CSBS Comments on the Large Bank Regulatory Capital Rule

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Office of the Comptroller of the Currency
400 7th Street SW, Suite 3E-218
Washington, DC 20219
Chief Counsel's Office
Attention: Comment Processing
Docket ID OCC-2023-0011

Board of Governors of the Federal Reserve System
20th Street and Constitution Ave NW
Washington, DC 20551
Ann E. Misback, Secretary
Docket No. R-1815
RIN 7100-AG66

Federal Deposit Insurance Corporation
550 17th Street NW
Washington, DC 20429
James P. Sheesley, Assistant Executive Secretary
Attention: Comments/Legal OES
RIN 3064-AF86

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

Dear Sir or Madam,

The Conference of State Bank Supervisors ("CSBS")[1] provides the following comments on the Notice of Proposed Rulemaking ("NPR," "proposal," or "proposed rule") issued by the

Federal Deposit Insurance Corporation ("FDIC"), the Board of Governors of the Federal Reserve System ("FRB"), and the Office of the Comptroller of the Currency ("OCC") (collectively, the "agencies") titled *Regulatory Capital Rule: Large Banking Organizations and Banking Organizations With Significant Trading Activity*.[2] The proposal standard") and alter many other key aspects of the existing regulatory capital framework for banking organizations with total assets of $100 billion or more ("large banking organizations," "LBOs," or "covered firms").

State regulators have long supported strong capital requirements, particularly for the largest U.S. banks. Unfortunately, the proposal is overly and unnecessarily complex, abandons appropriate regulatory tailoring, and could ultimately undermine U.S. banking industry diversity and financial stability. The agencies also have failed to adequately justify key design features of the proposed capital rule and explain meaningful deviations from the Basel standard. Moreover, the proposal was developed and issued with a flawed rulemaking process that undermines sound public policy and conflicts with various statutory notice-and-comment requirements.

Comments on the proposal are organized as follows:

Part I of the letter addresses state regulators' high-level views of the proposal, including:

- An appropriately tailored prudential framework is foundational to a diverse U.S. banking industry, economic growth, and financial stability, and therefore the proposal should generally not apply to Category III and IV LBOs.
- The proposed capital reforms would undermine banking industry diversity and financial stability by encouraging further industry consolidation and concentration, while accelerating a migration of financial activity out of the banking sector.
- Post-crisis regulatory reforms have led to a stronger, better capitalized banking system, and the agencies have failed to adequately justify substantially higher levels of capital mandated under the proposal.
- The proposal was developed and issued in a flawed manner that is at odds with sound public policy principles and statutory notice-and-comment requirements.

Part II of the letter provides more targeted recommendations related to numerous provisions of the NPR, including:

- the dual-requirement structure for LBOs;
- the definition of capital;
- credit risk;

- operational risk;
- securitization risk;
- equity risk; and,
- market risk.

I. State Regulators' High-Level Views of the Proposal

A. An appropriately tailored prudential framework is foundational to a diverse U.S. banking industry, economic growth, and financial stability, and, therefore, the proposal should generally not apply to Category III and IV LBOs.

The U.S. banking system serves as the primary engine of economic growth, with a diverse range of banks providing credit and financial services to communities large and small. As of the second quarter of 2023, there were over 4,600 banks in the United States with composite assets in excess of $23.5 trillion, including the smallest community banks to global systemically important banks ("G-SIBs"). There is significant diversity even among the firms covered under the proposal (i.e., Category I – IV LBOs), including their business models, product and service offerings, geographic footprints, risk profiles, foreign or domestic ownership, and other key factors. For example, the largest Category I firm is over 35 times the size of the smallest Category IV firm. U.S. banking system diversity and the nation's economic dynamism are inextricably linked.

State and federal regulators have a shared responsibility to promote a resilient, diverse banking system and the safety and soundness of individual firms through thoughtfully designed and appropriately tailored regulatory standards, paired with robust supervision. State regulators are concerned that the proposal falls short of this objective. In general, the NPR contains ill-designed, overly complex standards that fundamentally reject the sound principle of regulatory tailoring, the merits of which have been expressly recognized by Congress. If adopted as proposed, these new capital standards would lead to less effective supervision, less industry diversity, and heightened financial stability risks. Moreover, state regulators contend that the agencies have not adequately justified the need for many of the provisions that comprise the proposal, nor have they considered the substantial safety and soundness and financial stability gains achieved by the significant regulatory reforms following the Great Financial Crisis.

For these reasons, and as discussed further throughout this letter, state regulators recommend that the proposed capital rule should generally apply only to the "internationally active" firms whose risks the Basel standard is designed to address. This primarily aligns with Category I and II firms that are subject to the current advanced approaches capital framework, i.e., U.S. G-SIBs and LBOs with over $700 billion in total assets or significant cross-jurisdictional activity.

