital required in connection with securitization vehicles used by banking organizations to reduce the risk associated with originating mortgage loans.

Negative Impact on SMEs. The Proposed Rule would require banking organizations to hold additional capital against most SME exposures relative to exposures to larger businesses, even when the credit risk of the SME is equivalent to that of the larger business. This is because the Proposed Rule would apply a 65% risk weight to a corporate exposure made to an investment grade issuer if the issuer or its parent is publicly listed, but would apply a 100% risk weight if neither the borrower nor its parent is publicly listed. Given that few SMEs are publicly listed companies, corporate exposures to investment grade SMEs would rarely receive a 65% risk weight. The Proposed Rule would further discourage SME financing by effectively quadrupling the risk weight applicable to equity exposures to nonpublic SMEs.

Negative Impact on Consumer Financing, Including Credit Card and Home Equity Finance Activities. The Proposed Rule would also increase capital requirements for important consumer financing activities, including credit card and home equity credit facilities—facilities that enable consumers to meet emergency or unforeseen needs (e.g., unforeseen medical bills) and promote financial inclusion (e.g., new-to-credit consumers often use credit cards as their first step toward building a credit history). This is because the Proposed Rules would:

- Impose risk weights for regulatory retail exposures that are 10 percentage points higher than the Basel Framework;

- Impose a 10% credit conversion factor ("**CCF**") on the unused portion of unconditionally cancellable credit facilities, meaning that banking organizations must assume and hold capital against a 10% drawdown rate even for the portion of a credit card or home equity line that has not, in fact, been drawn down;

- Include the interest and fees earned from credit card and home equity lines in the interest, lease and dividend component and services component, respectively, of a banking organization's business indicator, producing disproportionately higher operational risk RWAs resulting from increased business volumes; and

- Impose higher capital charges on securitized credit card and home equity lines under the SEC-SA.

Unnecessarily Complex and Overly Restrictive Capital Deductions. In addition, the Proposed Rule would no longer apply the Agencies' 2019 simplified capital deduction framework to Category III and IV banking organizations, instead subjecting them to the unnecessarily complex capital deduction framework that currently applies only to Category I and II banking organizations. The Proposed Rule provides no explanation for why the simplified capital deduction framework is no longer appropriate for Category III and IV banking organizations and fails to consider the adverse impact of such a change.

Absence of Congressionally Mandated Tailoring. Lastly, the Banks believe that the Proposed Rule is at odds with the specific Congressional mandate, expressed in the Economic Growth, Regulatory Relief, and Consumer Protection Act of 2018 ("**EGRRCPA**"), which provides that the Federal Reserve "shall . . . differentiate among companies on an individual basis or by category, taking into consideration their capital structure, riskiness, complexity, financial activities . . . , size, and any other risk-related factors."[3] By applying more stringent capital requirements to all banking organizations with total consolidated assets of $100 billion or more without regard to the different risk profiles between these banking organizations, the Proposed Rule is inconsistent with the Congressional mandate set forth in the EGRRCPA.

Recommendations. In response to the deficiencies summarized above, we recommend specific changes to the Proposed Rule which the Banks believe will strengthen the financial system and allow banking organizations to remain strong, well-capitalized, and competitive as they continue to serve their communities. Our recommendations focus on the aspects of the Proposed Rule that most significantly affect the Banks, including changes to the adjustments to, and deductions from, regulatory capital and credit risk capital requirements. In addition, the Banks endorse the recommendations made by the Bank Policy Institute ("**BPI**") and the American Bankers Association ("**ABA**"), including the recommendations regarding the proposed operational risk capital requirements, which if finalized as proposed would significantly affect the Banks' ability to serve their communities.[4] To ensure a sound and resilient financial system, the capital rules should be appropriately structured to encourage regulated banking organizations to remain active in their lending businesses, particularly their mortgage, SME lending and consumer financing businesses which are so vital to economic growth.

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[3] 12 U.S.C. § 5365(a)(2)(A).

[4] BPI and ABA joint comment letter, Section V.

The Banks recommend the following revisions to the Proposed Rule:

Adjustments to and Deductions from Regulatory Capital

- **Threshold Deductions:** The Agencies should continue to apply the existing simplified threshold deduction framework to Category III and IV banking organizations.

- **Minority Interests:** The Agencies should allow Category III and IV banking organizations to continue to limit the recognition of minority interests as under the U.S. Capital Rules.

Credit Risk

- **Regulatory Residential Real Estate Exposures:** The Agencies should (i) align the risk weights for regulatory residential real estate exposures with those of the Basel Framework; (ii) avoid penalizing banking organizations subject to the ERB Approach that have first-lien and junior-lien exposures on the same property; and (iii) recognize private mortgage insurance as a credit risk mitigant.

- **Retail Exposures:** The Agencies should (i) align the risk weights applied to retail exposures with those in the Basel Framework; (ii) revise the proposed definition of transactor exposure to include a wider range of exposures that involve the same level of risk; and (iii) only include the exposure amounts to a counterparty and its consolidated subsidiaries in the banking organization's aggregate limit for regulatory retail exposures, not the exposure amounts to a counterparty's affiliates.

- **Corporate Exposures:** The Agencies should (i) eliminate the requirement that an investment grade obligor or its parent have publicly traded securities outstanding to receive a risk weight of 65%; (ii) create a Corporate SME exposure category with a risk weight of 85%; and (iii) create a lower risk weight category for highly regulated entities.

- **Exposures to Banks:** The Agencies should extend the lower risk weights for exposures to Grade A and B banks to any exposures (on-balance sheet or off-balance) with a maturity of three months or less, as well as Trade Credit Exposures with a maturity of six months or less. The Agencies should also apply the same risk weights to exposures to U.S. Securities and Exchange Commission-registered broker-dealers, regulated insurance companies and their foreign equivalents, with the standards for Grades A, B and C banks

adapted to the types of prudential requirements applicable to these types of entities.

- **Defaulted Exposures:** The Agencies should permit a banking organization to rely on its own credit risk management processes to determine whether an obligation is likely to default, and therefore would receive a 150% risk weight, rather than basing the determination on the obligor's default status to other creditors, which is often unknown to the banking organization and may be immaterial.

- **Off-Balance Sheet Exposures:** The Agencies should set the off-balance sheet exposure amount for unconditionally cancellable commitments with contractual credit limits equal to the lesser of (i) the unused portion of the commitment multiplied by the applicable CCF and (ii) the off-balance sheet exposure amount that would be calculated for the commitment under the proxy notional amount methodology if the commitment had no contractual credit limit. The Agencies should also apply a proxy notional amount methodology for unconditionally cancelable commitments that is based on the actual performance of those commitments and should set the CCF for unconditionally cancelable commitments no higher than 6.5%.

- **Securitization Framework:** The Agencies should (i) define a category of simple, transparent and comparable ("**STC**") securitizations and apply a ρ-value of 0.5 and 10% risk weight floor to all STC securitizations; (ii) exempt securitized retail exposures from the aggregate and granularity limits for banking organizations that invest in securitized retail exposures; (iii) recognize directly issued credit-linked notes as credit risk mitigants for synthetic securitization exposures; and (iv) allow banking organizations to use the Standardized Supervisory Formula Approach ("**SSFA**") provided in the U.S. Capital Rules to calculate RWAs for any securitization exposure entered into prior to July 27, 2023.

- **Equity Exposures:** The Agencies should (i) apply a 100% risk weight to direct investments by banking organizations in small businesses that would qualify for investments from small business investment companies ("**SBICs**"); (ii) extend the 100% risk weight category to include equity exposures related to projects that support important national interests (such as renewable energy and historic tax credit projects) and employee benefit plans; and (iii) <u>permit</u>, rather than <u>require</u>, banking organizations to use the full look-through approach instead of the alternative modified look-through approach for equity exposures to investment funds.

In addition to the recommendations listed above, the Banks respectfully submit that the Agencies should issue a revised Notice of Proposed Rulemaking reflecting the results of the Federal Reserve's data collection effort and the resulting estimated impact of the Proposed Rule based on an analysis of that data in order to provide the public with an opportunity to review and comment. Alternatively, the Agencies should extend the initial comment period. The Federal Reserve announced on October 20, 2023, almost three months after the Proposed Rule was published, that it would collect data to better understand the impact of the Proposed Rule on the banking organizations affected by the proposal.[5] The due date for the data collection is January 16, 2024, the same date to which the Agencies have extended the comment period for the Proposed Rule.[6] The Banks believe that the comment period for the Proposed Rule should not close until the Federal Reserve has published the results of the data collection effort and the public has had the opportunity to meaningfully comment on the data and how it may affect the Proposed Rule.[7]

The Banks also recommend that the Agencies evaluate the impact that the Proposed Rule would have on the U.S. banking sector and the broader U.S. economy if implemented alongside the Agencies' recently proposed rules on long-term debt, resolution planning, and any other significant regulatory changes that the Agencies anticipate proposing in the near future. These proposals are all interconnected and should not be examined on a piecemeal, stand-alone basis. The Agencies should consider the data that they receive on the Proposed Rule, along with any data that they have on related proposals, and provide the public with a comprehensive cost-benefit analysis of how these proposals would collectively affect the U.S. banking sector and the broader U.S. economy.

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

[6] Press Release, Board of Governors of the Federal Reserve System, Office of the Comptroller of the Currency and Federal Deposit Insurance Corporation, Agencies extend comment period on proposed rules to strengthen large bank capital requirements (Oct. 20, 2023), available at https://www.federalreserve.gov/newsevents/pressreleases/bcreg20231020a.htm.

[7] Vice Chair for Supervision Michael Barr has stated that the Federal Reserve plans to publish its analysis of the data collection effort and give the public an opportunity to comment. Fireside chat with Michael S. Barr, Vice Chair for Supervision, Board of Governors of the Federal Reserve System, Women in Housing & Finance, Inc. (Jan. 9, 2024). The Banks encourage the Agencies to publish a cost-benefit analysis based on their analysis of the collected data and to permit the public to comment through the formal notice and comment process.

The remainder of this comment letter describes our views on the specific aspects of the Proposed Rule that most significantly affect the Banks and offers recommendations to improve the proposal. Section II addresses the Agencies' proposed amendments to the adjustments to and deductions from regulatory capital. Section III addresses the Agencies' proposed amendments to the calculation of credit risk RWAs. Section IV recommends that the Agencies adopt certain transition periods when implementing the final rule.

II. Adjustments to and Deductions from Regulatory Capital

The Proposed Rule would effectively eliminate any differences between Category I and II banking organizations, on the one hand, and Category III and IV banking organizations, on the other hand, in the calculation of regulatory capital, i.e., the numerator of the risk-based and leverage capital ratios. Specifically, all Category III and IV firms would be required to recognize the impact of Accumulated Other Comprehensive Income ("**AOCI**") on CET 1 capital; would be subject to the 10% and 15% deduction thresholds for DTAs, MSAs and significant investments in unconsolidated financial institutions ("**UFIs**"); and would be subject to more limitations on the recognition of minority interests.[8]

While the Banks acknowledge the rationale for eliminating the ability of Category III and IV firms to opt out of the recognition of the impact of AOCI on CET 1 capital in the aftermath of the failure of Silicon Valley Bank ("**SVB**") and certain other specialized banking organizations earlier this year, there is no similar rationale for reversing the Agencies' 2019 final rule that simplified the framework for deductions from CET 1 capital and for the recognition of minority interests for banking organizations that are not Category I or II firms (the "**Capital Simplification Rule**").[9] Nowhere in any of the reports on the failures of SVB or other banks is there any suggestion that the amount of DTAs, MSAs, investments in UFIs or minority interests had anything to do with their failures,[10] nor does the

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[8] Proposed Rule § 3.21; § 217.21; § 324.21 (Minority interest); §§ 3.22(b), (c) and (d); §§ 217.22(b), (c) and (d); §§ 324.22(b), (c) and (d) (Regulatory capital adjustments and deductions).

