Brian Peters
122 Buttercup Ln.
Huntington, NY 11743

Nov. 28, 2023

Office of the Comptroller of the Currency, Treasury;
The Board of Governors of the Federal Reserve System;
The Federal Deposit Insurance Corporation.

To the appropriate Federal regulators:

Thank you for the opportunity to comment on Regulatory capital rule: Amendments applicable to large banking organizations and to banking organizations with significant trading activity. I am a citizen unaffiliated with any firm or industry group.

This comment letter aims to address the proposed amendments to the regulatory capital rule applicable to large banking organizations and those with significant trading activity. My insights, drawn from experience as a senior Bank Supervision officer at the Federal Reserve Bank of New York and as a senior risk manager at a systemically important financial institution, focus on the evolving structure of the financial sector, the role of market forces in setting capital requirements, and the implications of increased non-bank financial institution participation. Additionally, the letter will discuss the impact of these changes in the context of recent financial crises and the need for forward-looking, rather than reactive, regulatory approaches.

Framing the Objective

The objective in and of itself should not be to raise or lower regulatory minimum capital standards.

Instead, the object should be to insure that we have an efficient and resilient financial system that properly intermediates between borrowers and lenders, establishes prices in a rational and risk-adjusted manner, and is resilient to stress. In this way, these efforts should be forward-looking, rather than reactive to past events.

In the US, regulatory minimum capital standards are but one part of a Prompt Corrective Action (PCA) regime. PCA includes other elements, including limitations on capital distributions on debt and subordinated equity; acquisitions and branching; business activities; and senior executive officer compensation. Similarly, PCA is but one element of an effective system of bank regulation and supervision.

Importantly, the US regime is also supported by a deposit insurance scheme that is funded by the industry. This is important because it is universally agreed that the optimal number of bank

failures is not zero. This is important for equity markets and debt investors to have the proper incentives to monitor and provide discipline to banking firms.

Recognizing Changes to the Structure of the Financial System

In [1992], E. Gerald Corrigan, then President of the Federal Reserve Bank of Minneapolis, authored 'Are Banks Special?' for their Annual Report[1]. In this paper he posited that banks are special, different from other financial organizations, and therefore warrant a higher degree (and burden) of supervision for three reasons:

1. Banks offer transaction accounts.
2. Banks are the backup source of liquidity for all other institutions.
3. Banks are the transmission belt for monetary policy.

Here he argued that other apparent forms of transaction accounts, such as money market funds or repo transactions, that appear to have characteristics of bank transaction accounts, ultimately, at some point, end up reliant on bank transaction accounts. He goes on to say "As long as banks issue transaction accounts they, by definition, incur a form of "term structure" risk. That is, the presence of transaction balances on the books of a bank makes it difficult, if not impossible, to match the maturities of assets and liabilities ..."

Since Corrigan authored this analysis, the financial sector has changed in several important ways that are relevant for this discussion.

- Funding of financial institutions, both banks and more importantly non-banks, has changed from reliance on smaller, insured depositors, to larger pools of uninsured money, invested on a short-term or overnight basis through money market funds, repo facilities and uninsured bank deposits.
- Large banks have grown their share of national deposits due to interstate branching and technological development.
- There has been a tremendous growth in almost all aspects of the non-bank financial institution sector.

Banks, however, remain "special" for the finality of their transaction accounts and their integration into the payment system.

Banks remain the backup source of liquidity for all other institutions in normal times. But as we have seen through both the Federal Reserve response to the global financial crisis, the subsequent codification of lending rules within Dodd-Frank, and the actions taken by the Federal Reserve during the Covid-related Treasury repo crisis, banks no longer remain the

[1] https://fraser.stlouisfed.org/title/annual-report-federal-reserve-bank-minneapolis-473/annual-report-1982-18309

backup source of liquidity in a crisis. Instead, we have found that the Federal Reserve and Treasury have been willing to step in with funding facilities before the funding needs would be fully impacting regulated banks.

Similarly, the development and implementation of the Standing Overnight Repo Facility, with its expanded list of counterparties, has provided the Federal Reserve with another tool to implement monetary policy. One can also consider the extended unwind of the Fed's securities portfolio as another current method of implementing monetary policy.

To Corrigan's question, are bank's special, the answer is probably still yes, though perhaps not as special as in the past.