B. The proposed capital reforms would undermine banking industry diversity and financial stability by encouraging further industry consolidation and concentration, while accelerating a migration of financial activity out of the banking sector.

The banking industry has experienced significant consolidation, with the total number of commercial banks in the U.S. steadily declining from a high of about 14,500 banks in 1984 to a little over 4,600 banks today. Put another way, there has been a reduction of roughly 70% of U.S. bank charters in a mere 40 years. Over most of this period, bank failures were roughly offset by new bank entrants, meaning the decline in bank charters can be primarily attributed to merger activity.[4] State regulators are concerned that the proposal will encourage further industry consolidation, particularly among institutions approaching $100 billion in total assets, as well as the Category III and IV firms set to face much more stringent and complex regulatory capital requirements.

The proposed changes would require strategic decisions about business lines and product offerings; substantial resources in the form of additional capital, operational, and technical capabilities; and significantly enhanced risk management practices, policies, and procedures. Banks nearing the $100 billion asset threshold, as well as those that have already surpassed it, will have economic incentives to merge in order to spread the proposal’s additional costs across a larger asset base. This, in turn, will exacerbate market concentration, with fewer, ever bigger LBOs taking a more dominant position in the U.S. banking market.

Covered firms are likely to scale back or exit certain business lines or activities that would require additional capital and substantial compliance-related resources. A shrinking number of very large banks will compete to offer a more limited, more homogenized set of financial products and services to the market, while an increasing share of financial activity will migrate to a wide range of nonbank financial intermediaries (“NBFIs”). State regulators are concerned that a financial services market dominated by a few, very large homogeneous banks and a wide range of increasingly complex NBFIs will erode support for a diverse and thriving economy, particularly in local communities, and ultimately undermine U.S. financial stability as a whole.

C. Post-crisis regulatory reforms have led to a stronger, better capitalized banking system, and the agencies have failed to adequately justify

substantially higher levels of capital mandated under the proposal.

The agencies are issuing this proposal in the context of a banking system that is meaningfully stronger, more resilient, and better capitalized following a decade of significant post-crisis regulatory reforms. State regulators have a consistent history of supporting many elements of the Dodd-Frank Act and initial Basel III reforms, particularly those related to promoting higher levels of high-quality capital. For example, state regulators supported establishing new minimum common equity tier 1 (“CET1”) capital requirements for all U.S. banks, raising minimum tier 1 risk-based and leverage capital requirements,[5] strengthening leverage capital requirements through the Supplementary Leverage Ratio (“SLR”),[6] and maintaining robust Enhanced Supplementary Leverage Ratio (“eSLR”) requirements for G-SIBs and their bank subsidiaries.[7]

State regulators recognize that addressing certain widely agreed upon weaknesses in the current capital framework, such as those associated with current market risk-based capital requirements, may appropriately lead to heightened capital requirements. However, the agencies have proposed an unnecessarily complex rule that seems specifically designed to meaningfully raise capital across most categories of financial activities, with general disregard to underlying risk, and at an overly broad set of banking organizations. For example, and as described in detail below, the agencies propose subjecting firms with virtually no trading activity to the NPR’s expansive market risk requirements, inflating risk weights above the Basel standard for many different credit exposures, and setting various inputs for complex calculations, such as operational risk or securitizations, at heightened or restrictive levels.

The agencies’ objective of meaningfully raising capital seems at odds with their own frequent statements that LBOs are resilient and have sufficient capital to withstand severe economic downturns, as demonstrated by the results of the stringent stress testing regime. Additionally, several studies regarding optimal capital levels cited within the proposal suggest that current capital levels already exceed average optimal levels. Indeed, these studies estimate that the average optimal CET1 ratio is 11.75%,[8] and as of the end of Q2 2023, the aggregate level of CET1 across U.S. banks was 12.89%, or more than double the crisis-era low of 6.11%.[9] State regulators support strong capital requirements but question the agencies’ lack of rationale for substantially increasing CET1 capital requirements by an aggregate 16% across all covered holding companies and by 9% for their bank subsidiaries.

D. The proposal was developed and issued in a flawed manner that is at odds with sound public policy principles and statutory notice-and-comment

requirements.

The proposal represents a consequential rulemaking that raises significant, complex policy questions and design choices with vast economic implications for covered firms, the broader banking and financial system, and the United States as a whole. Despite these important implications, the agencies have failed to provide sufficient data, analysis, or well-reasoned justification throughout the NPR to demonstrate how and why specific provisions and the broader proposal were issued in their current form. This lack of transparency prevents the public from being able to analyze source data, understand the agencies' assumptions or decision-making process, and meaningfully comment on the proposal.