[9] Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System and Federal Deposit Insurance Corporation, *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).

[10] *See* Board of Governors of the Federal Reserve System, *Review of the Federal Reserve's Supervision and Regulation of Silicon Valley Bank* (April 28, 2023); Federal Deposit Insurance Corporation, *FDIC's Supervision of Signature Bank* (April 28, 2023); Federal Deposit Insurance (….continued)

Basel Framework make any changes to the recognition or deduction of any of these items in or from regulatory capital. In short, the return to a more complex, burdensome and ultimately costly threshold deduction framework for these categories of assets appears to be a solution in search of a problem.

The Capital Simplification Rule was adopted not as part of the interagency tailoring rules pursuant to the EGRRCPA,[11] but as a separate capital rulemaking pursuant to the Economic Growth and Regulatory Paperwork Reduction Act of 1996. This longstanding statute requires, among other things, that the Agencies conduct a review every ten years of the costs and benefits of their existing regulations and identify regulations that can be applied in a more efficient manner to reduce the economic burden on regulated institutions. [12] Accordingly, the Agencies implemented the simplified deduction framework explicitly to reduce the regulatory burden on banking organizations that were not Category I or II firms. The Proposed Rule gives no explanation for why the simplified capital deduction framework is no longer appropriate for Category III and IV banking organizations and fails to consider the significant adverse impact of such a change.

A. Threshold Deductions

Pursuant to the Capital Simplification Rule:

1) MSAs and DTAs can be included in CET 1 capital up to a limit of 25% of a firm's adjusted CET 1 capital for each asset type, with any excess above the limit being deducted from CET 1 capital;

2) investments in the capital of UFIs (without any distinction between significant and non-significant investments) can be included in CET 1 capital up to a limit of 25% of a firm's adjusted CET 1 capital for all such investments, with any excess above the limit being deducted from the

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Corporation, *FDIC's Supervision of First Republic Bank* (September 8, 2023); Office of Inspector General, Board of Governors of the Federal Reserve System, *Material Loss Review of Silicon Valley Bank* (Sept. 25, 2023); Office of Inspector General, Federal Deposit Insurance Corporation, *Material Loss Review of Signature Bank of New York* (Oct. 2023).

[11] Pub. L. No. 115-174 (2018).

[12] 12 U.S.C. § 3311 ("[T]he appropriate Federal banking agency shall…at regular intervals, provide notice and solicit public comment on a particular category or categories of regulations, requesting commentators to identify areas of the regulations that are outdated, unnecessary, or unduly burdensome" and "[T]he appropriate Federal banking agency shall…eliminate unnecessary regulations to the extent that such action is appropriate.")

corresponding tier of a firm's regulatory capital under the corresponding deduction approach; and

3) there is no aggregate deduction threshold applicable across the three asset types above which a further deduction from capital is required.[13]

In adopting the Capital Simplification Rule, the Agencies specifically found that the revised deduction thresholds were designed to "prevent, in a simple manner, unsafe and unsound concentration levels of these exposure categories in regulatory capital. The Agencies believe that the 25% common equity tier 1 capital deduction threshold would have appropriately balanced risk-sensitivity and complexity for non-advanced approaches banking organizations."[14]

The Proposed Rule would eliminate the simplified threshold deduction framework for DTAs, MSAs and investments in UFIs for Category III and IV firms and require such firms to apply the more complex framework that currently applies only to Category I and II firms. Under this framework:

1) DTAs, MSAs, and significant investments in UFIs in the form of common equity are each subject to a 10% deduction threshold, with any excess above 10% of adjusted CET 1 capital being deducted from CET 1 capital;

2) These three asset categories are, in the aggregate, also subject to a 15% deduction threshold, with any excess above 15% of adjusted CET 1 capital being deducted from CET 1 capital;

3) Significant investments in UFIs that are not in the form of common equity are fully deducted from a firm's regulatory capital using the corresponding deduction approach; and

4) The aggregate amount of non-significant investments in UFIs is subject to a 10% deduction threshold, with any excess above 10% of adjusted CET 1 capital being deducted from a firm's regulatory capital using the corresponding deduction approach.[15]

The Agencies give no substantive explanation for the reversal of their findings that underlay the simplified threshold deduction framework in the Capital Simplification Rule. Their sole explanation is the self-evident statement that extending to Category III and IV firms the same threshold deduction framework for

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[13] 12 C.F.R § 3.22(d); § 217.22 (d); § 324.22 (d).

[14] 84 Fed. Reg. 35234, 35237 (July 22, 2019).

[15] Proposed Rule § 3.22(d); § 217.22(d); § 324.22(d).

DTAs, MSAs and significant and non-significant investments in UFIs that applies to Category I and II firms would "creat[e] alignment across all banking organizations subject to the proposal."[16]

Moreover, in adopting the Capital Simplification Rule, the Agencies determined that the 10% individual threshold and 15% aggregate threshold deductions were unnecessarily complex and burdensome for firms that were not Category I and II banking organizations.[17] Nothing has changed since 2019 to make a return to the prior deduction framework for these types of assets less complex and less burdensome. A return to the prior threshold deduction framework would mean a return to the complexity of applying limits to DTAs, MSAs and investments in UFIs not just by each asset category, but across the aggregate of all three asset categories, and a return to the complexity of having to differentiate, for investments in UFIs, between significant and non-significant investments, between investments in common equity and other instruments, and between two different deduction approaches — one from CET 1 and one from the corresponding tier of capital.

As noted above, the Banks are concerned not only about the impact of individual parts of the Proposed Rule, but also about how different parts of the Proposed Rule can have, in the aggregate, a negative impact on certain banking products and services, including mortgage lending and servicing. Not only would mortgage lending be adversely affected by the more punitive risk weights and other aspects of the ERB Approach (as discussed in Section III.A of this letter), but the concurrent reduction in the deduction threshold for MSAs from 25% to 10% of CET 1 capital, plus the requirement for MSAs to share an aggregate 15% limit with DTAs and significant investments in UFIs in the form of common equity, would exacerbate this impact and contribute to a significantly higher cost of capital for the Banks to engage in mortgage lending and servicing.[18] Imposing higher capital requirements

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[16] 88 Fed. Reg. 64028, 64037 (Sept. 18, 2023). The framework already applies to Category III and IV banking organizations, and this reversal only introduces additional complexity, which is contrary to the goals articulated by the Agencies. *Id.* at 64028 (stating one of the goals of the proposal would be to "reduce the complexity of the framework.").

[17] 82 Fed. Reg. 49984, 49985-87 (Oct. 27, 2017); 84 Fed. Reg. 35234, 35236-37 (July 22, 2019).

[18] The Agencies justified limiting the amount of MSAs that may be included in regulatory capital due to "the relatively high level of uncertainty regarding the ability of banking organizations to both accurately value and realize value from these assets, especially under adverse financial conditions." 88 Fed. Reg. 64028, 64036. This analysis overlooks: (i) the increased sophistication of modeling approaches and valuation governance practices put in place under SR Letter 11-7 that (….continued)

for mortgage lending and MSAs would force banking organizations to pass on those costs to consumers or to reduce the size of their mortgage lending and servicing businesses. Both scenarios would further push mortgage activity out of the regulated banking sector and toward unregulated NBFIs,[19] increasing risk to the financial system.

Furthermore, the Proposed Rule would introduce risks to the mortgage servicing market that would impact not only banking organizations, but nonbank mortgage originators and servicers, prospective homeowners and government-sponsored enterprises ("**GSEs**"). Over the past decade, the mortgage industry has seen a significant shift toward nonbank independent mortgage companies. Despite increasing competition, banking organizations have continued to invest in mortgage servicing as a critical component to serving their customers. The Proposed Rule would not only discourage banking organizations from servicing mortgages and purchasing MSAs from other financial institutions, but may also encourage banking organizations to sell loans, MSAs and other mortgage-related assets they would otherwise choose to hold. As a result, the Proposed Rule could create market disruptions and valuation uncertainty in the MSA market by curtailing the diversity of firms that are able to participate in the market. Intensifying an already asymmetrical MSA environment would only serve to reduce liquidity in the MSA market, leading to a greater level of uncertainty and undermining banking organizations' "ability . . . to both accurately value and realize value from these assets."[20] Such an environment would generate secondary impacts to both bank and nonbank mortgage servicers by introducing inefficiency and volatility into the MSA market. In effect, this would produce exactly the type of "adverse financial conditions,"[21] that the Agencies have sought to avoid by limiting the amount of MSAs that banking organizations may include in regulatory capital.

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required increased discipline in the risk management of MSAs; (ii) the countercyclical nature of MSAs within the context of the mortgage market as they increase in value in a high-interest rate environment, which provides banking organizations with a source of non-interest income during periods where mortgage origination volume and the value of other fixed income assets are both declining; and (iii) the role of MSAs in providing a source of low turnover assets because they include funds held at banks in escrow on behalf of the borrower.

[19] From 1995 to 2007, NBFIs accounted for approximately 30% of the mortgage origination market. Today, NBFIs account for more than 70% of mortgage originations. Consumer Financial Protection Bureau, Summary of 2022 Data on Mortgage Lending (June 29, 2023), https://www.consumerfinance.gov/data-research/hmda/summary-of-2022-data-on-mortgage-lending/.

[20] 88 Fed. Reg. 64028 at 64036.

[21] *Id.*

If the Proposed Rule creates substantial downward pressure on the value of MSAs, the resulting financial impact would not be limited to Category III and IV banking organizations. Lower or more volatile MSA values directly affect the mortgage origination market by reducing the value passed to the originator at the time the servicing asset is created, which in turn could affect the supply of mortgages to prospective homeowners. Such conditions would also have adverse impacts to nonbank mortgage companies by reducing the value of MSAs they currently hold, limiting their funding sources and liquidity. If nonbank mortgage originators and servicers have reduced access to funding sources and liquidity, they may be unable to meet their operational and/or financial obligations to the GSEs. This could lead to the GSEs "experiencing significant financial losses or business interruptions in the event [mortgage servicers] cannot fulfill their obligations to [the GSEs]."[22]

In addition, the Banks are also concerned that the Proposed Rule's overly conservative treatment of DTAs would have unnecessary procyclical impacts on banking organizations. DTAs typically increase during stress periods when a banking organization realizes significant loan losses. During the same stress periods banking organizations also face significant increases in their allowance of credit losses (and the associated DTAs), which would impose additional demands on a banking organization's capital.

