January 12, 2024

Via Electronic Mail

Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, D.C. 20551
Attention: Ann E. Misback, Secretary

Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, D.C. 20429
Attention: James P. Sheesley, Assistant Executive Secretary, Comments/Legal OES

Office of the Comptroller of the Currency
400 7th Street, SW, Suite 3E-218
Washington, D.C. 20219
Attention: Chief Counsel's Office, Comment Processing

Re: Regulatory Capital Rule: Large Banking Organizations and Banking Organizations with Significant Trading Activity (Federal Reserve Docket No. R-1813, RIN 7100-AG64; FDIC RIN 3064-AF29; Docket ID OCC-2023-0008)

Ladies and Gentlemen:

The Bank Policy Institute, the Financial Services Forum, the Securities Industry and Financial Markets Association and the U.S. Chamber of Commerce[1] are filing this comment on the joint notice of proposed rulemaking issued by the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency that would amend the capital requirements applicable to large banking organizations and those with significant trading activity.[2] As described below, any final rule adopted based on this proposal would violate the Administrative Procedure Act,[3] and the proposal's defects can only be cured through proposal of a new rule.

Risk-based capital requirements are based on ratios that take a bank's regulatory capital[4] as their numerator and risk-weighted assets as their denominator; the proposal largely focuses on the latter and

---

1 *See* Appendix for more information on the Associations.

2 *See* Regulatory Capital Rule: Large Banking Organizations and Banking Organizations With Significant Trading Activity, 88 Fed. Reg. 64028 (Sept. 18, 2023) [hereinafter the "Proposal"].

3 5 U.S.C. § 551 *et seq.*

4 Regulatory capital primarily consists of shareholder equity in the bank.

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. Simply put, the stakes of how bank assets are risk-weighted are extremely high for banks, consumers, businesses and other bank customers, and the U.S. economy.

The proposal would result in a complete overhaul of how assets are risk weighted. First, the proposal would require all banking organizations with total consolidated assets of $100 billion or more to meet all applicable risk-based capital requirements as calculated under both (i) the existing U.S. standardized approach, as modified by the proposal and (ii) an entirely new "expanded risk-based approach" ("ERBA") that includes entirely new standardized measures for credit risk, operational risk, and credit valuation adjustment risk ("CVA").[5] Second, the proposal would eliminate entirely the existing U.S. internal models-based approach to calculating risk-weighted assets for credit risk. Third, the proposal would introduce a new approach to market risk into both the U.S. standardized approach and ERBA. Through these revisions, the proposal would substantially increase the regulatory costs of about $22 trillion in assets held by banks subject to the proposal, which represent 80 percent of all U.S. banking assets.

Given the consequences of the proposal's sweeping changes, one would reasonably expect the agencies to have undertaken a policymaking process that was deliberate, transparent, and based on all available data, and to have carefully considered all relevant aspects of the problems the proposal purports to address and potential alternative approaches to those problems. Unfortunately, the agencies failed to do so. The agencies provide no empirical justification or support for the weight assigned to numerous assets, even where they possess voluminous historical data that enables the evaluation of the risk of those assets. In the few cases where the agencies do state that they are relying on actual data, they have chosen not to disclose that data secret or to assert reliance on their collective "supervisory experience." And, not surprisingly given its deficit of data and analysis, the proposal makes no serious attempt at weighing its costs and benefits. Instead, the agencies simply purport to implement agreements reached in 2017 and 2019 by the Basel Committee on Banking Supervision, though even then with some significant deviations, almost always in a more stringent direction.[6] The ultimate result is a proposed rule that, if finalized, would

---

[5] A "standardized" approach to calculating RWAs involves the creation of separate categories of exposures, with all exposures within a category receiving uniform risk weights across all banking organizations. This stands in contrast to internal models-based approaches to calculating RWAs, in which banks use models based on their own loss history, calibrated to a certain standard mandated by the regulator, to assign bespoke risk weights to their exposures.