Notably, the agencies did not initiate any data collection from covered firms until two months after issuing the proposed rule,[10] at which time they also extended the comment period for this proposal.[11] State regulators welcome this data collection, but the public must have sufficient time to review and then comment on revisions to the proposal's impact and economic analysis prior to the agencies issuing a final rule. We welcome Vice Chair Barr's recent announcement[12] that the FRB plans to publish an analysis of the supplemental data collection and seek further public comment before proceeding to a final rule. Skipping this critical step would raise serious questions regarding the agencies' compliance with Administrative Procedure Act requirements governing the rulemaking process.[13]

The proposal also contradicts Congress's tailoring directive in the Economic Growth, Regulatory Relief, and Consumer Protection Act by applying a uniform set of complex capital requirements to all LBOs, regardless of size and business model. Not only does this run afoul of Congressional directive and intent, it also rejects the sound public policy principle of proportional, risk-based regulatory requirements for diverse banking organizations. As noted earlier, the agencies' decision to subject all Category I – IV firms to the same capital requirements will undermine banking industry diversity, economic dynamism, and financial stability.

Moreover, this proposal is but one of several highly impactful, complex, and interconnected proposed rulemakings that the agencies are currently pursuing, including, but not limited to the: (a) G-SIB surcharge proposal,[14] (b) long-term debt ("LTD") requirements,[15] (c) insured depository institution ("IDI") resolution plan proposal,[16] and (d) proposed Section 165(d) resolution planning guidance for both domestic[17] and foreign firms.[18] Agency principals have also noted the potential for substantive revisions to other key regulatory requirements beyond those already proposed.[19] Each of these proposals presents its own unique set of complex tradeoffs that require careful analysis and deliberation, by the public and the agencies themselves, to estimate their potential benefits and costs. By pursuing these interrelated revisions discordantly, the agencies have needlessly compounded the challenges associated with ascertaining their collective impact, benefits, and costs.

The proposal also raises important questions and concerns related to its cohesion and calibration with existing regulatory requirements and recently finalized rules. For example, the FRB's supervisory stress tests currently project hypothetical losses from a wide range of operational risk events, as well as substantial market losses for covered firms engaged in significant trading activity. LBOs must maintain sufficient capital to cover these hypothetical stress test losses via the Stress Capital Buffer ("SCB").

However, the NPR introduces new standardized operational risk and market risk capital requirements under the expanded risk-based approach, and these new requirements are estimated to substantially raise covered firms' risk-based capital requirements. Thus, the existing SCB requirements and newly proposed operational risk and market risk capital requirements could lead to banks overcapitalizing for these exposures.[20] As another example, the agencies recently finalized expansive revisions to the Community Reinvestment Act ("CRA"), but state regulators fear the proposal could undermine key CRA objectives. The proposed capital treatment of residential mortgage and small business loans, as detailed in Section II.C, could lead to covered firms curtailing these credit activities, which are fundamental components of banks' CRA programs.

Beyond the uncertain interactions between these various proposed, existing, or recently finalized rules, the sheer complexity and multifaceted nature of this proposal alone makes estimating its true impact difficult. At face value, the proposal is nearly 1,100 pages long and contains dense, complex calculations across nine comprehensive sections. While each section details significant changes to its portion of the existing capital rules, the ways the sections interconnect pose additional complications that are difficult to identify. These interconnections make the lack of a detailed impact analysis by the agencies all the more concerning, suggesting that the agencies have issued a proposal without an adequate or articulable understanding of its consequences.

State regulators recommend that the agencies take a more incremental and intentional approach to rulemaking that appropriately prioritizes and then sequences proposed regulatory changes. To the extent simultaneously proposing revisions to separate rules is the most sensible course of action, state regulators request that the agencies allow stakeholders ample opportunity to evaluate and provide feedback on such proposals.

Additionally, proposed regulatory changes must adequately consider and assess potential interconnections and avoid conflicts with other regulatory requirements. Finally, state regulators request that the agencies engage in a more robust pre-rulemaking impact analysis and share with the public the data, assumptions, and justifications underlying the design choices in these significant regulatory proposals.

Regarding the current proposal, state regulators request that the agencies publish a robust, updated economic analysis following the conclusion of its supplemental data collection, and then provide the public with another opportunity to comment before proceeding to a final rule. State regulators request that this analysis be comprehensive, covering all elements of the proposal, their internal and external interactions, and impacts by LBO Category (i.e., Categories I, II, III, and IV) and financial activity (e.g., credit card lending, securities underwriting, mortgage origination, mortgage servicing, etc.). Moreover, the public must have sufficient time to meaningfully digest and comment on the updated economic analysis. We request that the federal banking agencies provide at least 120 days to respond to critical information that will shape such a significant final rule. From a supervisory perspective, it is critical to establish clear and orderly regulations for banking organizations. Conflicting regulations lead to a supervisory environment in which examiners and bank management needlessly disagree over competing requirements, rather than focusing on core financial risks.

II. State Regulators' Recommendations on Key Provisions of the NPR

As noted earlier, and consistent with federal law requiring tailoring, state regulators request that the agencies apply the proposal only to Category I and II firms that are subject to the advanced approaches framework, and exempt Category III and IV firms from most elements of the proposed rule. Additionally, and regardless of its ultimate scope, state regulators offer the following recommendations to improve the proposal.