This procyclicality not only affects banking organizations during an economic downturn but, in practice, also impacts banking organizations' capital levels during normal economic times through the stress testing and capital planning processes. The implementation of the Current Expected Credit Losses ("**CECL**") accounting standard exacerbates this concern.[23] In 2019, the Agencies specifically recognized that, to the extent that the adoption of CECL would lead to the recognition of an increased amount of DTAs, the increase in the deduction threshold to 25% of CET 1 capital would help mitigate that effect. CECL continues to be a contributing factor to the amount of DTAs recognized by the Banks, and thus the rationale for the higher deduction threshold for DTAs remains unchanged from 2019. Recognizing losses that are included in AOCI can also lead to the recognition of DTAs. As a result, the combined impact of the elimination of the AOCI opt-out and a lower limit for the

[22] Fannie Mae 2022 Form 10-K at 44, 42-43, and 145-146.

[23] 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 (December 3, 2021).

inclusion of DTAs in CET 1 capital would be greater reductions in CET 1 capital than under the existing threshold deduction framework.

We recognize that the Agencies historically have been concerned with the ability of banks to realize DTAs against future taxable income, especially under adverse financial conditions. We note, however, that the U.S. Basel III capital rules are premised upon banks operating as going concern businesses, not as 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, particularly with respect to DTAs arising from timing differences. In addition, DTAs on a banking organization's balance sheet are already subject to a "more-likely-than-not" to be realized valuation standard under U.S. Generally Accepted Accounting Principles ("**U.S. GAAP**"). Experience has shown that valuation allowances have been established with appropriate conservatism such that DTAs are valuable assets that should be capable of being included in regulatory capital, subject to a reasonable threshold. The Banks respectfully submit that further limiting the recognition of DTAs in regulatory capital by lowering the deduction threshold for Category III and IV banking organizations as the Agencies have proposed is unwarranted and overly punitive.

The Banks therefore recommend that the Agencies retain the existing simplified threshold deduction framework without change. There is no basis for the Agencies to reverse themselves and undo the beneficial impact of the simplified threshold deduction framework they finalized in 2019. If the Agencies choose to amend the threshold deduction framework, the Banks recommend that the Agencies impose an individual threshold of 15% of CET 1 capital for DTAs, MSAs and significant investments in UFIs in the form of common equity and an aggregate threshold of 25% of CET 1 capital for Category III and IV firms.

In addition, in the event that the Agencies pursue any alternative other than leaving the existing simplified threshold deduction framework in place, the Agencies should provide for a transition period similar in duration to that for phasing in the impact of AOCI. Lowering the deduction thresholds will inevitably have an impact on the amount of Category III and IV firms' CET 1 and other regulatory capital, and the Banks respectfully submit that there is no reason for distinguishing between the impact of AOCI and the impact of lower deduction thresholds.

B. Minority Interests

The Capital Simplification Rule permitted Category III and IV banking organizations to recognize minority interests based on a straightforward limit of

10% of each tier of the banking organization's capital: (i) CET 1 minority interests up to 10% of CET 1 capital; (ii) Tier 1 minority interests up to 10% of Tier 1 capital; and (iii) total capital minority interests up to 10% of total capital.[24] In adopting the Capital Simplification Rule, the Agencies specifically found that "removing the current complex calculation for the amount of includable minority interest will reduce regulatory burden without reducing the safety and soundness of non-advanced approaches banking organizations," and that "the minority interest limitations in the final rule are simpler to calculate than those in the capital rule but are still appropriately restrictive for non-advanced approaches banking organizations."[25]

The Proposed Rule would reverse this simplified approach to limiting the recognition of minority interests for Category III and IV firms and require them instead to return to the prior framework for recognizing minority interests. Under this approach, a firm must calculate a subsidiary's minimum regulatory capital and buffer requirements (whether the subsidiary is subject to the U.S. Capital Rules or not, which means doing a pro forma capital calculation in the latter case) and then limit recognition of any minority interests issued by the subsidiary to the amount attributable to meeting the subsidiary's minimum capital and buffer requirements, and exclude any amount attributable to any surplus capital of the subsidiary.[26]

As with the proposed reversal of the simplified threshold deduction framework for Category III and IV firms, the Agencies give no substantive explanation for the reversal of their findings that underlay the simplified minority interest framework adopted in 2019. They simply refer to the outcome of the Proposed Rule: "Under the proposal, the limitations on minority interests that apply to banking organizations subject to Category I or II capital standards would also apply to banking organizations subject to Category III or IV capital standards."[27]

The Banks respectfully submit that nothing has changed since 2019 to warrant a return to the pre-2019 minority interest framework for Category III and IV banking organizations. As noted above, based on the various reports published about the failures of SVB, Signature Bank and First Republic, none of the failures had anything to do with the recognition of minority interests. Nor has the Basel Framework made any changes to the recognition of minority interests. There is

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[24] 12 C.F.R § 3.21(a); § 217.21(a); § 324.21(a).
[25] 84 Fed. Reg. 35234, 35240 (July 22, 2019).
[26] Proposed Rule § 3.21; § 217.21; § 324.21.
[27] 88 Fed. Reg. 64028, 64037 (Sept. 18, 2023).

simply no basis for the Agencies to reverse themselves and undo the beneficial impact of the simplified limits on minority interests.

The Banks also note that a return to the pre-2019 minority interest framework could either disincentivize attracting outside investors into the capital structure of operating subsidiaries (including through partial divestitures or spin-offs), especially nonbanking subsidiaries, to the extent such outside capital would not contribute to the consolidated capital of the parent banking organization, or could disincentivize holding any capital surpluses in the subsidiaries. Either result would limit the benefit of spreading the ownership risk of consolidated subsidiaries to outside sources of capital compared to the simplified framework of managing to a 10% minority interest limit at each tier of capital of the parent banking organization.

The Banks therefore recommend that the Agencies allow Category III and IV banking organizations to continue to limit the recognition of minority interests under the U.S. Capital Rules, without modification.

In the event that the Agencies nevertheless finalize the minority interest provisions of the Proposed Rule without change, the Agencies should provide for a transition period similar in duration to that for phasing in the impact of AOCI. There is no reason for distinguishing between the impact of AOCI and the impact of a revised minority interest framework.

C. AOCI

The Banks recognize that the Agencies have proposed to eliminate the ability of Category III and IV firms to opt out of recognizing the impact of AOCI on CET 1 capital to address some of the underlying issues that led to the failure of SVB earlier this year. If the Agencies choose to eliminate the AOCI opt-out in the final rule, however, they should extend the transition period from three years to five years. It would take time for banking organizations to adjust their balance sheets to account for the need to recognize certain unrealized gains and losses that they currently do not recognize for capital purposes. That is why the Agencies provided for a nearly five-year AOCI transition period when adopting the U.S. Capital Rules.[28] The Banks encourage the Agencies to provide for a similar transition period for AOCI when finalizing the Proposed Rule.

[28] 12 CFR § 3.300(b)(3); 12 CFR § 217.300(b)(3); 12 CFR § 324.300(b)(3).

III. Expanded Risk-Based Approach

The Banks support the Proposed Rule's elimination of the current advanced approaches for the calculation of credit risk and operational risk. The process of becoming an advanced approaches organization, including (i) developing and obtaining regulatory approval for models, (ii) the parallel run process of calculating RWAs under both the standardized approach and the advanced approaches until a firm is approved as an advanced approaches organization and (iii) the continuing obligation under the U.S. Capital Rules to calculate RWAs under both the standardized approach and the advanced approaches, is both significantly burdensome and ultimately unnecessary (as the standardized approach serves as a floor for the calculation of risk-based capital ratios). Three of the Banks[29] were advanced approaches banking organizations prior to the adoption of the Agencies' tailoring rules for capital and liquidity standards in 2019, and none of the Banks would like to relive the burden and complexity of the advanced approaches again.

As a general matter, the Banks therefore welcome the replacement of the advanced approaches with the Proposed Rule's ERB Approach. Although the ERB Approach is itself a standardized approach to calculating RWAs, it is more risk-sensitive than the current standardized approach and therefore would generally be expected to produce RWAs that more accurately reflect the credit risk to which Category III and IV firms are exposed.

The Banks are, however, concerned that the ERB Approach under the Proposed Rule suffers from a number of deficiencies that should be corrected in any final rule. These deficiencies generally fall into two major categories: either more punitive requirements relative to the Basel Framework (and also compared to how other major jurisdictions have or are proposing to implement the Basel Framework), or deficiencies in the methodology and mechanics of the provisions of the ERB Approach. The aggregate impact of these deficiencies would be to increase capital requirements to a level that the Banks strongly believe is unjustified, with all the negative knock-on effects of these higher requirements on the Banks' customers and communities, including U.S. consumers and businesses, and therefore the broader U.S. economy. The effects would include higher prices for banking products and services, reduced availability of banking products and services, and accelerated migration and concentration of non-deposit taking banking services and products in

[29] BB&T Corporation and SunTrust Banks, Inc., the predecessors to Truist Financial Corporation before they merged in 2019, were both non-advanced approaches banking organizations prior to their merger.

the shadow banking sector of unregulated or less well-regulated lending, payments and fintech companies.[30]

We now turn to a discussion of each of the specific deficiencies of particular concern to the Banks.

A. Regulatory Residential Real Estate Exposures

1. Risk Weights

While the Banks generally support the greater risk sensitivity and granularity of an approach that distinguishes between residential real estate exposures based on whether they are dependent on the cash flows of the underlying real estate and loan-to-value (LTV) ratios, the Proposed Rule would allocate risk weights to the various categories of regulatory residential real estate exposures that are in each case 20 percentage points higher than those in the Basel Framework.[31] The Banks are concerned that this deviation from the agreed international standards would adversely affect the availability of bank credit for residential real estate lending in the United States without any commensurate benefits to U.S. financial stability. Because the proposed risk weights also vary according to LTV, where smaller down payments by borrowers would lead to higher capital charges for bank lenders, the effects of excessively punitive capital requirements would be felt more acutely by LMI and first-time home buyers. This result is at odds with important government programs that are designed to provide first-time homebuyers and LMI consumers with access to homeownership. In addition, and compounding these effects, the Proposed Rule does not provide for any favorable risk weighting under the ERB Approach for regulatory residential real estate loans originated through qualifying home ownership programs.

The Banks therefore recommend that the Agencies align the risk weights for regulatory residential real estate exposures with those in the Basel Framework and also provide for a 50% risk weight for regulatory residential real estate loans originated through qualifying home ownership programs.

To the extent the Agencies are concerned that lower risk weights for residential real estate exposures would somehow disadvantage smaller banking

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[30] Chair Martin J. Gruenberg, Federal Deposit Insurance Corporation, Remarks at the Exchequer Club on the Financial Stability Risks of Nonbank Financial Institutions (Sept. 20, 2023), available at https://www.fdic.gov/news/speeches/2023/spsept2023.html.