[6] In 2017, the Basel Committee on Banking Supervision (the "Basel Committee") adopted significant changes to the standard for calculating RWAs associated with credit risk and operational risk. With respect to credit risk, the revised standard permits firms to continue to use internal models to calculate RWAs, but placed a floor on the output of those internal models based on standardized measures of RWAs. With respect to operational risk, the revised standard eliminated internal models in their entirety and introduced a standardized approach to calculating RWAs. As explained below, policymakers intended that these changes would not result in meaningful increases to overall capital requirements. To address perceived shortcomings with the previous international standard (primarily, under accounting for tail risk), the Basel Committee also adopted a new standard for calculating RWAs for market risk in 2016, which was then revised in 2019 to address certain calibration concerns.

be arbitrary, capricious, and an abuse of agency discretion. As such, the agencies should repropose the rules before finalizing them.

In a separate, forthcoming companion comment letter, we analyze the proposal in detail, and identify as a matter of substantive capital policy what revisions to capital requirements based on sound data and sensible analysis would look like. That letter effectively treats the proposal as an advance notice of proposed rulemaking, and we hope that it will assist the agencies in producing a new proposed rule that employs data and analysis to calculate risk, appropriately analyzes the costs and benefits of potential changes to their capital rules, and provides the public with adequate information on which to comment. As both a procedural and substantive matter, the current proposal fails that test.

In this letter, we focus on the proposal's legal deficiencies, and organize our discussion as follows: Part I provides an executive summary of the proposal's legal problems; Part II describes applicable legal requirements under the APA; Part III describes how the proposal violates both the procedural and substantive standards of the APA because it lacks a sufficient evidentiary basis, ignores evidence that is available, fails to explain the methodology and assumptions that underlie the proposal, and improperly fails to disclose underlying data and analysis from the public; Part IV describes how the proposed rule's reliance on Basel Committee agreements as a floor for any U.S. requirement is improper and arbitrary; Parts V through VIII identify the numerous reasons why the proposal is arbitrary and capricious and thus violates the APA's requirement of reasoned decision-making; Part IX explains why, as applied by the agencies in the proposal, the bank capital statutes would violate the non-delegation doctrine; and Part X describes why the agencies should issue a new proposal to amend the capital rules in a manner consistent with APA standards should they choose to move forward with any changes to those rules.

I. Executive Summary

- **The APA establishes clear procedural and other requirements that apply to all federal agency rulemaking, including the proposal.**
- **The proposal violates both the procedural and substantive standards of the APA because it lacks a sufficient evidentiary basis, ignores the evidence that is available, fails to explain the methodology and assumptions that underlie the proposal, and improperly fails to disclose underlying data and analysis from the public.**
    - The proposal's framework of proposed risk weights is not supported by sufficient data, evidence, or analysis; nor is it based on any standard of risk against which data, evidence, or analysis could be judged.
    - The proposal's approach to operational risk is based on unsubstantiated assertions about the general nature of operational risk, the relationship between operational risk and business activity, and the relative operational risk of fee-based activities.
    - The proposal would eliminate any role for internal models in calculating credit risk capital on the basis of conclusory, unsupported assertions that are belied by a massive body of evidence and conflict with current agency practice and past agency statements.
    - The proposal's punitive treatment of loans and other exposures to small- and medium-sized businesses that do not issue public securities is based on no data or analysis at all.
    - Key parts of the proposal's approach to market risk and CVA risk are proposed with no justification or explanation at all.
    - Other key elements of the proposed rule rely on a wide variety of data, analyses, and methodologies that appear to exist, but have not been made available to the public for

review and comment.

- The proposed rule repeatedly relies on non-public analyses that are said to arise from the agencies' "supervisory experience" and related conclusory assertions.
- Any data collected and analyzed by the Federal Reserve cannot support any final rule unless the agencies make that data and analysis available for public comment.

- **The proposed rule's treatment of Basel Committee agreements is improper.**
  - The proposed rule unjustifiably incorporates most aspects of the Basel Committee's 2017 and 2019 revisions without any independent analysis, explanation, or support offered by the agencies themselves, and without revealing the data (if any) relied upon in reaching those agreeements.
  - The proposed rule also departs from the requirements of the Basel agreements in unexplained and inconsistent ways.