A. Dual-Requirement Structure for LBOs

The proposal would require all LBOs to calculate their risk-based capital ratios under two separate approaches, the existing standardized approach and proposed expanded risk-based approach ("ERB approach"). According to this "dual-requirement structure," the lower of the two ratios would be used to establish a firm's minimum regulatory capital requirements. State regulators contend that the proposed dual-requirement structure introduces additional complexity without clear benefits and seems explicitly designed to raise risk-based capital requirements for LBOs irrespective of underlying risk.

Today, nine Category I and II domestic LBOs are subject to a somewhat similar dual-requirement structure, in that they must calculate their risk-based capital ratios according to the advanced approaches framework as well as the standardized approach.[21] For most Category I and II firms, the standardized approach results in higher risk-based capital requirements, meaning the standardized approach effectively serves to limit the extent to which internal models, which are a part of the advanced approaches framework, can lower a banking organization's capital requirements.[22] Indeed, a primary goal of subjecting Category I and II firms to the standardized approach is to ensure that subjective internal models do not unduly lower these firms' risk-based capital requirements.

The proposal would eliminate the advanced approaches framework, as well as most uses of internal models for calculating risk-based capital requirements, and replace it with the ERB approach, which can generally be described as a new set of more granular, risk-sensitive standardized measures for calculating risk-weighted assets ("RWA"). However, the NPR does not propose replacing the existing standardized approach with this new, more risk-sensitive ERB approach. Rather, all Category I – IV LBOs would now be subject to a dual-requirement structure where risk-based capital requirements are calculated under the existing standardized approach and the proposed ERB approach with the stricter of the two ratios being used to satisfy their capital requirements.

Ultimately, the agencies are proposing that each of the two standardized frameworks serve as a check on the other. On the one hand, this seems to undercut faith in the accuracy of either approach. On the other hand, it demonstrates that the agencies believe that LBO capital requirements should never decline, even if a more risk-sensitive model would lead to such an outcome. Indeed, the agencies state one reason for this dual-requirement structure is "to ensure that large banking organizations would not have lower capital requirements than smaller, less complex banking organizations."

Subjecting all LBOs to the dual-stack requirement will not further the agencies' goal of consistency or reduced complexity in capital requirements across covered firms. Some LBOs may be bound by the standardized approach, others the ERB approach, while LBO holding companies and their IDI subsidiaries may be bound by different approaches. Rather, the only consistent outcome from the proposal is that all covered LBOS will be subject to the most punitive approach.

State regulators request that the agencies consider the following alternative approaches to achieve a more appropriately tailored, less complex framework for calculating RWA:

- Apply the dual-requirement structure only to Category I and II firms, which are already accustomed to a dual measurement approach under the existing advanced approaches.
- Allow Category III and IV firms to opt-in to the ERB approach, just as they are able to opt-in to the advanced approaches framework currently.
- Generally calibrate the ERB approach's proposed risk-weights and calculation methodologies to more closely align with those of the Basel standard, and allow all standardized approaches banks the option to use the more granular and risk-sensitive ERB approach in lieu of the standardized approach.

B. Definition of Capital

1. Accumulated other comprehensive income

The proposal would end the current Accumulated Other Comprehensive Income ("AOCI") opt-out for Category III and IV firms, thus requiring these LBOs to include most elements of AOCI in regulatory capital, including net unrealized gains and losses on available for sale ("AFS") securities. This proposed change to the capital rule is not based on implementing the final Basel standard, but rather appears aimed at bolstering capital in light of lower securities portfolio valuations in the current interest rate environment. Indeed, numerous arguments for this proposed AOCI revision specifically mention the role that unrealized losses on AFS securities have played in recent banking stresses and failures.[23] However, state regulators note that market attention and scrutiny has not been confined to unrealized losses on AFS securities, but has rather focused on the entire securities portfolio, including held to maturity ("HTM") securities.

State regulators are concerned that requiring unrealized gains and losses on AFS securities to be reflected in regulatory capital would introduce significant volatility in capital ratios and potentially skew these institutions' capital positions in times of both crisis and stability. State regulators do not support the elimination of the AOCI opt-out for Category III and IV firms and request that the agencies maintain the current capital rule's treatment of AOCI.