[31] Proposed Rule §__.111(f)(5); Basel Committee on Banking Supervision, *CRE Calculation of RWA for credit risk*, CRE 20.82 and 20.84 (effective as of Jan. 1, 2023).

organizations,[32] the Banks believe the Agencies' concerns are misplaced. The impact of risk weights for any category of exposures in the ERB Approach should not be viewed in isolation. There are numerous other requirements under the ERB Approach and the other prudential standards that apply to large banking organizations, including the requirement to calculate RWAs for operational risk and the Stress Capital Buffer, that do not apply to smaller banking organizations. As a result, the benefits of greater risk sensitivity and granularity inherent in the ERB Approach should not be sacrificed out of a concern that Category I-IV firms would be advantaged in some way over smaller organizations that are subject solely to the standardized approach. The Banks also note that the standardized approach continues to serve as a floor to the ERB Approach, and thus it is difficult to see what incremental advantage the Agencies are concerned about. If anything, the Agencies should not exacerbate the impact of the Proposed Rule by applying a surcharge to its requirements relative to the Basel Framework because that will just have the effect of increasing the cost of bank lending and/or reduce its availability to U.S. consumers, with all the negative consequences that will have on the broader U.S. economy.

2. Value of the Property

When calculating the value of the property for a regulatory residential real estate exposure, the Proposed Rule permits the Agencies to require a banking organization to "revise the value of the property downward."[33] The Banks recognize that this approach is consistent with the Basel Framework, which permits national supervisors to require banking organizations to adjust the value of property downward. The Banks recommend, however, that the Agencies clarify under what circumstances they may require an adjustment to the value of property. The Agencies should also confirm that they would only require a downward adjustment (as well as permit an upward adjustment, consistent with the Basel Framework[34])

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[32] The Agencies state that "the proposal attempts to mitigate potential competitive effects between U.S. banking organizations by adjusting the U.S. implementation of the Basel III reforms, specifically by raising the risk weights for residential real estate and retail credit exposures. Without the adjustment relative to Basel III risk weights in this proposal, marginal funding costs on residential real estate and retail credit exposures for many large banking organizations could have been substantially lower than for smaller organizations not subject to the proposal. Though the larger organizations would have still been subject to higher overall capital requirements, the lower marginal funding costs could have created a competitive disadvantage for smaller firms." 88 Fed. Reg. 64028, 64170.

[33] Proposed Rule §__.103(c)(3)(ii).

[34] Basel Committee on Banking Supervision, *CRE Calculation of RWA for credit risk*, CRE 20.74(1).

based on valuation information specific to the property at issue, and not based solely on broad indices of real estate values.

3. Aggregation of First- and Junior-Lien Exposures

The Proposed Rule maintains the requirement in the standardized approach of the current U.S. Capital Rules that when a banking organization holds both a first-lien and a junior-lien of a residential real estate exposure, and there is no intervening lien, the banking organization must combine the liens and treat them as a single exposure.[35] Under the current U.S. Capital Rules, this treatment generally provides *favorable* capital treatment to the junior-lien exposure because it allows the junior-lien exposure to receive the 50% risk weight available to first-lien residential mortgage exposures on owner-occupied properties that are prudently underwritten. The Agencies overlook the fact that applying the same rule to the ERB Approach's treatment of residential real estate exposures, which depends in part on LTV ratios, can produce an *unfavorable* result. In fact, under the ERB Approach, if a banking organization that has a first-lien exposure to a borrower were to extend a junior-lien mortgage to that borrower, without an intervening lien, it could result in higher RWAs for that banking organization than if another banking organization extended the junior-lien mortgage.

For example, assume a residential borrower has two mortgages on a home. Banking Organization A holds the first-lien exposure of $750,000 and Banking Organization B holds the junior-lien exposure of $200,000. Neither exposure is dependent on cash flows and both are held against residential real estate with a market value of $1 million. Under the Proposed Rule, the first-lien exposure would qualify as a regulatory residential real estate exposure and would be assigned a risk weight of 50% because it is not dependent on cash flows and the LTV ratio for the first-lien exposure would equal 75% ($750,000 / $1 million). The second-lien exposure would qualify as an "other real estate exposure" because it is not a first-lien exposure, and would be assigned a risk weight of 100% because it is a residential mortgage exposure and is not dependent on cash flows. The resulting RWAs to Banking Organization A for the first-lien exposure would be $375,000 (50% * $750,000) and the resulting RWAs to Banking Organization B for the second-lien exposure would be $200,000 (100% * $200,000).

In contrast, if the same banking organization were to hold both the first- and second-lien exposures, the second-lien exposure would result in significantly higher

[35] 12 C.F.R. § 217.32(g)(3); Proposed Rule §__.101(b) (definition of "regulatory residential real estate").

combined RWAs for that banking organization. If Banking Organization A held both a first-lien exposure of $750,000 and a second-lien exposure of $200,000, both against residential real estate with a market value of $1 million, then under the Proposed Rule both exposures would be treated as a single regulatory residential real estate exposure because there is no intervening lien. The combined exposure would have an LTV ratio of 95% (($750,000 + $200,000) / $1 million) and is not dependent on cash flows. Consequently, the combined exposure would be assigned a risk weight of 70%. The resulting RWAs for the combined exposure would be $665,000 (70% * $950,000). By holding both exposures, Banking Organization A would recognize $290,000 more in RWAs than if Banking Organization A held only the first-lien exposure. Banking Organization B, however, only recognized $200,000 in RWAs for holding the second-lien exposure.

The underlying risk of default associated with the combined exposure held by one banking organization, compared to the two individual exposures held by two different banking organizations, is identical. If anything, there are risk management *benefits* when a single banking organization holds both the first- and second-lien exposures on the same property, such as the banking organization's ability to coordinate the handling of both liens should the borrower run into financial hardship. As a result, the Banks believe that there is no justification for applying higher RWAs to a banking organization holding a combined exposure without an intervening lien, than to two banking organizations holding the first- and second-lien exposures separately. This result is illogical and could disincentivize banking organizations from extending second-lien mortgages to clients if they also hold the first-lien mortgage exposure.

The Banks therefore recommend that the Agencies revise the Proposed Rule to either (i) permit, but not require, banking organizations subject to the ERB Approach to combine real estate exposures when there is no intervening lien so that they may treat first-lien and junior-lien exposures as separate exposures, or (ii) cap the RWAs resulting from the combined exposure at the aggregate amount of RWAs that would be recognized by two separate banking organizations if the junior-lien exposure were held by a second banking organization.

4. Recognition of private mortgage insurance

The Proposed Rule would not provide for the use of private mortgage insurance ("**PMI**") as a credit risk mitigant. By contrast, the Basel Framework permits national regulators to permit banking organizations to recognize PMI if the PMI "meets the operational requirements of the credit risk mitigation framework

for a guarantee."[36] While the Banks acknowledge the Agencies' long-standing concern with monoline credit insurers as eligible guarantors, the Banks believe that the definition of "eligible guarantor" under the U.S. Capital Rules is unduly narrow and in effect makes it unjustifiably difficult for banking organizations to diversify their credit risk by shifting risk to insurance companies and other entities that have sufficiently diversified risk exposures. Rejecting PMI as a credit risk mitigant without exception would limit banking organizations' ability to engage in residential real estate lending, reducing the availability of credit generally and increasing the relative proportion of residential real estate lending undertaken by the shadow banking sector, consisting of entities that are less well-regulated or altogether unregulated.[37]

The Banks therefore recommend that the Agencies adopt an approach more consistent with the Basel Framework by modifying the definition of "eligible guarantor" — for purposes of both the standardized approach under existing subpart D and the ERB Approach under the Proposed Rule — as follows:

- In paragraph (2)(i) of the definition, add that the requirement to have issued and outstanding an unsecured debt security without credit enhancement that is investment grade may be satisfied not just by the guarantor itself, but by any parent entity of the guarantor; and

- In paragraphs (2)(ii) and 2(iii) of the definition, add a proviso to the effect that, if the guarantor's creditworthiness is positively correlated with the credit risks of the guaranteed exposures or if the guarantor is an insurance company engaged predominantly in the business of providing credit protection, the guarantor may nevertheless qualify as an eligible guarantor if it satisfies the banking organization, in accordance with the banking organization's credit risk management criteria, policies and procedures for the recognition of guarantees, that the guarantor has sufficiently diversified its risk profile relating to underlying exposures by industry sector or type of borrower, geographic region, maturity, and type of asset.

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[36] Proposed Rule §__.111(f)(5); Basel Committee on Banking Supervision, *CRE Calculation of RWA for credit risk*, CRE 20.76.

[37] The Agencies have recognized the value of PMI in mitigating credit risk in their Interagency Guidelines for Real Estate Lending Policies, which require banking organizations to acquire mortgage insurance, among other forms of credit enhancement, for any mortgage or home equity loan on an owner-occupied, 1- to 4-family residential property which has an LTV ratio greater than or equal to 90%. 12 CFR § 34, Appendix A to Subpart D; 12 CFR § 208, Appendix C; 12 CFR § 365, Appendix A.

B. Retail Exposures

1. Risk Weights

The Proposed Rule would include three categories of retail exposures under the ERB Approach: transactor exposures, regulatory retail exposures, and other retail exposures, with risk weights of 55% for transactor exposures, 85% for regulatory retail exposures and 110% for other retail exposures.[38] Each of these risk weights is 10 percentage points higher than the risk weights that apply under the Basel Framework.[39]

The Agencies justify these more punitive risk weights for retail exposures compared to the Basel Framework on the basis that lower risk weights could cause lower marginal funding costs for retail exposures for large banking organizations than for smaller banking organizations, creating a competitive disadvantage for smaller firms.[40] As discussed in the regulatory residential real estate exposures section above, however, the Banks respectfully submit that the Agencies' concerns are misplaced. Under the ERB Approach, large banking organizations would be subject to numerous other requirements, such as operational risk, market risk and CVA risk capital requirements, and the Stress Capital Buffer, that do not all apply to smaller banking organizations. These requirements all make the aggregate capital requirements higher for Category I-IV firms than for smaller banking organizations. As a result, the Banks do not believe that adopting risk weights for retail exposures in the Proposed Rule that are consistent with the Basel Framework would put smaller banking organizations at a disadvantage.

On the contrary, imposing more punitive risk weights on retail exposures than those in the Basel Framework would result in higher overall costs of bank lending to retail customers and/or reduce the availability of retail lending. In addition, although certain retail exposures would receive lower risk weights under the Proposed Rule than under the U.S. Capital Rules, the proposed risk weights for retail exposures – when combined with the additional capital requirements associated with retail lending due to the proposed operational risk capital requirements and the application of a CCF for unconditionally cancelable commitments (as discussed further in Section III.F.2) – would increase the effective capital requirements for retail lending compared to the U.S. Capital Rules, harming retail borrowers. LMI consumers would be most harmed by the higher effective risk weights for retail exposures, including credit cards, because credit cards are typically the first path for these consumers to build their credit history. Reducing access to these important retail products would force consumers to rely on less

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[38] Proposed Rule §__.111(g).

[39] Basel Committee on Banking Supervision, *CRE Calculation of RWA for credit risk*, CRE 20.68.

[40] 88 Fed. Reg. 64028, 64170 (Sept. 18, 2023).

regulated sources of lending, such as buy-now-pay-later or payday loans offered by NBFIs.

In addition, more punitive risk weights for retail exposures under the Proposed Rule would also result in more punitive risk weights for securitized retail exposures, including securitized credit card debt and consumer auto loans, as discussed in greater detail in Section III.G.2.