Reflecting on recent financial crises, particularly the global financial crisis and the Covid-related Treasury repo crisis, it is pertinent to consider how the proposed regulatory changes could have influenced these events. The increased reliance on Federal Reserve and Treasury interventions during these crises highlights the shifting dynamics in liquidity provision and crisis management. The proposed capital rules should, therefore, be evaluated not only in the context of past events but also for their potential to shape responses to future financial stress scenarios. This evaluation is crucial to ensure that the regulatory framework remains robust and adaptable to the evolving landscape of the financial system.

Basel Capital Requirements Is an Agreement among Banks

The Basel capital process is generally seen as an agreement among bank supervisors to harmonize capital requirements. The first set of Basel capital requirements was developed in order to have Japanese financial institutions to increase their capital levels. It is important to note that the concerns about the level of Japanese bank capital was driven by banks counterparty exposure.

The Basel capital process should more correctly seen as an agreement among banks to compete on a level playing field; an agreement intermediated and negotiated by the national banking supervisors. As witnessed through the process, banks will generally seek to have preferential rules for their own national banking market, but have a level playing field to compete in the broader international capital markets.

Each supervisor does have the right to implement more strict capital standards, but due consideration should be given to the fact that the broad construct of the Basel Capital Accord has been broadly accepted by banks across jurisdictions.

Fixed Risk-Weight Rules Were a Flaw in the Original Basel Accord

The Basel II process began late in the last century. A common refrain at the time was "A regulatory framework based on a simple risk weight scheme has become less and less effective in assessing an appropriate level of regulatory capital against these new, complex risk exposures."

The Basel Committee recognized the tension behind more precisely tailored capital requirements that aligned to firms risk management and pricing practices, and more standardized risk weights that could be broadly applicable to smaller, less sophisticated firms at a lower regulatory compliance burden. The belief, at that time and perhaps still today, is that the more advanced approach would create the proper alignment and incentives for banks to capitalize exposures for the specific nature of the risk for their own portfolio. This tension still exists today, but the agency proposal has abandoned the advanced approach (for which, we should note, they were the strongest proponents in Basel).

The advanced approach has its genesis in existing supervisory guidance, specifically the Federal Reserve's SR99-18 "Assessing Capital Adequacy in Relation to Risk at Large Banking Organizations and Others with Complex Risk Profiles" (July 1, 1999). Some salient quotes:

> Simple ratios - including risk-based capital ratios - and traditional rules of thumb no longer suffice in assessing the overall capital adequacy of many banking organizations, especially large institutions and others with complex risk profiles such as those significantly engaged in securitizations or other complex transfers of risk.
>
> This SR letter emphasizes the growing need for banking organizations to take greater efforts to assure that their capital is not only adequate to meet formal regulatory standards, but also is fully sufficient to support their underlying risk positions.
>
> It is particularly important that large institutions and others with complex risk profiles be able to assess their current capital adequacy and future capital needs in a systematic and comprehensive manner in light of their risk profiles and business plans.

Banking institutions were required to take several steps that are simpler in statement than execution:

1. Identifying and measuring all material risks
2. Relating capital to the level of risk
3. Stating explicit capital adequacy goals with respect to risk
4. Assessing conformity to the institution's stated objectives

The key point here is that institutions were not to rely on simple measures of regulatory capital adequacy, but instead must affirmatively determine the level of risk they were willing to take, and to hold capital commensurate with the economic riskiness of their exposures.

By abandoning an advanced approach in favor of a more standardized approach, regulators are displaying a degree of hubris that they can determine the riskiness of exposures more reliably than those who make and manage these exposures.

The Market, Not Regulators, Set Capital Requirements

This may appear odd coming from a former regulator, but minimum regulatory capital requirements no longer determine the capitalization of credit creation. Credit provision is more rightfully seen as being determined by the marginal additional risk of a transaction to an existing efficient portfolio as seen through the risk appetite of market participants

Regulatory capital requirements, whether risk-based, or simple, such as a leverage ratio, are constraints that are overlaid on bank and other regulated market participants in determining their portfolio composition. The presence of constraints that raise the capitalization of a transaction above that required on an economic basis will not result in the transaction being done at a higher cost by the institution, but instead, through the magic of competitive markets, will result in the transaction being executed by another entity. Raising the required level of bank capital (the sum of minimum requirements and expected levels of 'buffer capital') will result in the transaction being held by unregulated market participants.