2. Other adjustments to regulatory capital and treatment of MSAs

The proposal revises other areas of the current capital rules for Category III and IV LBOs, including how certain items are either deducted from, or recognized for, regulatory capital purposes, including threshold items like mortgage servicing assets ("MSAs"), deferred tax assets, and significant investments in the capital of unconsolidated financial institutions (collectively, "threshold items"), as well as minority interests. These revisions are meant to further the agencies' stated goal of "enhanc[ing] the consistency of requirements across large banking organizations."[24]

However, in the name of consistency, the agencies are simply reverting to the capital treatment for threshold items and minority interests that they previously deemed overly complex and burdensome. They reached this conclusion after thorough and thoughtful deliberations with the banking industry during the decennial Economic Growth and Regulatory Paperwork Reduction Act ("EGRPRA") review process. Following the most recent EGRPRA review, the agencies committed to simplifying the capital treatment of threshold items and minority interests in 2017,[25] and subsequently issued a final rule to simplify the capital framework's treatment of these items for non-advanced approaches firms in 2019.[26]

To put it another way, the agencies are undoing reasonable, iterative capital reforms they recently finalized following the EGRPRA review process with little justification beyond "consistency."

As it relates specifically to MSAs, the proposed capital treatment of these assets at Category III and IV firms could lead to broader market implications and unintended consequences. In response to lowering the current 25% MSA capital deduction threshold to 10%,[27] Category III and IV LBOs may seek to optimize their balance sheets by selling MSAs. This would likely accelerate the post-crisis trend of MSAs migrating out of the banking sector and into the nonbank mortgage servicing sector. Indeed, several nonbank mortgage firms have noted in recent earnings reports that they are already preparing for continued bank retreat from the space.[28] In a more alarming scenario, market valuations of MSAs could be depressed if Category III and IV firms seek to downsize their MSA holdings for capital purposes. A broad, downward repricing of MSAs could negatively impact other holders of these assets, particularly nonbank mortgage servicers, who may face margin calls if they have pledged these assets for credit facilities. MSA markdowns could also result in losses, thereby lowering nonbank mortgage servicers' capital.

Given these concerns and the lack of a clear, compelling rationale, state regulators do not support the NPR's proposed capital treatment of threshold items, including MSAs, and minority interests. State regulators request that the agencies maintain the current rule's approach to these items for Category III and IV firms.

C. Credit Risk

The NPR proposes substantive changes to credit risk RWA through the ERB approach, which is generally designed and calibrated to be more granular and risk-sensitive than the existing standardized approach. Credit risk RWA calculations under the ERB approach present a tradeoff in the form of increased complexity and granularity in return for lower risk-weightings for certain assets. However, the benefits of this additional complexity are diminished since many of the credit risk weights in the proposal are set higher than those in the Basel standard. As noted earlier, state regulators maintain that the agencies have not provided adequate justification for deviating from the credit risk weights set forth under the Basel standard.

The proposed changes to credit risk RWA are significant enough that they will undoubtedly impact covered firms' individual lending and broader business decisions. Indeed, certain covered firms have already signaled that they will "de-emphasize lower return portfolios" in light of the potential revisions and that their "RWA management strategy focuses on core clients."[29] While each institution will differ in its approach, covered firms will review and analyze each lending area impacted by the proposal in a similar manner. As we discuss below, these changes can impact credit availability, market liquidity, and push the associated activities to other parts of the financial system.

1. Real estate lending exposures

The proposal alters the capital treatment of single-family mortgages under the ERB approach, which stratifies risk weights based on a mortgage's loan-to-value ("LTV") ratio. Higher LTV loans may indicate more underlying credit risk, and leveraging LTV to set RWA on residential real-estate loans may provide enhanced risk sensitivity across mortgage loans. However, the agencies have proposed risk weights that exceed those of the Basel standard by 20% across all LTV bands. State regulators have concerns about the potential impact these heightened risk weights on higher LTV bands could have on credit availability and pricing for first-time homebuyers and buyers in low- and moderate-income ("LMI") communities.[30] Specifically, LBOs would see an increase in the capital requirement for mortgage loans to borrowers who cannot provide 20% for a downpayment, which would undoubtedly impact affordable housing, which will disproportionately impact first-time homebuyers[31] and LMI communities. Capital rules should not increase costs passed on to LMI consumers and exacerbate widespread housing affordability issues.[32]

The increase in RWA across real estate lending exposures will be felt across the banking industry, not just by LBOs. Community banks utilize credit lines from LBOs to extend mortgage loans to their customers and often sell those mortgages to LBOs. This is a critical secondary market tool enabling smaller banks to serve their customers' home buying needs without unnecessary exposure to interest rate risk. If partner-LBOs leave the market or raise their rates to a level partner-banks and their customers cannot tolerate, access to affordable housing finance will be further curtailed.

This provision is another example in which the agencies have deviated from the Basel standard with little to no explanation or adequate justification. While the agencies state their intent is to avoid putting smaller banks at a competitive disadvantage to their larger counterparts, state regulators maintain there are more reasonable and fairer approaches to promote a level, competitive residential real estate lending market. As recommended earlier, the agencies could align the proposed ERB approach's risk weights to those of the Basel standard and allow any standardized approach firm to opt-in to the ERB approach framework.