The Banks therefore recommend that the Agencies align the risk weights applied to retail exposures with the Basel Framework by applying risk weights of 45% to transactor exposures, 75% to regulatory retail exposures, and 100% to other retail exposures.

2. Definition of Transactor Exposure

The Proposed Rule defines transactor exposures as credit facilities where "the balance has been repaid in full at each scheduled repayment date for the previous 12 months" or an overdraft facility where "there has been no drawdown over the previous 12 months."[41] Although the Banks acknowledge that this definition is consistent with the Basel Framework, the proposed definition of transactor exposure could be understood to exclude from the most favorable risk weight certain retail exposures that the Banks believe should be classified as transactor exposures because they expose banking organizations to the same level of risk.

First, the proposed definition of transactor exposure may not permit a banking organization to account for grace periods for credit facilities. If a banking organization grants a consumer the option to make loan payments within a grace period following the scheduled repayment date, with no penalty, the loan should not be considered to bear greater credit risk from a regulatory capital perspective. This scenario presents no greater risk to the banking organization than when a consumer makes loan payments before the scheduled repayment date. The Agencies should amend the Proposed Rule to define a transactor exposure to include regulatory retail exposures where a customer has made all payments by the scheduled repayment date for the previous twelve months, and the scheduled repayment date includes any applicable grace periods.

Second, it is unclear whether the proposed definition of transactor exposure provides banking organizations with flexibility to allow consumers to make late payments during extraordinary circumstances, such as a natural disaster, a global pandemic, or a federal government shutdown. Banking organizations should be able to provide their consumers with flexibility to make late payments during such extreme circumstances without having to incur additional capital charges for treating the exposures as regulatory retail exposures, rather than continuing to

[41] Proposed Rule §__.101(b) (definition of "transactor exposure").

recognize them as transactor exposures.[42] The Agencies should expressly clarify in the final rule that banking organizations may recognize retail exposures as transactor exposures if the exposures would be transactor exposures if not for customers making late payments that were temporarily permitted by the banking organization due to extraordinary circumstances.

Third, it is also unclear whether the proposed definition of transactor exposure would permit banking organizations to treat credit cards or other consumer revolving credit facilities that consumers have not drawn from in the previous twelve months as transactor retail exposures. The Banks respectfully submit that it is unreasonable to apply a higher risk weight to a retail exposure merely because the consumer has chosen to not use a credit card or otherwise borrow from the banking organization. The Agencies should expressly clarify in the final rule that the definition of transactor exposure includes credit card and other revolving credit facilities from which consumers have not drawn funds in the previous twelve months.

Finally, it is unclear from the proposed definition of transactor exposure if a banking organization that has a retail customer who switches from one credit facility to another would be able to roll over that customer's credit activity. For example, if a customer switched credit cards in the previous twelve months, would a banking organization be able to count the scheduled repayment history from that customer's previous credit card toward the customer's current credit card? If not, then a banking organization would need to apply a higher risk weight each time a customer switches credit cards, regardless of that customer's history of repaying credit card balances. There is no additional credit risk to a banking organization if a customer switches from one credit card to another. The Agencies should therefore expressly clarify in the final rule that banking organizations may recognize payments that a customer made in the previous twelve months on any previous credit facilities when the customer switches to a new credit facility.

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[42] The Agencies have actively encouraged banking organizations in the past to accommodate customers affected by extraordinary circumstances, such as natural disasters and the COVID-19 pandemic. *See, e.g.,* Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, National Credit Union Administration, Interagency Supervisory Examiner Guidance for Institutions Affected by a Major Disaster, 4-5 (Dec. 2017), https://www.federalreserve.gov/supervisionreg/srletters/sr1714a1.pdf; Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, National Credit Union Administration, Office of the Comptroller of the Currency Consumer, Financial Protection Bureau Conference of State Bank Supervisors, *Interagency Statement on Loan Modifications and Reporting for Financial Institutions Working with Customers Affected by the Coronavirus*, 1 (March 22, 2020), https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20200322a1.pdf.

3. Aggregate and Granularity Limits

Under the Proposed Rule, for a retail exposure to qualify as a regulatory retail exposure, the sum of the exposure amount and the amounts of all other retail exposures to the obligor and to its affiliates must not exceed $1 million.[43] By including "affiliates" in the aggregate limit for regulatory retail exposures, the Proposed Rule would introduce a significant operational challenge for banking organizations.

A banking organization may not be able to determine all the affiliates of its retail obligors. Customers are often not required to provide a banking organization with a list of their affiliates – whether consolidated subsidiaries or sister companies – when applying for a credit card or other type of retail loan. This makes it difficult for banking organizations to identify the affiliates of their obligors. In addition, affiliates can include companies that are controlled by an obligor for purposes of the Bank Holding Company Act ("**BHC Act**"). "Control" is a complex concept under the BHC Act, and unless the obligor is a banking entity itself, it would likely not know which entities "control" it or are "controlled" by it for BHC Act purposes. It is therefore very challenging for a banking organization to identify all of an obligor's affiliates on the basis of a bank regulatory "control" test.

Due to this operational challenge, the Banks recommend that the aggregate limit for regulatory retail exposures be revised to include only aggregate exposures to the obligor, not to its affiliates. If the Agencies nevertheless determine to include affiliates in the aggregate limit for regulatory retail exposures, the Banks recommend that the Agencies limit the scope of affiliates to an obligor's consolidated subsidiaries. When finalizing the Single-Counterparty Credit Limits ("**SCCL**") rule in 2018, the Federal Reserve chose to generally limit affiliates to consolidated subsidiaries to reduce the burden and complexity of complying with the rule.[44] The Agencies should similarly reduce the burden on banking organizations in the Proposed Rule by limiting the definition of affiliate to consolidated subsidiaries.

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[43] Proposed Rule §__.101(b) (definition of "regulatory retail exposure").

[44] *See* 12 C.F.R. § 252.71(b) (definition of "affiliate"); 83 Fed. Reg. 38460, 38465 (Aug. 6, 2018). The Banks recognize that the final SCCL rule requires covered companies to aggregate their credit exposures to multiple counterparties if those counterparties are "economically interdependent" with one another or are "connected by a control relationship," as defined in the rule. *See* 12 C.F.R. §§ 252.76(b) (economic interdependence) and (c) (control relationships). This aggregation, however, only applies if the covered company has aggregate net credit exposures to any counterparty that exceeds 5% of the covered company's tier 1 capital. 12 C.F.R. § 252.76(a)(1). To the extent the Agencies wish to provide for an aggregation with a broader group of affiliates for purposes of retail exposures under the Proposed Rule, the Banks recommend that the Agencies adopt a similar threshold for any such aggregation.

The aggregate and granularity limits for regulatory retail exposures would also introduce an operational challenge for banking organizations that invest in securitized retail exposures. As discussed in greater detail in Section III.G.2, the Proposed Rule would require banking organizations that invest in securitized retail exposures to look through the securitizations to the underlying retail exposures, which is operationally challenging for banking organizations because they do not generally have access to this information.

The aggregate limit for retail exposures in the Proposed Rule would also create a cliff effect for certain retail exposures. A loan for $1 million would qualify as a regulatory retail exposure, receiving a risk weight of 85% and resulting in RWAs of $850,000. The same loan for $1,000,001 would not qualify as a regulatory retail exposure and thus would be subject to a risk weight of 100% as a corporate exposure. This would result in RWAs increasing by $150,001 for only a $1 increase in loan size. Although this issue is less consequential for natural persons, who rarely borrow over $1 million, it has significant implications for small businesses. The Banks recognize that the Agencies need to impose a limit on what qualifies as a regulatory retail exposure. At the same time, the Banks believe that the Proposed Rule would have a negative impact on lending to SMEs, of which this cliff effect is one example. To reduce the negative impact of this cliff effect on small businesses, the Banks recommend that the Agencies include a Corporate SME exposure category with a risk weight of 85% in the final rule for all exposures to SMEs that do not qualify as retail exposures, as discussed in greater detail below.

C. Corporate Exposures

1. Investment Grade Corporate Exposures

The Proposed Rule would apply a 65% risk weight to an investment grade corporate exposure if the issuer of the exposure or its parent company has outstanding securities that are publicly traded. The Proposed Rule's investment grade corporate exposure rules unduly favor lending to large, publicly traded businesses, including SMEs, which are not publicly traded. [45] This would adversely impact the cost and availability of credit for the small businesses that drive the U.S.

[45] The Banks note that the definitions of "retail exposure" and "regulatory retail exposure" in the Proposed Rule would effectively preclude most SMEs from qualifying as retail exposures because of the aggregate limit of $1 million for all retail exposures to any obligor and its affiliates. *See* Proposed Rule, §___.101(b) (definitions of "regulatory retail exposure" and "retail exposure").

economy through job creation, innovation, competition and community development.[46]

The Agencies' explanation for the publicly traded requirement for a 65% risk weight is that it is "simple, objective criterion" and "publicly-traded corporate entities are subject to enhanced transparency and market discipline as a result of being listed publicly on an exchange." While certainly objective, the publicly traded criterion has no relationship to credit risk. The Proposed Rule does not contain data showing that publicly traded companies are less likely to default than other investment grade companies, nor are the Banks aware of any such evidence for U.S. exposures. In fact, some non-U.S. research indicates that the separation of management and control in public companies encourages management risk taking and makes such companies riskier than the equivalent privately held company.[47] Other jurisdictions, such as the UK and EU, have adopted or proposed capital rules that permit banking organizations to apply a 65% risk weight to investment grade corporate exposures regardless of whether or not the issuer is publicly traded.[48]

The increased disclosures required of public companies does not change their credit risk to banks because banking organizations perform their own underwriting on corporate exposures to determine which qualify as investment grade. Issuers that are not publicly traded regularly provide banking organizations with sufficient information for the banking organizations to evaluate the issuer's

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[46] A 2019 report by the Small Business Association found that small businesses accounted for 44% of U.S. economic activity. In addition, small businesses of 500 employees or fewer make up 99.9% of all U.S. businesses and 99.7% of firms with paid employees. *See* Office of Advocacy of the U.S. Small Business Administration, Small Businesses Generate 44 Percent of U.S. Economic Activity (Jan. 30, 2019), available at https://advocacy.sba.gov/2019/01/30/small-businesses-generate-44-percent-of-u-s-economic-activity/.

[47] *See* Reserve Bank of Australia, Kenney, La Cava & Rodgers, *Why Do Companies Fail*, available at https://www.rba.gov.au/publications/rdp/2016/pdf/rdp2016-09.pdf ("A public company is around 0.4 percentage points more likely to fail in a given year than a comparable private company.").

[48] Prudential Regulation Authority, CP16/22 – Implementation of the Basel 3.1 standards: Credit risk – standardised approach, Chapter 3.97 (Nov. 30, 2022), available at https://www.bankofengland.co.uk/prudential-regulation/publication/2022/november/implementation-of-the-basel-3-1-standards/operational-risk; European Commission, Proposal for a REGULATION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL amending Regulation (EU) No 575/2013 as regards requirements for credit risk, credit valuation adjustment risk, operational risk, market risk and the output floor, 14 (Oct. 27, 2021), available at https://eur-lex.europa.eu/resource.html?uri=cellar:14dcf18a-37cd-11ec-8daf-01aa75ed71a1.0001.02/DOC_1&format=PDF.

creditworthiness. Moreover, exposures to certain types of obligors that provide important services to our communities, such as public finance or nonprofit organizations, are often investment grade equivalent risks, but such obligors are unlikely to be publicly traded.

