House Financial Services Committee

Subcommittee on Financial Institutions and Monetary Policy

Rules Without Analysis: Federal Banking Proposals Under the Biden Administration

Testimony of Greg Baer, President and CEO, Bank Policy Institute

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Chairman Barr, Ranking Member Foster, and members of the Subcommittee, thank you for the invitation to testify today. My name is Greg Baer, and I am the CEO of the Bank Policy Institute, which is a research and advocacy group supported by banks with more than $100 billion in U.S. assets. As our membership comprises the full range of banks covered by the recent capital proposal, I welcome the opportunity to testify today.

Our comment letters to the banking agencies set forth our concerns and suggestions for improvement in considerable detail.[1] Today, I will attempt to summarize them.

Overview

If adopted, the capital rule proposed by the federal banking agencies would have a profound effect on the availability and cost of credit for nearly every American business and consumer, as well as on the resiliency of U.S. capital markets. The U.S. economy would suffer a significant, permanent reduction in GDP and employment; U.S. capital markets would become less liquid and therefore more dependent on non-bank intermediation in normal times and on governmental support when those non-banks step away during times of stress. Given the stakes involved, the proposal is remarkable for its lack of analytical rigor, its hostility to the use of relevant data as opposed to pre-formed opinions, and its failure to consider both its costs and benefits, not just to banks but to all corners of the U.S. economy.

At a macro level, the proposal contains no standard by which to determine what an appropriate risk weight should be for the risks it proposes to capitalize, and therefore makes it impossible to determine whether a proposed risk weight is too high or too low or whether the costs of higher capital outweigh the benefits. This marks a departure from prior practice.

At a micro level, in almost every case the proposed risk weight for a given asset is based on no identified data or historical experience and no economic analysis. In most cases, the proposal simply takes as given the risk weights negotiated by agency staff in Basel in 2017 and 2019, which, in turn, are lacking in data or analysis, or at least any that has been made public. Also, in many cases, the agencies not only take Basel risk weights as a baseline for the proposal, but also add arbitrary surcharges on top of the Basel weights, again with very little explanation. Finally, the proposal fails completely to acknowledge that in the United States, and in the United States alone, a stress capital charge for most of the same risks is already imposed by the Federal Reserve through its stress testing process.

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[1] Comment Letter from the Bank Policy Institute and American Bankers Association (Jan. 16, 2024), *available at* https://bpi.com/wp-content/uploads/2024/01/ABA-BPI-Basel-III-Endgame-Comment-Letter-Final-2024.01.16.pdf [hereinafter *BPI/ABA Letter*]

The proposal ignores massive data on the performance of banks operating in the United States, which should have formed the basis for the proposal. The agencies propose to eliminate the Advanced Approaches to credit risk that employs more granular and adaptable bank models even though retention of those models was the core component of the 2017 Basel agreement they purport to be implementing and have by all account produced accurate results for well over a decade of use. Perhaps not coincidentally those results argue for a significantly lower capital charge than the agencies' proposed Standardized Approach.

The proposal then adds to the heightened risk weights for credit a massive charge for operational risk, which is not currently a component of the U.S. Standardized Approach.

In all these cases, respondents are denied any meaningful opportunity to provide comment: we do not know the standard used to calibrate the risk weights; the proposal generally provides no data or analysis to support the risk weights chosen; and the proposal fails to acknowledge any overlap with existing rules, much less seek comment on how that overlap should be reconciled.

If finalized, the principal consequence of the proposal would be a significant increase in the overall capital requirements of large banks in the United States – and only the United States. By the agencies' own initial estimate, the proposal would require 16 percent more capital. Even those numbers are clearly understated. While we await a revised impact analysis from the agencies based on an after-the-fact data collection, a private sector analysis of the effect of the proposal on GSIBs has shown that the Basel proposal when combined with a GSIB proposal would increase their capital requirements by 30 percent[2] – about 50 percent higher than the agencies' estimate. The agencies have also estimated that the proposal would increase market risk risk-weighted assets by an astonishing 75 percent.[3]

And as a bottom line, the proposal effectively finds that large U.S. banks are currently critically undercapitalized – something no one in the real world believes for a moment.

The proposed rule fails as a matter of both administrative law and policy. It is based on no articulated standard and provides no evidence to support its requirements, and those requirements are inconsistent with all evidence that we and other commenters can identify on our

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[2] *See* Comment Letter from the Financial Services Forum, American Bankers Association, Bank Policy Institute and Securities Industry and Financial Markets Association (Dec. 22, 2023), *available at* https://www.sifma.org/wp-content/uploads/2023/12/Associations-Letter-re-B3E-Impact-on-U.S.-GSIBs.pdf.

[3] Even this estimate may be significantly understated. Whereas the agencies estimated an overall increase in market risk RWAs for Category I and II banks (which includes the 8 U.S. GSIBs and Northern Trust) of 76.7 percent, a quantitative impact study of the GSIBs shows that the impact on GSIBs could be as high has 112%, and would only be as low as 73 percent if banks were able to maintain current model approvals; as described in multiple industry letters, current model approvals would be endangered under the more restrictive qualification and approval requirements of the proposed market risk framework. *See* Comment Letter from the International Swaps and Derivatives Association, Inc. and the Securities Industry and Financial Markets Association (Jan. 16, 2024), *available at* https://www.sifma.org/wp-content/uploads/2024/01/ISDA-SIFMA-Comment-Letter-January-16-2024-Basel-III-Endgame.pdf.

own. The proposal must be withdrawn, reconsidered, and reproposed based on identified data and cogent analysis.

The Proposed Rule Is at War with Reality

The costs imposed on the U.S. economy by the proposal are even more unacceptable because incurring them is so unnecessary.