In contrast to the standardized approach, the ERB approach would no longer recognize private mortgage insurance ("PMI") as a mitigating factor for loans with LTVs over 80%. Since the agencies propose all covered firms be subject to the dual-requirement structure, LBOs will be able to recognize PMI on mortgages for risk-based capital purposes under the standardized approach but will not be able to do so for the same loans with PMI under the ERB approach. This odd and conflicting outcome should be avoided, and state regulators recommend that PMI qualify as a mitigating factor to lower RWA for high LTV loans under the ERB approach.

The agencies requested comments on whether mortgages originated through home ownership programs that provide a public benefit and include risk mitigation features should be assigned a lower risk weight.[33] State regulators support lower risk weights for such mortgages and note that many states and local municipalities provide homebuying assistance programs for a range of borrowers, including first-time homebuyers and LMI individuals and families.

2. Retail lending exposures

The proposed changes to retail lending RWA could also have an unintended impact on credit availability. The proposal provides for different treatment of revolvers and transactors for retail lending. While one type of borrower could present heightened risk, state regulators are concerned that the differing capital treatment could impact bank lending decisions in a way that threatens consumers' credit availability and negatively impacts a covered firm's ability and desire to work with distressed borrowers.

Here again, the agencies have proposed risk weights for retail lending exposures that surpass the Basel standard with little to no justification. State regulators note that the agencies have also proposed a retail lending RWA framework that includes complex tests and decision trees for classifying these exposures and establishing their associated risk weights but have not provided the more advantageous Basel risk weights that would potentially outweigh the added costs and complexity of the retail lending RWA tests.

3. Corporate credit exposures

The proposed rule provides more favorable capital treatment to exposures to publicly traded companies over private companies under the ERB approach. The ERB approach would allow a covered firm to assign a 65% risk weight to an exposure to a company that is investment grade and has a publicly traded security outstanding or that is controlled by a company that has a publicly traded security outstanding (a “listing requirement”).[34] This listing requirement would lead to an unjustified increase in funding costs for private companies vis-à-vis public companies, providing economic advantages to the latter at the expense of the former. State regulators do not believe being a publicly listed company equates to being more or less creditworthy than a private firm and echo other requests[35] for any data or evidence to the contrary. Many private companies are independently audited, with lenders frequently requiring audited financials as part of the lending process. While the listing requirement is consistent with the Basel standard, both the UK and EU dropped the listing requirement[36] after an extensive consultative period.[37] As one EU stakeholder noted, listing on a recognized exchange is not a determinant of banks’ investment grade decisions.[38]

Moreover, the agencies have not considered the proposal’s potentially significant unintended consequences on private companies or sought to adequately assess the higher credit costs to this substantial segment of corporate borrowers. Recent analysis notes that there are 18,000 private and 2,800 public U.S. companies with more than $100 million in annual revenue,[39] meaning nearly 87% of corporate borrowers would face more punitive capital treatment under the proposal. State regulators recommend the agencies remedy the proposal’s disparate credit risk RWA treatment for private firms.

4. Defaulted exposures

The proposal includes a new definition for defaulted exposures, and as a result, presents significant complexity for covered institutions. The proposed new definition for defaulted exposures would apply to any credit obligation of the borrower, not just obligations to the covered firm, that is 90 days or more past due or in non-accrual status. While the Basel framework builds out a detailed credit monitoring standard,[40] the use of the word “any” in the proposed U.S. definition provides for a unique compliance challenge that fails to acknowledge banks’ lending due diligence processes. State regulators are concerned about the viability of requiring banks to track this level of information on their borrowers in an accurate and timely manner across a potentially wide range of bank and nonbank financial institutions. Furthermore, the proposal does not appropriately recognize the risk mitigation benefits and protection for a lender that has a senior position on a loan. State regulators request that the agencies not adopt this overly broad and unworkable definition for defaulted exposures.

D. Operational Risk

Under the current internal models-based approach (referred to as the “advanced measurement approach”), only Category I and II LBOs are required to hold capital to absorb potential losses from disruptions due to internal failures, such as insider risk or system failures, or external shocks like a cyberattack or natural disasters. The proposal would replace the current advanced measurement approach with a standardized approach based on an LBO’s business volume and historical losses, and would, for the first time, subject Category III and IV firms to an express capital charge for operational risk. Indeed, a significant portion of the NPR’s estimated 16% increase in CET1 requirements is due to

the proposed operational risk capital requirements. However, operational risk losses are already captured as part of the stress testing process, and state regulators maintain that the agencies have failed to justify a separate, expansive operational risk-based capital requirement to absorb operational losses at Category III and IV firms. The proposed operational risk framework requires substantial revisions for Category I and II firms, as well.