If a banking organization has sufficient financial statements and other information to determine that an issuer is investment grade in accordance with its credit risk management standards – which the banking organization's supervisors examine – the banking organization should be permitted to classify a corporate exposure as investment grade. The Banks note that the definition of "investment grade" in the U.S. Capital Rules does not include any requirement for the obligor to have publicly traded securities outstanding, and similarly do not believe that it should be necessary under the ERB Approach for an obligor to have publicly traded securities outstanding in order to qualify for the 65% risk weight for investment grade corporate exposures.[49]

The Banks are also concerned about the competitive impact of the listing requirement relative to non-U.S. banking organizations that are not subject to this requirement, including UK and EU banking organizations, and the shadow banking sector. If U.S. banking organizations have to apply a 100% risk weight to credit exposures to investment grade, privately held companies, the percentage of financing provided to such companies by non-U.S. banking organizations, private credit funds and other lenders that are not subject to the U.S. Capital Rules would likely increase, continuing a shift away from the regulated banking sector and creating additional risk to U.S. financial stability to the extent those lenders do not have a track record or the ability to continue lending through adverse economic conditions. In light of the fact that one of the justifications for increased capital requirements since the global financial crisis, including the supervisory DFAST and SCB requirements, is to ensure that large U.S. banking organizations hold enough capital to be able to lend in economically stressed conditions, pushing lending to privately held companies away from the U.S. banking sector would be a paradoxical result, and one that would be highly damaging to the U.S. economy.[50]

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[49] The Agencies also allow banking organizations to rely on their own investment grade determinations in other contexts, including the OCC's investment securities regulations, and there is no evidence that doing so has presented any safety and soundness concerns.

[50] *See generally* Sayee Srinivasan and Jeff Huther, American Bar Association, The Basel III endgame proposal: Yet another gift to private credit funds (Nov. 3, 2023), available at https://bankingjournal.aba.com/2023/11/the-basel-iii-endgame-proposal-yet-another-gift-to- (….continued)

The Banks therefore recommend that the Agencies eliminate the requirement that an obligor or its parent have publicly traded securities outstanding to receive a risk weight of 65%. This would mitigate the adverse impact of the Proposed Rule on SMEs and help ensure competitive parity between U.S. banking organizations and their non-U.S. peers and NBFIs. In the alternative, the Agencies should at most require that an obligor or its parent must have an outstanding investment grade debt security without credit enhancement for the corporate exposure to receive a 65% risk weight.

2. Corporate SME Exposures

The Proposed Rule's categorization of corporate exposures also unduly favors large businesses over small businesses. Unlike the Basel Framework, the Proposed Rule does not include a separate risk weight category of 85% for corporate SMEs.[51] The Agencies implicitly acknowledge this difference when they ask if they should create a Corporate SME risk weight category.[52] The combination of the publicly traded securities requirement described above and the absence of a specific exposure category for Corporate SMEs would make it more challenging for affected banking organizations to provide credit to SMEs. Without a Corporate SME exposure category of 85%, a banking organization would likely be required to apply a 100% risk weight to an SME corporate exposure. The inevitable result would be to incentivize banking organizations to lend to larger, publicly traded issuers that qualify for a 65% risk weight.

The Banks therefore recommend that the Agencies include a Corporate SME exposure category with a risk weight of 85% in any final rule for any SMEs that do not qualify as retail exposures. Not only would this align the U.S. bank capital requirements with the Basel Framework, but it would also support capital formation for SMEs. Moreover, this would reduce the imbalance between the treatment of larger companies and SMEs under the ERB Approach.

3. Exposures to Highly Regulated Companies

The Agencies ask in the preamble to the Proposed Rule if they should apply a risk weight that is less than 100% to corporate exposures for "highly regulated" companies, such as open-ended mutual funds, mutual insurance companies, pension

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private-credit-funds/; Matt Wirz and Peter Rudegeair, Wall Street Journal, Big Banks Cook Up New Way to Unload Risk (Nov. 7, 2023), available at https://www.wsj.com/finance/banking/bank-synthetic-risk-transfers-basel-endgame-62410f6c.

[51] Proposed Rule §__.111(f)(5); Basel Committee on Banking Supervision, *CRE Calculation of RWA for credit risk*, CRE 20.47.

[52] 88 Fed. Reg. 64028, 64054 (Sept. 18, 2023) (Question 40).

funds, or registered investment companies.[53] The Banks recommend that the Agencies incorporate a lower risk weight category—such as the same 65% risk weight for investment grade corporate exposures—for these highly regulated entities. The Agencies should define "highly regulated" companies to be consistent with paragraphs (1), (2), (3), and (7)(iv), (v) and (vi) of the definition of "financial institution" in the U.S. Capital Rules, to the extent entities listed in those paragraphs are not already classified under another credit exposure category (such as the Grade A-C framework for banks, if extended to other prudentially supervised institutions).[54]

D. Exposures to Banks

1. Risk Weights

The Proposed Rule's treatment of exposures to banks under the ERB Approach unaccountably deviates from the Basel Framework by limiting the application of the lower risk weights of 20% and 50% for Grade A and B banks to Trade Credit Exposures with a maturity of three months or less.[55] This approach is more restrictive than the Basel Framework, which applies lower risk weights to Grade A and B bank exposures to two different categories of bank exposures:

i. any exposure (whether on-balance sheet or off-balance sheet) with a maturity of three months or less; and

ii. any Trade Credit Exposure with a maturity of six months or less.[56]

The Agencies provide no rationale for the Proposed Rule's more restrictive approach compared to the Basel Framework, limiting themselves to asking a question about whether the maturity for Trade Credit Exposures should be six months or less rather than three months or less, but ignoring the Basel Framework's treatment of all bank exposures with a maturity of three months or less.[57]

The Banks believe that there is no good reason for the Proposed Rule to apply a more punitive treatment to bank exposures than the Basel Framework, especially because a banking organization would be able to limit renewing, extending or entering into new exposures with short-term maturities (i.e., three

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[53] 88 Fed. Reg. 64028, 64054 (Sept. 18, 2023) (Question 39).

[54] 12 C.F.R. § 217.2 (definition of "financial institution").

[55] Proposed Rule §__.111(d).

[56] Proposed Rule §__.111(f)(5); Basel Committee on Banking Supervision, *CRE Calculation of RWA for credit risk*, CRE 20.21 and 20.31.

[57] 88 Fed. Reg. 64028, 64042 (Sept. 18, 2023) (Question 19).

months or less) in the event of a material change in the credit risk profile of another bank. Consequently, the Banks recommend that the Proposed Rule be modified to extend the lower risk weights for exposures to Grade A and B banks to any exposures (on-balance sheet or off-balance sheet) with a maturity of three months or less, as well as to Trade Credit Exposures with a maturity of six months or less.

2. Other Prudentially Regulated Firms Qualifying for Same Treatment as Banks

The Basel Framework permits national regulatory authorities to extend the Basel Framework's treatment of bank exposures to "securities firms and other financial institutions . . . provided that these firms are subject to prudential standards and a level of supervision equivalent to those applied to banks," including capital and liquidity requirements.[58]

In the United States, broker-dealers registered with the U.S. Securities and Exchange Commission are subject to extensive regulation, including with respect to capital requirements, and outside the United States broker-dealers are generally regulated in similar ways, and in some jurisdictions, such as the EU, are subject to Basel III-based capital rules. Insurance companies both in and outside the United States are also regulated and subject to capital requirements and liquidity requirements.[59]

As a result, the Banks believe that regulated broker-dealers and insurance companies generally pose an analogous level of credit risk as exposures to banks, and therefore recommend that the Proposed Rule's treatment of exposures to banks be extended to SEC-registered broker-dealers and their foreign equivalents, and regulated insurance companies and their foreign equivalent. The criteria for distinguishing between Grade A, B and C institutions should be adapted to take into account the specific levels of capital requirements and liquidity requirements applicable to broker-dealers and insurance companies.

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[58] Proposed Rule §__.111(f)(5); Basel Committee on Banking Supervision, *CRE Calculation of RWA for credit risk*, CRE 20.40.

[59] Many states have enacted laws based on the National Association of Insurance Commissioner's (NAIC's) model Insurance Holding Company System Regulatory Act, which contains a liquidity stress testing framework applicable to insurance companies. NAIC (2021), available at https://content.naic.org/sites/default/files/MO440_0.pdf. NAIC has also produced a map depicting adoption of the latest model legislation, available at https://content.naic.org/sites/default/files/smi_state_adoption_maps_models.pdf.

E. Defaulted Exposures

The ERB Approach in the Proposed Rule would apply a 150% risk weight to any non-retail exposures (excluding sovereign and real estate exposures and policy loans), where the obligor is unlikely to pay its credit obligations due to the fact that the obligor: (i) has a credit obligation with the banking organization that is 90 days or more past due or in nonaccrual status; or (ii) has a credit obligation with *any creditor* that has been sold at a credit-related loss, has a distressed restructuring including certain features that have been agreed to with *any creditor*, is subject to a pending or active bankruptcy proceeding, or has a credit obligation for which *any creditor* has taken a full or partial charge-off, write-down, or negative valuation adjustment against the obligor for credit-related reasons.[60]

Unlike the treatment of defaulted exposures under the standardized approach, the Proposed Rule would require all banking organizations subject to the ERB Approach to evaluate the credit performance of a non-retail (i.e., wholesale) obligor not just on a firm's own credit exposures to that obligor, but also on any credit exposures by the same obligor to any creditor. It would be operationally challenging for banking organizations to obtain adequate data to evaluate an obligor's credit to certain other creditors, particularly those outside of the United States. The Agencies are obviously aware of this challenge, as demonstrated by their question asking what operational challenges a banking organization would face in identifying which exposures meet the proposed definition of defaulted exposure and whether banking organizations are able to obtain the necessary information to assess credit obligations to third-party creditors.[61]

Requiring banking organizations to comply with the definitional requirements of a defaulted wholesale exposure would create a substantial burden and may force banking organizations to rely on sub-standard data. Rather than evaluating the likelihood that a wholesale obligor will repay its obligations based on the criteria prescribed in the Proposed Rule, a banking organization should be permitted to rely on its own credit risk management processes to determine whether an obligation is likely to default.

The Agencies require banking organizations to maintain robust credit risk management frameworks. For example, safety and soundness guidelines require banking organizations to perform due diligence on their credit portfolios and establish effective internal policies, processes, systems, and controls to ensure that

[60] Proposed Rule §__.111(i) (emphasis added).