Since major reforms were instituted in the wake of the Global Financial Crisis, the level of common equity tier 1 capital, the highest-quality capital, has increased nearly 3.5 times. Other prudential enhancements since the crisis have further bolstered bank stability: banks hold dramatically more liquid assets, have substantially expanded their risk management functions, and have reduced risk across the board. Banks have weathered very large macroeconomic shocks and market turmoil. Benefiting from diversification across both product and geographic lines, they have proven themselves time and again to be amply capitalized.

Even by 2017, when the Basel agreement was reached, its authors concluded that no further increases in capital were required. As Mario Draghi, Chairman of the Group of Central Bank Governors and Heads of Supervision who oversaw Basel III, stated: "The focus of the exercise was not to increase capital. As a matter of fact, the GHOS almost a year ago endorsed this review by the Basel Committee, provided it wouldn't create a significant capital increase in the aggregate of the banking system."[4] The Basel Committee's impact study published at that time concluded, "Finalization of Basel III results in no significant increase in overall capital requirements," and capital in fact was projected to slightly *decrease* for the 96 internationally active banks in the data set in aggregate.[5]

Since 2017, there also has been no evidence that U.S. banks hold insufficient capital against the four risks addressed in the proposal. Much attention has focused, since March 2023, on the case of Silicon Valley Bank, but it did not fail due to credit, operational, market or CVA risk: its borrowers repaid their loans; it suffered no cyber-attack or other operational loss; and it did not trade securities or hedge with derivatives. Its problems were liquidity and interest rate risk. The proposal does not claim otherwise.

Further evidence of the adequacy of current capital levels comes from the Federal Reserve's own annual stress test, which the Federal Reserve has said provides "the public and firms with credible, independent assessments of each firm's capital adequacy under stress."[6] For 2022, total loss absorbency on the balance sheet of the 33 banks included in the stress tests – equity plus allowances for credit losses and eligible long-term debt of GSIBs – was in excess of $2.8 trillion, while total net stress losses under that severely adverse scenario were approximately $300 billion. Thus, absorbency was more than nine times net losses predicted under a stress akin to the Global Financial Crisis and another Great Recession.

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4 https://www.bis.org/bcbs/b3/ghos_20171207_2.htm

5 Basel Committee on Banking Supervision, *Basel III Monitoring Report: Results of the Cumulative Quantitative Impact Study* 1 (December 2017) (https://www.bis.org/bcbs/publ/d426.pdf)

6 *2023 Stress Test Methodology* at 3.

The agencies' proposal is also at odds with innumerable statements from agency principals themselves, detailed in our comment letter. The proposed rule and its implicit finding that large U.S. banks are significantly capitalized thereby constitutes a radical, unexplained break with these prior statements and all the analysis and experience that supported them.

The Components of the Proposed Rule

Risk-based capital requirements are based on ratios that take a bank's regulatory capital as their numerator and risk-weighted assets as their denominator; the proposal largely focuses on the latter and would fundamentally change how risk-weighted assets are calculated for nearly every type of asset and exposure. The risk weight attached to each asset has a direct and significant effect on whether a bank chooses to hold and how it prices that asset; collectively, those risk weights drive the bank's overall capital requirement and its ability to compete for capital against other companies.

The proposed rule would establish a new standardized, government-devised approach to establishing risk weights, which it names the "Expanded Risk-Based Approach." That approach covers four categories of risk: credit risk, operational risk, market risk and credit valuation adjustment risk (the last basically being the risk of default by a derivatives counterparty).

Despite the clear function of these risk weights – to reflect an asset or exposure's *risk of loss* – the proposed rule includes no standard for determining what the appropriate risk weight should be for credit risk and CVA risk and includes no standard for converting operational risk into risk-weighted assets. There is no legal standard, no quantitative standard, and no qualitative standard for "risk" in these contexts, leaving even the most basic aspects of the calibration of these risk weights and risk weight methodologies unknowable.

The consequences of this omission are significant. If any such standard were identified, a commenter could then assess that standard and provide data and analysis on two fundamental questions: *first*, whether that proposed standard is appropriate for determining risk-based capital requirements; and *second*, whether the proposed risk weights and risk-weighting methodologies are consistent with that standard. But the proposal does no such thing.

The concept of a standard against which to measure risk is not novel or difficult. The current Advanced Approaches to credit risk – the internal-models-based approach that the proposal would eliminate entirely – uses as its standard of risk potential credit losses in a given year at a 99.9 percent confidence interval. Both the current U.S. operational risk capital rule and the Basel II standard on which it was based rely on a clear empirical standard of operational risk: a bank's operational risk exposure is defined as equal to the 99.9th percentile of the distribution of potential aggregate operational losses over a one-year horizon. The proposal replaces these standards with no standard.

Legal and Policy Defects with Respect to Each Component

Even if the proposal contained an articulated standard against which to judge its risk weights, it would remain arbitrary and capricious because it cites no data or information to support the weights it assigns for each of its four risks. The proposal is thus inconsistent with

both the procedural and substantive requirements of the Administrative Procedure Act.

Credit Risk

An overly punitive Standardized Approach

The failure to base capital charges for credit risk on data and analysis is remarkable given the massive historical data available to the agencies, which could inform analysis on probability of default and loss given default for all types of loans. For example, the proposal ignores all of the following data sources:

- Banks report quarterly to the Federal Reserve on loss rates for auto loans, commercial and industrial loans, commercial real estate loans, and a range of other exposure categories.[7] The data includes delinquency and default rates.