1. Business indicator component

Operational risk-based capital requirements will be set, in part, on business volume as measured by the proposed business indicator component (“BIC”). The calibration of the BIC, which approximates operational risk exposure based on prior years of business activity and volume, would subject LBOs with higher overall business volume to higher operational risk capital requirements. The proposal would also apply the same risk charge to all gross fee- and commission-based income captured under the BIC’s services component regardless of type. Since fees play a very significant role in calculating the operational risk capital charge, state regulators object to having fees, such as those from safe deposit rentals and service charges on deposit accounts, treated similarly to underwriting and securities brokerage fees and commissions. State agencies recommend that the federal banking agencies consider establishing a cap for fee-based revenue in the BIC, similar to the cap for interest, lease, and dividend income, and adjust the BIC to better recognize the wide range of risks associated with various categories of fee income.

2. Internal loss multiplier

The second component of the new standardized approach, the internal loss multiplier (“ILM”), is based on the ratio of an LBO’s historical operational losses to its business indicator component. The agencies claim that higher historical operational losses are correlated with higher future operational risk exposures and have designed the ILM to ensure that higher historical operational losses lead to higher operational risk capital requirements. However, state regulators note that the ILM is overly conservative, and that by flooring the ILM at 1, LBOs with low historical operational losses will receive no benefit for a history of strong risk governance and risk management processes. This deviates significantly from the Basel standard, which permits the ILM to be less than 1, thus allowing a bank with losses that are small relative to its business volume to hold less operational risk-based capital. Basing the ILM on an LBO’s unique operational loss experience (and with a floor of 1) introduces the potential for greater variability in operational risk capital charges and overstated capital requirements if different techniques are used to capture and quantify loss events.

Key aspects of the proposal would judge operational risk on retrospective indicators that may not accurately reflect future operational risks, such as natural disasters or significant cyber events.

Moreover, the proposal would exaggerate and overemphasize historical operational losses by using a lengthy 10-year lookback period to calculate the ILM. State regulators recommend that the agencies remedy these issues by scaling operational losses that have occurred throughout the lookback period, placing increased weight on more recent operational losses and lower weights on more distant operational losses and those due to “one-off” events. Additionally, the agencies should shorten the lookback period so as not to unduly penalize LBOs for distant material operational losses that are likely less relevant to operational risks going forward.

3. Additional recommendations for operational risk

State regulators highlight other concerns with the proposed operational risk framework, including that it could reduce merger activity for at-risk institutions, as healthier acquiring institutions may be reluctant to acquire a bank with elevated material operational losses due to the resulting punitive capital treatment. For example, when calculating the BIC, an

LBO would be required to include three full years of data for the acquired bank, in addition to any data relevant to the bank over the period prior to the acquisition or merger. Furthermore, LBOs would be required to include an acquired bank's operational loss event data for 10 full years (including the period prior to the acquisition). While some operational risks present ongoing exposures to an acquiring bank, such as risks from litigation or regulatory noncompliance, other types of operational risks may be less relevant, or even reduced, on a go-forward basis, such as risk resulting from a natural disaster or a resolved cyber event. To increase the willingness of healthy banks to acquire troubled institutions, the agencies should consider ways to exclude or discount, when appropriate, an acquired bank's material loss events so as not to unduly penalize the acquiring bank from an operational risk capital perspective. Should an LBO receive supervisory approval to exclude certain losses attributed to the acquired bank, the operational risk framework should clearly explain how to adjust the ILM calculation and reporting requirements based on the timing of such approval.

Finally, the proposal's broad definition of "operational loss event" would include material losses from natural disasters. This would discourage covered banks from having a physical presence in and serving certain geographies and communities, to the detriment of these communities and undermining an important goal of the CRA. State regulators request that the agencies exclude natural disasters from the definition of operational loss events.

E. Securitization Risk

The proposal does not adopt the Basel standard's "simple, transparent and comparable" ("STC") securitization criteria, which was developed jointly by the Basel Committee and the International Organization of Securities Commissions ("IOSCO").[41] The aim of STC is to help transacting parties more effectively measure potential risks and returns within an asset class. Disregarding the Basel Committee's and IOSCO's recommended path to distinguish between STC and non-STC securitizations leads to an overly conservative standard that treats all U.S. securitizations under the ERB approach the same way Basel treats riskier non-STC securitizations. Specifically, the proposal increases the supervisory calibration parameter, p, from 0.5 to 1.0 for securitization exposures. Under the Basel standard, STC securitizations would have p set at 0.5 versus 1.0 for non-STC securitizations.

State regulators ask the federal agencies to explain why they chose not to propose the Basel standard's STC criteria and to provide a more detailed discussion of why they set the p-factor at 1.0. A recent discussion paper from the Bank of England's Prudential

Regulatory Authority ("PRA") recommended that the Basel Committee evaluate the setting of this critical parameter and the rest of the securitization capital framework, noting the PRA "expects that this would be a complex exercise requiring a significant amount of data and analysis."[42] Yet in the current proposal, stakeholders are left with an unsatisfying explanation, absent data, that the parameter was set to allow for "appropriately conservative risk-based capital requirements when combined with the reduced risk weights applicable to certain underlying assets" that are impacted by lower input values.[43] State regulators question whether this level of conservatism is necessary given some of these risks are impacted in other parts of the proposal, namely the agencies' more conservative proposed credit risk weights on underlying credit exposures. A more thorough explanation of the supervisory parameter change is warranted for this additional deviation from the Basel standard, as it risks putting U.S. firms at a competitive disadvantage for a critical market activity.