[61] 88 Fed. Reg. 64028, 64040 (Sept. 18, 2023) (Question 14).

their credit risk management system reflects appropriate risk weights assigned to credit exposures.[62] Banking organizations are currently free to determine to what extent they wish to rely on information about an obligor's performance on obligations to other creditors, and should continue to be free to do so instead of being compelled to treat any other credit-related problem vis-à-vis any other creditor (such as a write-down) as meaning that its own exposures to that same obligor are all defaulted exposures. If the Agencies determine that banking organizations' current credit risk management practices are insufficient to evaluate the likelihood that a wholesale obligor defaults on an obligation, the Agencies should address any such general weaknesses by issuing revised guidance on credit risk management practices. They should not replace banking organizations' credit risk management processes for determining whether an exposure to a wholesale obligor has a reduced expectation of repayment by using the U.S. Capital Rules to adopt a rigid, prescriptive approach to making that determination.

If the Agencies nevertheless insist on requiring banking organizations under the ERB Approach to treat exposures as defaulted exposures based on the performance of that obligor's credit to any third-party creditor, the Agencies should limit this treatment to situations in which the banking organization has knowledge – through disclosures by the obligor, or through reports from external credit rating agencies – that the obligor has defaulted on another obligation. Moreover, consistent with the Basel Framework, the third-party default should be subject to a materiality threshold. For example, a possible approach to a materiality threshold would be for banking organizations to treat an exposure as due to a third-party default only if it exceeds (i) 5% of the banking organization's tier 1 capital[63] or (ii) 5% of the obligor's total exposure to the banking organization. Without a materiality threshold, banking organizations would likely have to consider exposures from investment grade obligors as defaulted exposures even for immaterial defaults.

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[62] *See* Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System and Federal Deposit Insurance Corporation, *Interagency Guidance on Credit Risk Review Systems*, 85 Fed. Reg. 33278 (June 1, 2020); *Interagency Guidelines Establishing Standards for Safety and Soundness*, 12 CFR part 30, Appendix A (OCC); 12 CFR part 208, Appendix D-1 (Board); 12 CFR part 364, Appendix A (FDIC).

[63] This would be consistent with the materiality threshold that the Agencies currently apply for aggregating credit exposures to more than one counterparty due to economic interdependence or control relationships in the SCCL rule. 12 C.F.R. § 252.76(a)(1).

F. Off-Balance Sheet Exposures

1. Commitments with No Pre-set Limits

For off-balance sheet commitments without an express contractual maximum amount, the Proposed Rule would require banking organizations subject to the ERB Approach to determine the undrawn amount using a proxy notional amount. The proxy notional amount would be calculated by taking the lesser of (i) the average total drawn amount since the creation of the commitment, and (ii) the average total drawn amount over the prior eight quarters, multiplying it by 10 and subtracting the current drawn amount.[64] The Basel Framework does not explicitly include such an approach in calculating the exposure amount for commitments without an express contractual amount.

The Banks are concerned that the Proposed Rule's formula not only deviates from the Basel Framework, but does so in a way that could, under certain circumstances, produce unintended consequences. For example, a credit card customer with a $20,000 stated commitment amount, a $1,000 average drawn amount for the prior eight quarters, and a current drawn amount of $0 would produce a $2,000 off-balance sheet exposure amount under the Proposed Rule ($20,000 times a 10% CCF). If the same exposure were to have the credit limit removed, the Proposed Rule's proxy methodology would produce an off-balance sheet notional amount of $10,000 and an off-balance sheet exposure amount of $1,000 ($10,000 times a 10% CCF). Assuming the same CCF and counterparty risk weight for the two exposures, the proxy notional amount methodology would result in half the amount of the off-balance sheet exposure. The Proposed Rule thus could have the paradoxical effect of incentivizing banking organizations to remove pre-set spending limits on certain customers or, alternatively, reduce their credit lines.

To avoid this effect, the Banks recommend that for unconditionally cancellable commitments with contractual credit limits, the off-balance sheet exposure amount should be equal to the lesser of (i) the unused portion of the commitment multiplied by the applicable CCF and (ii) the off-balance sheet exposure amount that would be calculated for the commitment under the proxy notional amount methodology if the commitment had no contractual credit limit.

In addition, the Agencies claim that applying a multiplier of 10 to the average total drawn amount in the proxy notional amount methodology is justified because "supervisory experience suggests that obligors similar to those with charge cards

[64] Proposed Rule §__.112(a)(5).

have average credit utilization rates equal to approximately 10 percent."[65] The Agencies do not, however, provide any empirical evidence to support this claim. A multiplier of 10 would lead to excessive commitment amounts for charge cards and other unconditionally cancelable commitments. The Banks therefore support the recommendation made in the BPI and ABA joint comment letter that the Agencies revise the proxy notional amount methodology to apply a treatment for charge cards and other unconditionally cancelable commitments based on the actual performance of those commitments.[66]

2. Credit Conversion Factor for Unconditionally Cancelable Commitments

Under the Proposed Rule, banking organizations subject to the ERB Approach would be required to apply a CCF of 10% to unconditionally cancelable commitments.[67] The Agencies explain that a banking organization should be required to hold capital against an unconditionally cancelable commitment because, in practice, banking organizations often extend credit to borrowers even when they are under economic stress.[68] The Agencies do not, however, provide any empirical data to support setting the CCF for unconditionally cancelable commitments at 10%. Empirical studies have shown that the implied CCF for unconditionally cancelable commitments of banking organizations in the United States is no higher than 6.5%, and is even lower for certain exposures, such as credit card loans.[69]

The Banks therefore recommend that the Agencies set the CCF for unconditionally cancelable commitments no higher than 6.5% to appropriately reflect the likelihood that a borrower would draw upon the unused portion of an unconditionally cancelable commitment.

G. Securitization Framework

1. SEC-SA – Supervisory Parameter ρ

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[65] 88 Fed. Reg. 64028, 64056 (Sept. 18, 2023).

[66] BPI and ABA joint comment letter, Section IV.B.3.

[67] Proposed Rule §__.112(b).

[68] 88 Fed. Reg. 64028, 64056 (Sept. 18, 2023).

[69] See TCH Research Study, "Empirical Analysis of BCBS-Proposed Revisions to the Standardized Approach for Credit Risk," THE CLEARING HOUSE (May 2016), available at https://bpi.com/wp-content/uploads/2018/07/20160519_tch_study_bcbs_standardized_approach_for_credit_risk.pdf.

As part of SEC-SA, the Proposed Rule would apply a supervisory parameter ρ of 1.0 for securitization exposures and 1.5 for resecuritization exposures.[70] The Basel Framework also applies a supervisory parameter ρ of 1.0 for securitization exposures and 1.5 for resecuritization exposures, but includes a third category for certain traditional securitization exposures. The Basel Framework applies a supervisory parameter ρ of 0.5, as well as a 10% risk weight floor, to STC securitizations, which include asset-backed securities, commercial mortgage-backed securities, and residential mortgage-backed securities. The Proposed Rule does not adopt the concept of STC securitizations as part of the ERB Approach, instead treating these exposures as indistinguishable from other securitizations and applying a *ρ*-value of 1.0. The Agencies have thus effectively applied a surcharge to the securitization framework under the ERB Approach compared to the Basel Framework by failing to recognize a lower supervisory parameter for STC securitization exposures. This is yet another way in which an individual component of the ERB Approach, when aggregated with the treatment of regulatory residential and other real estate exposures, can exacerbate the overall negative impact of the Proposed Rule on bank mortgage lending activities, to the detriment of U.S. consumers, the U.S. mortgage lending market, and the broader U.S. economy.

The Banks respectfully submit that there is no basis for the Agencies to double the supervisory parameter *ρ* for STC securitizations to 1.0 from the 0.5 included in the Basel Framework. The credit default risk of securitization exposures, whether for traditional securitization exposures or synthetic securitization exposures, has not deteriorated since the finalization of the U.S. Capital Rules. On the contrary, the Banks' experience with securitization exposures, whether as originators or investors, is that a combination of enhanced disclosures, improved due diligence procedures, and credit risk retention requirements, have all contributed to containing the credit default risk of securitization exposures compared to the period before the global financial crisis. If the Agencies are not inclined to follow the Basel Framework and recognize a category of STC securitizations that would benefit from both a 0.5 supervisory parameter ρ and a 10% minimum risk weight floor, at a minimum the Agencies should hold the supervisory parameter for all securitization exposures (other than resecuritization exposures) steady at 0.5. This would at least acknowledge the absence of any systematic deterioration in the credit default risk of securitization exposures since the U.S. Capital Rules were finalized.

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[70] Proposed Rule §__.133(a)(5).

2. Securitized Retail Exposures

As discussed above, the Proposed Rule would impose more punitive risk weights on securitized retail exposures by applying higher risk weights to the assets underlying securitized retail exposures, such as credit card debt and consumer auto loans. If the risk weights for retail exposures increase then, under the SEC-SA, the risk weights for securitized retail exposures based on underlying retail assets would also increase.[71] Requiring banking organizations to hold additional capital against securitized retail exposures would prevent banking organizations from receiving the same benefit from either securitizing underlying retail exposures (if the bank is originating a securitization and must retain the credit risk on a portion of the securitized assets) or investing in a securitization exposure based on underlying retail exposures.

The aggregate and granularity limits for regulatory retail exposures would also introduce an operational challenge for banking organizations that invest in securitized retail exposures. The Proposed Rule would require a banking organization that invests in a securitized retail exposure to look through the securitization to the underlying retail exposures. The investing banking organization would then need to identify the obligor for and the amount of each underlying retail exposure to ensure that the underlying retail exposures, when aggregated with the banking organization's other retail exposures, do not exceed (i) the aggregate limit of $1 million to any obligor or its affiliates, or (ii) the granularity limit of 0.2% of the banking organization's total regulatory retail exposures.[72]

A banking organization that originates a securitized retail exposure would have records of the retail obligors for and the amounts of each underlying exposure, but banking organizations that invest in securitized retail exposures generally would not have access to this information. Sponsors of securitized retail exposures typically do not disclose the identities of retail obligors associated with the underlying exposures, in part to protect the retail obligors' privacy. Even if investors could access this information, it would be operationally challenging for investing banking organizations to track each underlying retail exposure and calculate when an investment in a securitized retail exposure causes the banking organization to exceed the aggregate or granularity limits with respect to a particular retail obligor. The operational challenges presented by the Proposed Rule would make it less attractive for banking organizations to invest in securitized retail exposures. With fewer participants in the market, it would be more difficult for banking organizations to securitize their retail exposures, which is an important tool to help

[71] Proposed Rule §__.133(b).

[72] Proposed Rule §__.101(b) (definition of "regulatory retail exposure").

banking organizations manage the risk from consumer loans, credit cards and other retail activities.

The Banks therefore recommend that the Agencies exempt securitized retail exposures from the aggregate and granularity limits in the Proposed Rule for banking organizations that invest in securitized retail exposures.

3. Recognition of Directly Issued Credit-Linked Notes

As part of any final rule, Agencies should clearly codify recognition of directly issued credit-linked notes ("**CLNs**") as credit risk mitigants for synthetic securitization exposures. Banking organizations often use CLNs to mitigate their credit risk from portfolios of underlying loans. If a CLN meets the appropriate operational criteria, a banking organization may recognize that CLN as a credit risk mitigant in the capital rules, allowing the banking organization to reduce its RWAs for the securitization exposure. As discussed in the Federal Reserve's recent FAQs on Capital Adequacy of Bank Holding Companies, Savings and Loan Holding Companies, and State Member Banks, issued on September 28, 2023, a banking organization can recognize credit risk mitigation for some CLNs that are issued indirectly by a special purpose vehicle.[73] A banking organization may recognize a CLN under these circumstances if the transaction meets the operational criteria described in 12 C.F.R. § 217.41 or § 217.141 and meets the definition of synthetic securitization exposure in 12 C.F.R. § 217.2.