- OCC researchers have previously used a supervisory data set that includes comprehensive, historical account-level data on credit cards, including detailed information on borrower characteristics along with delinquency and default performance.[8]

- The Federal Housing Finance Agency houses the National Mortgage Database, which includes loan-level information on default and loss experience as well as detailed property and borrower characteristics; the Mortgage Bankers Association and private data vendors maintain historical, segment-level databases on performance of commercial real estate loans.

- Credit rating agencies maintain robust databases of corporate credit performance.

- Most notably, large banks have been submitting data to the banking agencies to support the risk weights across all portfolios under the Advanced Approaches since 2014.[9] This information contains detailed historical data.

Notwithstanding this enormous body of historical loss data – much of it directly used by the agencies for other supervisory and regulatory activities – the proposed rule makes almost no reference to any of these data sources and appears to have ignored them completely in calculating the risk weights it proposes.

A proposal based on data and analysis would have produced very different risk weights. To provide just a few notable examples:

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7 Board of Governors of the Federal Reserve System, *Capital Assessments and Stress Testing Information Collection* (Reporting Form FR Y-14Q), *available at* https://www.federalreserve.gov/apps/reportingforms/Report/Index/FR_Y-14Q.

8 *See* Florentin Butaru, Qingqing Chen, Brian Clark, Sanmay Das, Andrew W. Lo and Akhtar Siddique, *Risk and risk management in the credit card industry*, 72 J. of Banking & Fin. 218, 220.

9 *See* Federal Financial Institutions Examination Council, *Regulatory Capital Reporting for Institutions Subject to the Advanced Capital Adequacy Framework—FFIEC 101*, *available at* https://www.ffiec.gov/pdf/FFIEC_forms/FFIEC101_202309_f.pdf.

- For **credit card loans**, experience taken from regulatory reports supports a risk weight of 73 percent, whereas the proposal would impose an effective risk weight of 111 percent, to which would be added a further operational risk charge – combining for a total risk weight of approximately 140 – 190 percent, or roughly double what the actual risk requires.[10] Furthermore, credit card loans are subject to a further stress capital charge through the Federal Reserve's stress test, of which the proposal takes no account.

- For **other consumer loans**, data from the Advanced Approaches supports a risk weight of 50 percent.[11] The proposal would introduce a risk weight of 85 percent, which is 10 percentage points higher than what U.S. agency staff agreed to in Basel and materially overstates the actual credit risk, particularly for auto loans. These loans are also subject to a further stress capital charge.

- The proposal would impose new capital charges on **unused credit card lines** based on no analysis and in conflict with historical data. (As a result, banks would likely reduce lines for credit card holders, with particular harm to lower-income consumers who rely on unused lines as an emergency source of funding and as a way to build a credit history.)

- Risk weights for **business loans** are similarly overstated. According to FFIEC reports, documented historical experience from 2014 to 2022 suggests that a risk weight of 41 percent would be appropriate. Instead, the proposal establishes a general risk weight of 100 percent, with a 65 percent risk weight available only to businesses that are both (1) rated investment-grade by the bank and (2) have securities listed on a national exchange or have a parent that does. The latter requirement would effectively impose a 100 percent risk weight on loans to tens of thousands of creditworthy small and mid-sized businesses, as well as high credit-quality mutual funds and pension funds that generally do not list securities on an exchange.[12]

  Whether with or without a listed security, historical analysis based on FFIEC data from 2014 to 2022, combined with the Advanced Approaches risk weight formula, shows that a business rated investment-grade by a bank merits a risk weight significantly below 65 percent, and below the 41 percent for all business loans – something on the order of 30 percent.

- Risk weights for **mortgage loans** would range from 40 to 90 percent, even before one considers the impact of the separate operational risk charge and the Federal Reserve's stress test, which could add as much as 25 percent; for loans intended to be sold to government-

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[10] Paul Calem and Francisco Covas, *The Basel Proposal: What It Means for Retail Lending*, Bank Policy Institute (Nov. 8, 2023), *available at* https://bpi.com/the-basel-proposal-what-it-means-for-retail-lending/.

[11] *Id.*

[12] The proposal includes no analytical basis for the securities listing requirement. In fact, researchers using a robust data set have demonstrated that the listing requirement does not result in more consistent internal ratings across banks or lower credit risk, demonstrating that the requirement is arbitrary. *See* Francisco Covas and Barbora Stepankova, *Consistency in Risk Weights for Corporate Exposures Under the Standardized Approach*, Staff Working Paper – Bank Policy Institute (Jan. 2022), *available at* https://bpi.com/wp-content/uploads/2022/01/Consistency-in-Risk-Weights-for-Corporate-Exposures-Under-the-Standardized-Approach.pdf.

sponsored enterprises, the effective risk weight could be as high as 140 percent.[13] Documented historical experience based on data from FFIEC reports from 2014 to 2022 suggests an average risk weight of 25 percent is more appropriate. For GSE loans, the assumed loss rates – even leaving aside the operational risk and stress test add-ons – are higher than those for the worst losses in history – those originated from 2005 to 2008.[14]

Elimination of a more advanced, internal-models-based approach

Compounding the effect of punitive standardized risk weights, the proposal would eliminate the Advanced Approaches for credit risk for the largest banks.

Ending the use of internal models for credit risk would be a repudiation of the core element of the 2017 Basel agreement that the agencies purport to be implementing.[15] That agreement's most negotiated and prominent feature was the continued use of bank models subject to an "output floor," meaning models cannot collectively produce RWAs lower than 72.5 percent of those calculated using a standardized approach.

Ending the use of internal models for credit risk greatly increases the costs of over-calibration of standardized risk weights. In every other major jurisdiction implementing the 2017 Basel agreement, those standardized risk weights are effectively discounted given that in most cases internal models or external credit ratings (the use of which is not permitted in the United States) will produce a significantly lower capital charge. Basically, the standardized charges in that framework were intended to apply at a 72.5 percent discount and will continue to do so in every other major country.