A Greater Share of Non-Bank Participation Increases Importance of Counterparty Exposure Management

Banks will likely remain active in originating credit exposures with high capital charges, in part due to the linkage to deposit creation, however they will likely originate-to-distribute these exposures, selling them to non-bank financial institutions. The non-bank financial institutions will naturally seek to obtain leverage for their purchases as it is generally economically inefficient to hold an unlevered portfolio of credit exposures. This financing/leverage will be provided by the originating banking organizations through their prime-brokerage activities.

In essence, leverage is moving from the regulated to the unregulated financial sector. When a greater amount of transactions are completed outside of the regulated banking sector, the risks will become more opaque to policymakers. This in turn could hamper policy response to periods of stress.

Whether the benefits of moving the risk from the self-funding regulated banking sector to the non-bank sector outweigh the risks is not a question I can answer, but one that should be thoughtfully considered.

Increased Regulatory Min. Capital Requirements May Not Lessen Frequency of Distress

Bank regulatory capital can be thought of as having two components: a regulatory minimum tied to the PCA regime, and a 'buffer' above this minimum. It is the size of the buffer, and not the level of the minimum requirement, that determines the probability that losses will result in the bank breaching the regulatory minimum and falling subject to whatever PCA-based remedies are required.

Minimum bank regulatory capital instead exists to insure that, once the PCA threshold is breached, there is value in the firm to remediate or resolve the issues at hand. Looked at another way, the level of the minimum requirement is protection against erosion of the deposit insurance fund resources as a firm is resolved.

The Capitalization Approach for Operational Risk Is Flawed

Basel II introduced the concept of an operational risk capital charge. The approach was created out of whole cloth at the time. It followed from the Basel II approach of encouraging firms to capture their own loss data, and calibrate models to their specific risk profile. However, unlike credit risk models, this approach had not been widely implemented in the industry.

In fact, the nature of operational risk losses is different from the credit risk losses that were the basis of the Basel approach. Credit risk losses were assumed to be driven by a single systematic risk factor; when this risk factor is perturbed credit risk losses across the industry rise in a somewhat correlated fashion.

Operational risk losses are different; they are idiosyncratic and not driven by the single systematic risk factor. The appropriate way to address operational risk is not through individual capitalization of a high confidence interval loss estimate, but rather through an insurance-based pooling approach. The insurance industry is predicated upon the pooling of large numbers of idiosyncratic risk such that the uncorrelated nature of the losses requires less aggregate capital to cover tail events.

A more appropriate approach for operational risk would be to require capitalization at a lower confidence interval (say a small multiple of annual recurring losses) and a requirement to purchase insurance for losses above this deductible amount.

There would likely be a sizeable market for such exposure, meaning that the risk would be broadly syndicated among insurers, reinsurers and CAT bond providers. This would also provide market-based pricing based on the underwriting of the specific risks of the individual institution.

Other Specific Comments

III. Proposed changes to the capital rule

A. Calculation of capital ratios and application of buffer requirements

This proposal is overly burdensome and unnecessary.

Ideally, capital would be help in proportion to risk. This justifies one risk-based approach. The largest risk of relying on a singular risk-based approach is that the default estimates of very senior securities is under-estimated leading to an incentive to excessively leverage these assets.

This, in essence, is what occurred with super-senior CDOs during the 2008 financial crisis. The proper control for this is to apply a simple leverage ratio.

A second set of risk-sensitive weights is an unnecessary complication.

III. Proposed changes to the capital rule

B. Definition of capital

1. Accumulated other comprehensive income

Under GAAP, banking balance sheets are calculated using a mix of accrual and current market values. The balance of how market-sensitive the calculation of bank balance sheets, and by association bank capital levels, has been debated for several decades, with the clear trend towards more market-based approaches.

The proposal envisions adjusting regulatory capital for "all net unrealized holding gains and losses on available-for-sale (AFS) debt securities." This captures a substantial part of the value change from only the asset side of the balance sheet.

To more appropriately capture the effect of market-based value changes on the firm one should appropriately allow for the inclusion of the mark-to-market effects on the liability side of the balance sheet.

At a minimum, the bank capital ratio should be adjusted for the unrealized value change associated with long-term debt issued by the bank. In a period of falling rates, when assets will be experiencing unrealized gains, the term debt issued by the institution will incur MTM losses, and the similar but opposite offset will occur during a period of rising rates.