In the recent FAQs, the Federal Reserve stated that directly issued CLNs are unlikely to meet the operational requirements of 12 C.F.R. § 217.41 or § 217.141 or the definition of synthetic securitization exposure. Synthetic securitization exposures must include a transfer of credit risk through a guarantee or credit derivative, and the definition of credit derivative requires standard industry credit derivative documentation. Directly issued CLNs are not generally executed under standard industry credit derivative documentation, but incorporate industry-standard credit default terms into the terms of the CLNs themselves. The operational criteria for synthetic securitization exposures also recognize certain types of credit risk mitigants, including financial collateral. The credit risk mitigant of a CLN consists of the cash proceeds of the CLN, which the Federal Reserve

[73] Board of Governors of the Federal Reserve System, Frequently Asked Questions about Regulation Q, Capital Adequacy of Bank Holding Companies, Savings and Loan Holding Companies, and State Member Banks (Sept. 28, 2023), available at https://www.federalreserve.gov/supervisionreg/legalinterpretations/reg-q-frequently-asked-questions.htm.

considers to be different from financial collateral because the cash is not held on deposit for the holders of the CLNs.

The Federal Reserve stated in its FAQs that it is willing to exercise a Reservation of Authority for directly issued CLNs because a banking organization can, in principle, transfer credit risk to the CLN investors at least as effectively using a directly issued CLN as a CLN issued through a special purpose vehicle. The Banks agree with the Federal Reserve's position that directly issued CLNs are equally as effective at transferring credit risk to CLN investors as CLNs issued through a special purpose vehicle. Given that direct and indirect CLNs are both equally effective risk mitigants, the Banks recommend that the Agencies codify this point by revising the Proposed Rule to include CLNs as recognized credit derivatives and credit risk mitigants for purposes of synthetic securitization exposures.

4. Grandfathering of Existing Simplified Supervisory Formula Approach Exposures

The Proposed Rule would replace the SSFA with the SEC-SA as the approach for calculating RWAs for securitization exposures under the ERB Approach. This would require all banking organizations subject to the ERB Approach to recalculate RWAs for their existing securitization exposures, which are currently calculated using the SSFA, using the SEC-SA instead.[74] While the Proposed Rule would provide for a three-year transition period for the aggregate calculation of RWAs under the ERB Approach, a requirement to go back and recalculate RWAs for all existing traditional and synthetic securitization exposures would be both operationally burdensome and would retroactively alter the economics of these existing securitization exposures to the extent that the SEC-SA would result in a higher amount of RWAs.

The Banks therefore recommend that the Proposed Rule be modified to allow banking organizations to use the SSFA to calculate RWAs for any securitization exposures entered into prior to July 27, 2023, the date on which the Agencies adopted and published the Proposed Rule.[75]

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[74] Proposed Rule §__.132(a)(1); Proposed Rule §__.133.

[75] This approach would be similar to that adopted in the U.S. Capital Rules, which use the date of enactment of the Dodd-Frank Act as the effective date on which regulatory capital instruments issued by banking organizations needed to comply with the criteria for recognition as regulatory capital instruments under the then applicable Basel III framework, as subsequently implemented by the U.S. Capital Rules. *See* 12 C.F.R. § 217.20(e)(1)(i).

H. Equity Exposures

The Proposed Rule, in its treatment of equity exposures under the ERB Approach, would eliminate the 100% risk weight category for non-significant equity exposures up to 10% of a banking organization's total capital that is part of the standardized approach under the current U.S. Capital Rules.[76] The 100% risk weight categories would be limited to community development investments and equity exposures to unconsolidated SBICs or through consolidated SBICs.[77] The elimination of the general 100% risk weight category for non-significant equity exposures subject to an aggregate cap of 10% of a banking organization's total capital deviates from the Basel Framework, which specifically contemplates such a category for equity investments "made pursuant to national legislated programs."[78] The Banks believe that the elimination of the category of non-significant equity exposures subject to a 100% risk weight would disincentivize banking organizations subject to the ERB Approach from making a number of equity investments that benefit small businesses and companies or organizations that are engaged in projects that advance important national interests, such as renewable energy. This would have a negative impact not only on the businesses that benefit from such bank equity investments, but on the broader U.S. economy.

1. Investments in Small Businesses

The Proposed Rule would discourage banking organizations from investing directly in small businesses. The Proposed Rule would require a banking organization subject to the ERB Approach to apply a 400% risk weight for direct investments in small businesses (as non-publicly traded equity exposures) while applying a 100% risk weight to indirect investments in small businesses made through investments in SBICs. The Banks believe that there is no reason for the Agencies to incentivize indirect investments in small businesses through SBICs at the expense of direct investments in the same types of small businesses. Both direct and indirect investments in small businesses should receive the same risk weight.

The Banks therefore recommend that the Agencies modify the Proposed Rule to apply a 100% risk weight to direct equity investments by banking organizations in small businesses that would qualify for investments from SBICs.

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[76] Proposed Rule §__.141(b).

[77] Proposed Rule §__.141(b)(3).

[78] Basel Committee on Banking Supervision, *CRE Calculation of RWA for credit risk*, CRE 20.59.

2. Projects that Advance National Interests and Employee Benefit Plans

The elimination of the 100% risk weight category for non-significant equity exposures also would discourage banking organizations subject to the ERB Approach from investing in projects that advance important national interests. The Proposed Rule's scope of 100% risk-weighted equity exposures would exclude various equity exposures that currently qualify for non-significant equity exposure treatment, such as equity exposures related to renewable energy, historic property rehabilitation, tax equity finance transactions, and certain investments in minority depository institutions. The Banks believe that investing in these types of projects is important to advance U.S. national interests, including addressing climate change, expanding access to affordable housing, and enhancing the national infrastructure. By eliminating the 100% non-significant equity exposures category, the Proposed Rule would increase the risk weights applied to these equity exposures, in most cases to 400%. Significantly increasing the capital that banking organizations must hold against these equity exposures would inevitably discourage banking organizations from investing in these types of projects.

The same considerations apply to banking organizations' employee benefit plans and deferred compensation plans, whether they are qualified or non-qualified ERISA plans.[79] Many of these plans are overfunded, i.e., the value of their assets exceeds their liabilities, and currently banking organizations are not penalized for having overfunded employee benefit plans because they are able to treat their exposures to such plans, to the extent applicable, as non-significant equity exposures with a risk weight of 100%, subject to the waterfall provisions of Section ___.52(b)(3)(iii) of the U.S. Capital Rules. By eliminating this category of 100% risk-weighted equity exposures in the Proposed Rule, the Agencies would effectively disincentivize banking organizations from maintaining overfunded employee benefit plans. The Banks respectfully submit that this is not a sensible consequence of the Proposed Rule, especially in light of the typically conservative investment guidelines of banking organizations' employee benefit plans.

The Banks therefore recommend that the Agencies modify the Proposed Rule to extend the 100% risk weight to equity exposures related to renewable energy, historic property rehabilitation and tax equity finance transactions, as well as overfunded employee benefit plans. Consistent with the Basel Framework, the Banks also recommend that the Agencies apply a 100% risk weight to equity

[79] 29 U.S.C. § 1003; 29 CFR §§ 2530.201-1 and 201-2.

investments that are made pursuant to any national legislative program, including minority depository institutions, subject to an aggregate cap of 10% of total capital.[80]

3. Equity exposures to investment funds

The Proposed Rule would require equity exposures to investment funds to be treated as "market risk covered positions" and therefore subject to the calculation of market risk capital requirements unless a banking organization neither (i) has access to an investment fund's prospectus, partnership agreement or similar contract that defines the fund's permissible investments and investment limits, nor (ii) is able to use the look-through approach to calculate a market risk capital requirement for its proportional share ownership share of each exposure held by the investment fund, or obtains daily price quotes for the investment fund.[81] In addition, to the extent an equity exposure to an investment fund is treated as an equity exposure subject to credit risk, the Proposed Rule would mandate the use of the full look-through approach and would only permit the alternative modified look-through approach if a banking organization does not have sufficient information to use the full look-through approach.[82]

The Banks have two main concerns with these provisions of the Proposed Rule. First, it is not clear whether a banking organization's exposure to separate account bank-owned life insurance ("**BOLI**") or corporate-owned life insurance ("**COLI**") would qualify for the exemption from the definition of "market risk covered position" for an equity position arising from deferred compensation plans, employee stock ownership plans, and retirement plans.[83] Banking organizations often use BOLI/COLI separate accounts to offset the future costs of providing employee benefits, not for trading purposes or to seek short-term profits. The Agencies should clarify in the final rule that BOLI/COLI separate account exposures are exempt from being treated as market risk covered positions in the same way as equity positions arising from deferred compensation plans, employee stock ownership plans, and retirement plans.

Second, the Proposed Rule should not mandate the use of the full look-through approach for equity exposures over the alternative modified look-through

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[80] Proposed Rule §__.111(f)(5); Basel Committee on Banking Supervision, *CRE Calculation of RWA for credit risk*, CRE 20.59.

[81] Proposed Rule, §§___.202(1)(ii)(C) and (2)(vi).

[82] Proposed Rule, §§___.142(a)(1) and (2).

[83] Proposed Rule, §___.202(2)(xv).

approach. The U.S. Capital Rules permit a banking organization to use either one of the three available look-through approaches (i.e., the full look-through approach, the simple modified look-through approach and the alternative modified look-through approach), using the permissive term "may" in Section___.53(b) (full look-through approach) and Section___.53(d) (alternative modified look-through approach). The full look-through approach, although undoubtedly more granular than the alternative modified look-through approach, is also more burdensome and time-consuming, particularly for investments in funds sponsored and managed by third parties. As the alternative modified look-through approach cannot produce RWAs that are lower than those produced under the full look-through approach, the Banks respectfully submit that there is no reason to obligate banking organizations to use the full look-through approach if they are willing to accept the trade-off of the less burdensome, but more conservative, alternative modified look-through approach. The Banks therefore recommend that Section___.142(a)(1) of the Proposed Rule be amended to read in relevant part that a "[Banking Organization] may use the full look-through approach described in paragraph (b) of this section" (emphasis added).

IV. Transition Periods

The Banks respectfully submit that the Agencies should incorporate the following transition periods into a final rule:

- The AOCI opt-out should be phased out over a five-year period.
- If included in the final rule, the changes to the threshold deduction framework and minority interest frameworks should be phased in over a five-year period.
- The changes to the aggregate calculation of RWAs under the ERB Approach should be phased in over a three-year period.

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The Banks appreciate the opportunity to comment on the Proposed Rule. If the Agencies have any questions about this comment letter, please contact the individuals listed in Appendix A.

Respectfully submitted,

Capital One Financial Corporation
The PNC Financial Services Group, Inc.
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Appendix A

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