Put another way, having negotiated in Basel an output floor of 72.5 percent, the agencies now propose a de facto output floor of 100 percent but only for U.S. banks, *and* with the Standardized Approach that forms the basis of that output floor set even higher than the Basel agreement in almost every major respect.

Even this formulation understates the impact: the 72.5 percent output floor is an average, and that means some loans in other jurisdictions could receive risk weights significantly lower than 72.5 percent of the risk weight the same loan would receive under the U.S. proposal. Thus,

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[13] *See* Paul Calem and Francisco Covas, *The Basel Proposal: What It Means for Mortgage Lending*, Bank Policy Institute (Sept. 30, 2023), *available at* https://bpi.com/the-basel-proposal-what-it-means-for-mortgage-lending/.

[14] *See* Laurie Goodman and Jun Zhu, "Bank Capital Notice of Proposed Rulemaking – A Look at the Provisions Affecting Mortgage Loans in Bank Portfolios," Urban Institute (Sept. 2023), *available at* https://www.urban.org/sites/default/files/2023-09/Bank percent20Capital percent20Notice percent20of percent20Proposed percent20Rulemaking.pdf.

[15] The Basel framework contemplates the continued use of internal models for credit risk. Although the Basel Committee provides that implementing only the Standardized Approaches would not, in and of itself, constitute noncompliance with the Basel framework, *see* Basel Committee on Banking Supervision, *High-level summary of Basel III reforms*, 12 (Dec. 2017), *available at* https://www.bis.org/bcbs/publ/d424_hlsummary.pdf, nothing in the Basel framework requires the elimination of internal models for credit risk, and implementing the Basel standards in the United States in no way necessitates the elimination of internal models for credit risk.

for lower-risk activities, U.S. banks would be at a serious competitive disadvantage compared to foreign peers, and U.S. borrowers will be seeing higher prices for business or consumer loans compared to the rest of the world.

There is no evidence whatsoever that internal models for credit risk have led to a systematic understatement (or overstatement) of risk at any bank. Since 2014, banks have used internal models to gauge credit risk for capital purposes, subject to back-testing and model approval from an independent risk function, an independent model validation group, internal auditors and agency examiners.[16] The virtue of internal models is that they are inherently more granular and risk-sensitive than government-imposed, one-size-fits-all standardized methodologies, and they can also be adjusted over time to reflect changing behavior.

Despite the fact that agency representatives spent years developing this component of the 2017 Basel Committee revisions, the proposal fails to consider this carefully crafted alternative. Incredibly, *the proposal does not mention the Basel Committee's revised framework for internal credit models at all.* The proposal also contains no mention of the fact that every major banking center abroad that has implemented the 2017 Basel Committee revisions, including both the European Union and the United Kingdom, has chosen to implement the 2017 framework for internal credit models.

The conclusion here is inescapable: the problem with internal models is not that they are inaccurate, but rather that they produce lower capital charges than the agencies would prefer for reasons other than accuracy. And they deprive the agencies of a monopoly in assessing credit risk for capital purposes. All banks should have the option of using internal models subject to the existing regulatory regime in order to ensure their accuracy.

Operational Risk

If the proposal were adopted without change, large U.S. banks would end up holding over $300 billion in capital against so-called "operational risk" – basically the risk of non-financial loss, in theory through events like a cyber-attack but in practice through fines from the banking

[16] The agencies nowhere acknowledge a rigorous model risk management regime that they themselves have established. In 2011, the Federal Reserve and OCC issued their *Supervisory Guidance on Model Risk Management*, which lays out the requirements that banks must follow for robust model development, testing, governance, and independent validation. This 2011 supervisory guidance: (i) defines robust standards for model development, documentation, testing, justification, empirical verification and outcomes analysis, review, and governance of models; (ii) requires that a competent independent model validation group validate that all the requirements specified in the guidance have been met for every model a bank uses; and (iii) mandates that banks' internal audit groups assess the effectiveness of both the model development and the independent validation. As a result of these requirements, internal models for credit go through numerous reviews, with each review serving a different purpose. The guidance was expressly designed to mitigate potential issues with model uncertainty, and by all accounts has served fit for that purpose. Since 2011, the agencies have seen no cause to revisit that guidance and have made no public observation that it is flawed, much less failing to such an extent that it must be abandoned entirely in favor of sole reliance on government-set, standardized models. There has never been a public enforcement action against a bank for underreporting its risk weights under the Advanced Approaches; nor have there been material losses reported at banks attributable to credit risk modeling failures.

agencies and civil litigation judgments. This capital charge is produced by creating more than $3.5 trillion in phantom assets to represent operational risk – which, unlike credit and market risk, is not based on actual assets held by banks, but instead on a bank's income and operational loss history – and then imposing a capital charge against those phantom assets. For capital purposes, approximately 24 percent of banks' collective risk-weighted assets would stem from these phantom assets.

This requirement is massively overstated, and the agencies provide no basis for it in the proposal.

- The proposal ignores relevant data in calibrating the operational risk capital requirement. The Federal Reserve collects historical data on operational risk losses for stress testing purposes.[17] Data going back to the first quarter of 2001 is available and is quite detailed, including information on loss amounts, loss classifications, and loss descriptions. There is no evidence that the agencies considered that data.

- Furthermore, ORX – an operational risk management association – has collected a massive data set on operational risk losses, which also extends back to the early 2000s.