F. Equity Risk

The proposed rule introduces several overly complex changes to the method for calculating equity risk, creating additional complications for covered banks regardless of size and business model. The ERB approach would increase the risk weight of non-significant equity exposures, including clean energy tax equity exposures. If enacted, the RWA for such exposures would quadruple from 100% to 400% and may result in traditional tax equity becoming prohibitively costly for covered banks.

State regulators point out that, in contrast, the proposal retains the 100% risk weight for community development investments under the National Bank Act and equity exposures to small business investment companies premised on the agencies' claim that such investments "generally receive favorable tax treatment and/or investment subsidies that make their risk and return characteristics different than equity investments in general." State regulators argue that this disparity may substantially impact LBOs' participation in the tax equity market if such investments become uneconomical.

Adopting an approach that could limit an LBO's participation in this market also seems contrary to a 2020 rule issued by the OCC, in which it recognized the benefits of tax equity investments and codified the authority of national banks to engage in tax equity finance transactions under the agency's lending authority.[44] State regulators further contend that most LBOs already comply with strict equity investment requirements and note that potentially disincentivizing investments in projects that rely on tax equity project financing could shift business to smaller institutions or nonbank competitors.

Among other changes, the proposal also introduces a default 1,250% risk weight to be applied in circumstances where the RWA for equity exposures to investment funds cannot be calculated using one

of the granular proposed look-through approaches. These modified look-through approaches rely on the nature and quality of information available about an investment fund's underlying assets and liabilities. However, state regulators contend that automatically applying a 1,250% risk weight in the event an LBO has limited ability to appropriately capture and manage the risk and price volatility of such equity exposures is excessive and inappropriate under the present circumstances, especially when the agencies are seeking feedback on whether an LBO should be able to rely on information from sources other than the investment fund itself if there is inadequate data to make the calculation and there is a likelihood that the risk weight would increase.[45]

State regulators argue that an alternative, more balanced method for calculating RWA amounts for equity exposures to an investment fund would be more appropriate. If enacted as proposed, LBOs would face the daunting possibility of having to apply different look-through approaches to different investment funds' equity exposures based merely on the type of available information.

G. Market Risk

State regulators have concerns with the scope of application of the proposal's market risk capital requirements. In particular, all Category I – IV LBOs would be subject to the significantly revised market risk capital framework, regardless of their volume of trading activity. The proposed market risk capital requirements also include a trading activity threshold that would scope in smaller banking organizations engaged in significant trading activity, which is defined as total trading assets plus trading liabilities being greater than or equal to $5 billion, or 10% of total assets. The agencies seek comment on these proposed application thresholds.[46]

State regulators recommend that the agencies utilize only the significant trading activity threshold, rather than bank asset size, to determine which banking organizations should be subject to the revised market risk capital requirements. Additionally, state regulators request that the agencies tailor the market risk capital requirements for any Category III, Category IV, or smaller firm that triggers the significant trading activity threshold. This approach ensures that firms significantly engaged in trading activity are holding capital to account for market risks, while appropriately exempting firms with de minimis activity and concomitantly limited risks from the substantial complexity and risk management, governance, and operational requirements associated with the proposal's market risk capital requirements.

Conclusion

Strong capital requirements are foundational to promoting the safety and soundness of individual banks and the broader banking system. However, state regulators are concerned that the agencies' proposed capital rule would introduce unnecessary complexity, reject regulatory tailoring, and diminish U.S. banking industry diversity and financial stability. Moreover, the agencies have developed and issued the proposal without providing critical data or rationale that justifies its design, including notable deviations from both the Basel standard and current U.S. capital framework that appear designed to significantly raise capital requirements.

State regulators encourage the agencies to generally limit the scope of application of any final rule to Category I and II LBOs, while making significant revisions to the proposal to limit unintended consequences and undesirable outcomes. Furthermore, state regulators request that the agencies publish an updated economic analysis following the conclusion of its supplemental data collection, and then provide the public with another opportunity to comment before proceeding to a final rule.

Sincerely,

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Footnotes

1. CSBS is the nationwide organization of banking and financial regulators from all 50 states, the District of Columbia, and the U.S. territories. State regulators supervise state-chartered banks, as well as nonbank financial services providers such as mortgage companies and money services businesses. Created in 1902, CSBS has for more than a century given state regulators a national forum to coordinate supervision and develop policy, provide training to state banking and financial regulators, and represent its members before Congress and federal financial regulatory agencies.
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