- The proposal also fails to acknowledge that U.S. banks are already required to capitalize for operational risk through the Federal Reserve's stress test. The proposed rule would create $2 trillion in phantom operational risk assets, and another $1.5 trillion in phantom assets already results from the SCB that is calculated in the Federal Reserve's annual stress test, whose latest iteration imposed $188 billion in aggregate operational risk losses.[18]

- The cumulative effect of these two operational risk capital charges leads to overall capital requirements for operational risk that are 3.5 times larger than the largest losses experienced by U.S. banks in the worst year since 2003. Nearly 25 percent of large U.S. banks' total risk-weighted assets would result from operational risk capital charges, whereas the average for banks in other jurisdictions is nearly half that amount.

- One source of the overstatement of operational risk is a material over-capitalization for the risk arising from fee-related income. Unlike the calculation of the interest component and the financial component of the business indicator for operational risk, the services component does not offset revenues with expenses. There is also no upward limit on the size of the services component; in contrast, for the interest component, there is a cap set at 2.25 percent of interest-earning assets. This method of deriving operational risk RWAs disincentivizes banks from diversifying their income streams away from net interest income and runs counter to sound risk management practices.

- The vastly overstated base operational risk charge in the proposal is, in turn, subject to a

[17] Data submitted confidentially under the FR Y-14Q data collection regime includes operational loss history, so this dataset is not available to the public.

[18] The $188 billion estimate of losses associated with operational risk events stemmed from the 2022 stress tests, which included all banks subject to the proposal (Categories I-IV). The 2023 stress test yielded an estimate of $185 billion, reportedly for a subset of those banks (Categories I-III).

bank-specific "internal loss multiplier," designed to assess whether that bank's individual operational risk loss history differs from the norm over the past ten years. It is worth noting that by the time the rule is scheduled to take effect, crisis-era litigation settlements and government fines will no longer be included in the ten-year lookback period. Thus, while good policy would require the agencies either to make the multiplier symmetrical (also giving favorable treatment for good operational loss history) or to eliminate it altogether (as the EU and UK have done), it is not a major driver of the overstatement of operational risk capital.

In sum, the current proposal with respect to operational risk capital should be thoroughly reconsidered and re-proposed with a lower calibration, and once it is adopted, the operational risk component of the Federal Reserve's stress test should be eliminated, as there is no conceptual or analytical basis for it.

Market Risk

The proposed rule would establish a standardized measure of market risk that produces outsized increases in market risk capital despite no indication that firms have undercapitalized those activities. According to the proposal, market risk RWAs are expected to rise 75 percent for affected banks. The proposal requires market risks to be capitalized using either a standardized approach – which, among other problems, does not sufficiently recognize the benefits of diversification – or a models-based approach that determines a substantial part of the capital requirement through a draconian stress test. Additionally, the eligibility requirements for the models-based approach lack empirical support and have the potential to introduce volatility and uncertainty into capital requirements, as banks could be forced to switch between applying models-based and standardized approaches due to the inability to pass arbitrary tests.[19]

The proposed rule also ignores completely its overlap with the Global Market Shock in the Federal Reserve's stress test. Both are intended to ensure a bank can endure a severe market stress; both capture market risk losses; and both estimate those losses based on extreme tail events. Further, both frameworks use market shocks calibrated based on similar historical loss data; both constrain the effects of credit risk mitigation and portfolio diversification; and both use similarly severe liquidity horizon assumptions. And the Global Market Shock already overstates risk: a 2019 study suggests that several factor shocks have less than a 1-in-10,000 chance of occurring based on historical data.[20] For several asset classes, the combined shocks from GMS and the Basel standardized charge would far exceed those experienced in the most severe shock that have ever happened over a *six-month* period. For BBB corporate bonds, the GMS alone exceeds the most severe losses experienced over a six-month period for that asset class since 2008. When GMS shocks are combined with the Fundamental Review of the Trading Book, capital requirements for certain exposures can even exceed maximum potential loss.

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[19] *See* Greg Hopper, *The New Profit and Loss Attribution Tests: Not Ready for Prime Time*, Bank Policy Institute (Dec. 14, 2023), *available at* https://bpi.com/the-new-profit-and-loss-attribution-tests-not-ready-for-prime-time/#:~:text=In%20light%20of%20these%20fundamental,reporting%20and%20monitoring%20purposes%20only.

[20] *See* SIFMA (August 2019) Global Market Shock and Large Counterparty Default Study, *available at* https://www.sifma.org/wp-content/uploads/2019/09/SIFMA-GMS-LCD-Study-FINAL.pdf.

Given the important role banks and their affiliated broker-dealers play in U.S. capital markets, the proposed rule would do substantial damage. An unjustified increase in market risk capital requirements would raise the cost of debt and equity financing while reducing market liquidity. The increase in the costs of debt financing and hedging activities would translate to increased prices for consumers as they purchase homes, automobiles or other goods and services funded in capital markets.[21] In addition, the proposal would reduce the liquidity of the U.S. capital markets, which would drive up the cost of funding for American businesses.

Again, there is nothing about the real-world performance of U.S. banks to justify an implicit finding that their trading operations are critically undercapitalized, and the proposed rule makes no attempt to do so. It just makes up the risk weights without any tether to data or analysis.

Derivatives Counterparty Risk

The treatment of default risk with derivatives counterparties is based on no historical data or analysis. The proposal includes two new approaches for calculating this risk, neither of which allows for the use of internal models. The shift away from internal models is expected to result in an approximate 10 percent increase in risk-weighted assets for this risk – again, with no evidence to suggest that current capitalization levels are insufficient.

Tailoring

The proposed rule, in conjunction with other rules proposed over the summer, would have the practical effect of repealing the tailoring provisions of the Economic Growth, Regulatory Relief and Consumer Protection Act of 2018, at least with respect to capital and related requirements. Although the agencies certainly have the right to identify to Congress laws with which they disagree, they lack the authority to override Congress and must implement all statutory mandates. Although the regional banking turmoil of 2023 may merit some change to the law, Congress has not enacted any such changes; rather, through their actions the agencies have assumed the lawmaking process.

The proposed rule would largely apply the same capital requirements to banks in Categories I through IV, namely by (i) requiring banks in Categories I through IV to calculate RWAs in the same manner, including by requiring Category III and IV banks to move to the dual-stack approach previously only required for Category I and II banks; (ii) requiring Category III and IV banks to recognize unrealized gains/losses on available-for-sale debt securities and most other elements of accumulated other comprehensive income (AOCI) in regulatory capital; (iii) requiring Category III and IV banks to apply the capital deductions and minority interest

[21] With respect to the increased costs of hedging that would result from the proposal, see David Murphy and Sayee Srinivasan, *Capital proposal: Endgame for a robust U.S. derivatives market?*, ABA Banking Journal, *available at* https://bankingjournal.aba.com/2023/11/capital-proposal-endgame-for-a-robust-u-s-derivatives-market/ ("It is highly likely that banks will react to these proposals, if finalized, by increasing fees for providing market access, reducing the amount of risk that they allow clients to transfer, and refusing to provide access at all to the least profitable clients.").

treatments that currently apply to only Category I and II banks; (iv) applying the supplementary leverage ratio and countercyclical capital buffer to Category IV banks; and (v) requiring all Category I through IV banks – regardless of the extent of their trading activities – to calculate market RWAs under the revised market risk capital rule. Some of these changes conceivably could be justified as a reaction to events of March 2023; the majority, however, bear no relation. Furthermore, even where change is deemed necessary, the agencies have failed to tailor requirements and instead have opted to treat mid-sized banks the same as GSIBs. In particular, the requirement for Category IV banks to apply a dual-stack approach – meaning those banks must calculate their capital ratios using both the current U.S. Standardized Approach and the Expanded Risk-Based Approach, with the lower of the two being the binding capital requirement – would impose undue costs and burdens without a commensurate supervisory or policy benefit.

The proposed rule also has a disproportionate impact on the U.S. operations of foreign banks, which are particularly hard hit by the punitive risk weights imposed on fee income. The proposed GSIB surcharge rule could also subject many of them to heightened regulation even though they are in general shrinking their U.S. footprints at least in part because of the existing level of regulation.

Regulatory Overlap

The proposal would result in significantly higher effective capital requirements for most covered banks with respect to market risk (primarily associated with trading assets and activities) and operational risk. The proposal does not consider the possibility that these significant increases to the capital requirements for both types of risk would lead to redundancy, in whole or in part, with the capital required for these same risks through the Federal Reserve's stress tests.

Market risk

As defined by the Federal Reserve, market risk is "the risk of loss on a position that could result from movements in market prices."[22] Both the existing Global Market Shock (GMS) component of the Federal Reserve's stress testing framework and the proposed rule are designed to measure and capitalize this risk. Their designs bear striking similarities: both assess a bank's ability to withstand a period of extreme market stress over a long duration; both shock trading positions at high confidence levels; and both have bigger shocks for asset classes with longer assumed liquidation periods.[23] Analysis based on publicly available data demonstrates that the proposal's approach to market risk and the GMS are duplicative – that is, they are expressly

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[22] *See* 12 C.F.R. § 217.202.

[23] The stated purpose of the stress capital charge is to ensure that banks have sufficient capital to "both absorb losses during times of economic stress and continue to lend to households and businesses and meet their obligations." Stress Testing Policy Statement, 84 Fed. Reg. 6664, 6666–67 (Feb. 28, 2019), *available at* https://www.govinfo.gov/content/pkg/FR-2019-02-28/pdf/2019-03503.pdf. Pursuant to a codified Federal Reserve policy statement, the "severely adverse scenario" is designed to reflect "conditions that characterized post-war U.S. recessions," and its Global Market Shock component is designed to reflect "large, previously unanticipated moves in asset prices and rates." 12 C.F.R. 252, Appendix A. The stress test is therefore designed to assess tail risk.

designed to capture the same market risks of a single set of trading positions, with the results that these market risks must effectively be capitalized twice.[24]

Operational risk

Similar issues arise in the context of the proposal's treatment of operational risk relative to the capitalization of that risk under the Federal Reserve's stress testing framework. Specifically, large banks are already required to hold capital for operational risk through the Federal Reserve's annual stress tests, which the Federal Reserve designs both to reflect aggregate operational-risk losses for the industry over the stress test projection horizon and to account for "large and infrequent operational-risk losses" that may be incurred by a firm.[25] Therefore, combining the new Standardized Approach for operational risk with the stress test capital charge would lead to a substantial overstatement of capital requirements for operational risk.[26]

Systemic risk

For GSIBs, the inflated higher risk-weighted assets from the Basel proposal would feed into the GSIB surcharge score under the approach adopted by the U.S. agencies. Thus, with this multiplier effect, GSIBs will be considered more systemically important and incur a higher capital charge, even as their risk is unchanged. The proposal takes no account of this effect and fails to consider alternatives to offset it – for example, recalibrating the surcharge to reflect economic growth since the framework was finalized in 2015.

Resolution risk

The purposes of the Basel proposal overlap with the agencies' current long-term debt proposal, which would generally apply long-term debt requirements to larger banks (other than U.S. GSIBs currently subject to the TLAC rule). The long-term debt proposal seeks to ensure additional funds are available to banking organizations to aid their resolution and protect uninsured depositors.[27] Although the contemplated capital increases under the Basel proposal should reduce the need for long-term debt, given that increased capital can also absorb losses for a distressed bank and protect uninsured depositors, the rules are actually designed to increase concurrently. Indeed, the long-term debt proposal is calibrated based on RWAs that the Basel proposal may increase by $2.2 trillion.[28] Although the long-term debt proposal states that the Basel proposal would, therefore, "lead mechanically to increased requirements for [long-term

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[24] Greg Hopper, *Why is the FRTB Expected Shortfall Calculation Designed as It Is?*, Bank Policy Institute (May 23, 2023), *available at* https://bpi.com/why-is-the-frtb-expected-shortfall-calculation-designed-as-it-is/; Greg Hopper, *How Can The Global Market Shock More Effectively Complement The Fundamental Review of the Trading Book?*, Bank Policy Institute (May 30, 2023), *available at* https://bpi.com/how-can-the-global-market-shock-more-effectively-complement-the-fundamental-review-of-the-trading-book/.

[25] *See* 2023 Stress Test Methodology, at 23.

[26] Francisco Covas, *About Excessive Calibration of Capital Requirements for Operational Risk*, Bank Policy Institute (Oct. 30, 2023), https://bpi.com/about-excessive-calibration-of-capital-requirements-for-operational-risk/.

[27] *Long-Term Debt Requirements for Large Bank Holding Companies, Certain Intermediate Holding Companies of Foreign Banking Organizations, and Large Insured Depository Institutions*, 88 Fed. Reg. 64,524 (Sep. 19, 2023).

[28] *See Regulatory Capital Rule: Large Banking Organizations and Banking Organizations With Significant Trading Activity*, 88 Fed. Reg. 64,028, 64,168 (Sept. 18, 2023).

debt] under the [long-term debt] proposal," the agencies cannot provide a robust cost-benefit analysis accounting for the ultimate impacts of the Basel proposal. Until the Basel proposal is finalized, neither the agencies nor the public have the information to fully assess the benefits and costs of the two proposals.[29]

Correlation of Risks

The proposal would impose capital charges for credit risk, operational risk, market risk, and CVA risk on a purely aggregate basis. That is, it assumes that all such risks would arise and impose losses on covered banks at the same time, effectively assuming that all such risks are perfectly correlated. Under a 99.9-percent confidence-interval assumption, it would mean that, if credit risk losses are in the 0.1-percent tail of the distribution of credit losses, the same is true for market risk losses, operational risk losses, and losses associated with credit quality of banks' derivatives counterparties. This assumption is flatly inconsistent with all available evidence, which implies a fatal problem with the proposal that it does not acknowledge, let alone thoughtfully consider and resolve.

In particular, the proposal presents no historical evidence of operational risk losses being correlated with financial risks. Fines or judgments against banks for anti-money laundering and sanctions compliance, antitrust violations and consumer credit practices – which now make up the largest operational risk loss events – would appear entirely uncorrelated with credit and market loss events. The only case where there appeared to be some correlation involved penalties for mortgage practices in connection with the credit losses of the Global Financial Crisis. However, in reality, there was low correlation because the actual litigation losses were generally recognized several years later.

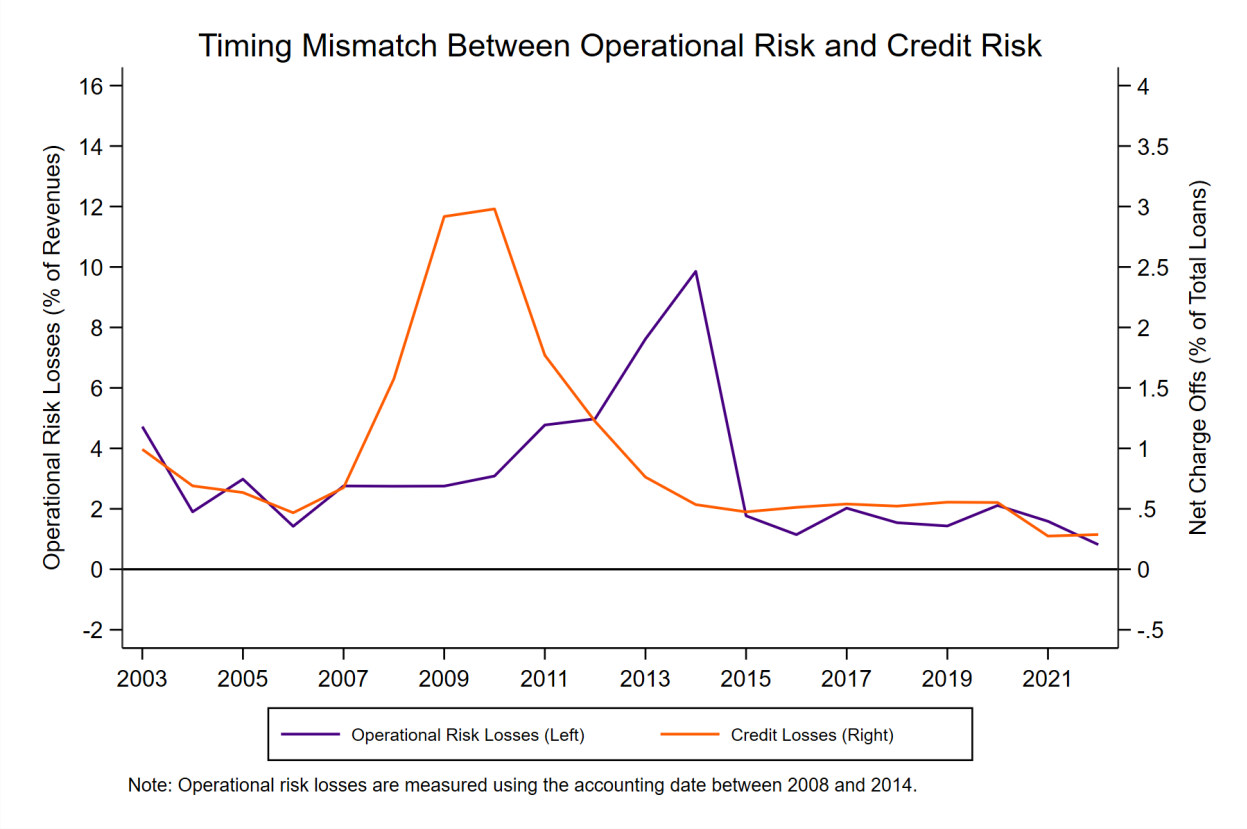
As Governor Waller explained in his dissent from the proposed rule:

> [T]here is no discussion on why operational risk capital needs to be an additional charge as opposed to just using the existing capital stack to absorb operational losses. Having an additional layer of operational risk capital would make sense if large operational risk losses tend to occur contemporaneously with credit and market losses. But there is little evidence of that. For example, some of the largest operational risk expenses U.S. banks have incurred were those owing to fines and lawsuits associated with mortgage underwriting and securitization leading up to the 2008–09 financial crisis. But banks didn't incur those losses until

[29] Additionally, the long-term debt proposal would likely be *three* times more costly than the agencies estimate, after factoring in the interactions of the debt proposal with current regulation, market practice, and banking organizations' current debt shortfalls. *See* Haelim Anderson, Francisco Covas and Felipe Rosa, *The Long-Term Debt Proposal and Bank Profitability*, Bank Policy Institute (Dec. 7, 2023), https://bpi.com/the-long-term-debt-proposal-and-bank-profitability/. The agencies estimate a total funding cost of $1.5 billion; a more accurate estimate is $4.9 billion. The agencies estimate a 3-basis-point decline in net interest margin (NIM); a more accurate estimate is a 10-basis-point decline in NIM. The agencies' assumptions would lead to a 26-basis-point decline in return on average tangible common shareholders' equity (ROTCE); a more accurate estimate is an 80-basis-point decline in ROTCE. These significant costs would burden banks at the same time that they must grapple with the costs of the Basel proposal.

> years after the financial crisis because it takes time to recognize fiduciary failings, bring forward legal claims, and adjudicate those claims. That is typical for these sorts of losses, which often stem from litigation. An important question, therefore, is why do banks need to sideline separate buckets of operational risk, credit risk, and market risk capital when those risks are unlikely to manifest at the same time? It is similar to asking individuals to establish separate emergency funds for shocks to their income, such as losing their job, and shocks to their expenses, like a fire in their house or their car breaking down. Households understand it is exceedingly unlikely that they will experience a month where all these shocks hit simultaneously, so their emergency funds are less than the sum of those individual expected expenses.[30]

Below is a graphical illustration of this point from our comment letter, showing the history of actual operational and credit losses since 2003; the correlation is weak to non-existent.



Note: Operational risk losses are measured using the accounting date between 2008 and 2014.

The proposal's counterfactual assumption of perfect correlation also represents a marked and unexplained change in policy. In prior rulemakings, the agencies have expressly declined to add incremental operational risk capital charges to risk-weighted assets calculated using

[30] Statement by Christopher J. Waller, Governor, Board of Governors of the Federal Reserve System, on the Proposed Amendments to the Capital Framework (July 27, 2023), *available at* https://www.federalreserve.gov/newsevents/pressreleases/waller-statement-20230727.htm.

standardized risk weights on the following grounds: "Because the general risk-based capital rules include a buffer for risks not easily quantified (for example, operational risk and concentration risk), [banks subject to the Standardized Approach] would not be subject to an additional direct capital charge for operational risk."[31] The proposal would continue that approach for the existing Standardized Approach that would apply to all smaller banks and act as a "floor" for larger banks subject to the proposal.

Any operational risk capital charge needs to be discounted very substantially, and there is a strong case for eliminating it altogether. And there is no case for retaining a second charge in the stress test if one is adopted for Basel purposes.

The Role of Basel

Nearly the entirety of the proposal relies in whole or in part upon decisions made by the Basel Committee in 2017 and 2019. Yet almost none of the various requirements and associated methodologies and other details based on the Basel Committee's standards is accompanied by *any* associated analysis, reasoning, or evidentiary support required of the agencies themselves as part of the U.S. rulemaking process under the APA. The Basel Committee's deliberations and decision making occurred wholly outside the U.S. administrative law framework. Furthermore, to the extent that the Basel Committee agreement was based on analysis, that analysis was conducted almost a decade ago, averaged results among quite different banks around the world, and included no analysis of the impact on smaller U.S. banks to which the proposal would apply. While promoting international consistency in capital regulation may benefit U.S. public policy in certain respects, it does not excuse the agencies from the basic obligation under U.S. law to independently explain and justify the proposal in its own right.

As Director McKernan of the FDIC noted in dissenting from the proposed rule:

> As the complexity of the capital framework mounts, we are asked to defer more and more to the technical work of, and the backroom deals made at, the Basel Committee. In the case of the Basel III standards, the Basel Committee has made some key decisions with little or no explanation. That then leaves the U.S. bank regulators unable to defend or perhaps even understand important aspects of the Basel III standards that we are now proposing to implement.

In sum, an agreement reached by agency staff in 2017 is no policy or legal excuse for failing to produce data and analysis to justify a U.S. rule.

Summary

We urge the agencies to withdraw this proposal, draft a new one, show their work, and seek public comment.

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[31] Risk-Based Capital Guidelines; Implementation of New Basel Capital Accord, 68 Fed. Reg. 45900, 45902 (Aug. 4, 2003).