- **The proposed rule fails to consider many other important aspects of the problem.**
  - The proposed rule does not account for the fact that the new capital requirements would largely duplicate the capitalization of risks that are already captured by the Federal Reserve's stress-test framework.
  - The proposal fails to consider the lack of correlation or negative correlation among the credit, market, operational, and others risks for which it would impose capital charges on a summary basis.
  - The proposal fails to meaningfully consider the concrete competitive and market consequences of subjecting different banks to different capital requirements for identical loans, assets and activities.
  - The proposal fails to meaningfully consider the practical and policy problems associated with subjecting larger banks to two differently calculated capital requirements for identical loans, assets, and activities.
  - The proposal fails to meaningfully consider the demonstrable financial stability risks and social costs of creating significant regulatory incentives for the shift of lending, capital markets, and other activities to less-regulated financial institutions.
  - The proposal fails to meaningfully consider potential tensions and inconsistences between what the proposal would require and other existing legal requirements for banks.

- **The proposed rule is based on economic analysis that is deficient and inconsistent with the evidence.**

- **The proposed rule would significantly increase capital requirements for large banks without evidence that current requirements are insufficient, and in the face of considerable evidence (incuding statements by agency principals) that current requirements are more than adequate.**

- **The proposed rule does not consider numerous viable alternatives.**

- **As applied by the agencies in the proposal, the bank capital statutes would violate the non-delegation doctrine.**

- **The agencies should propose a new rule that corrects the proposal's numerous legal deficiencies.**

II. The APA establishes clear procedural and other requirements that apply to all federal agency rulemaking, including the proposal.

The APA sets forth certain requirements for rulemaking that apply broadly to federal agencies.[7] The APA requires agencies to "give interested parties an opportunity to participate in the rule making through submission of written data, views, or arguments."[8] As courts have made clear, "[i]ntegral to these requirements is the agency's duty to identify and make available technical studies and data that it has employed in reaching the decisions to propose particular rules."[9] Agencies "must explain the assumptions and methodology" underlying a proposed rule "and, if the methodology is challenged, must provide a complete analytic defense."[10] If an agency omits some of the "critical factual material" and analysis from a proposed rule, it must disclose the material and then provide "further opportunity to comment" before finalizing the rule.[11]

Agency action is also subject to being set aside by a reviewing court under the APA if it is "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law."[12] Agency action is "arbitrary and capricious if the agency has relied on factors which Congress has not intended it to consider, entirely failed to consider an important aspect of the problem, offered an explanation for its decision that runs counter to the evidence before the agency, or is so implausible that it could not be ascribed to a difference in view or the product of agency expertise."[13] For instance, an agency acts arbitrarily if it "depart[s] from precedent or practices" without "offer[ing] a reason to distinguish them or explain[ing] its apparent rejection of their approach."[14] An agency likewise violates the APA if it acts without considering "significant and viable and obvious alternatives," or if its action contains "unexplained inconsistencies."[15] Action is also arbitrary and capricious if the agency "fail[s] to consider a factor the agency must consider

---

[7] The banking regulators are not exempt from these requirements, nor from judicial review of their compliance with these requirements and with the applicable substantive constraints on their decision making. The banking regulators have some discretion in imposing capital requirements on *individual* financial institutions, *see* 12 U.S.C. § 3907(a)(2), but their generally applicable legislative rules are subject to ordinary principles of judicial review. For federal banking regulators, as for all agencies, there is a "strong presumption in favor of judicial review of final agency action," *Am. Hosp. Ass'n v. Becerra*, 142 S. Ct. 1896, 1902 (2022), and "an agency must carry a heavy burden to rebut th[at] strong presumption," *United Natural Foods, Inc. v. NLRB*, 66 F.4th 536, 542 (5th Cir. 2023).

[8] 5 U.S.C. § 553(c).

[9] *Owner-Operator Independent Drivers Association v. FMCSA*, 494 F.3d 188, 199 (D.C. Cir. 2007) (quotation marks omitted).

[10] *Small Refiner Lead Phase-Down Task Force v. EPA*, 705 F.2d 506, 535 (D.C. Cir. 1983).

[11] *Chamber of Commerce v. SEC*, 443 F.3d 890, 900–01 (D.C. Cir. 2006).

[12] 5 U.S.C. § 706(2)(A).

[13] *Motor Vehicle Mfrs. Ass'n of U.S., Inc. v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 43 (1983).

[14] *Physicians for Soc. Resp. v. Wheeler*, 956 F.3d 634, 644 (D.C. Cir. 2020).

[15] *Dist. Hosp. Partners, L.P. v. Burwell*, 786 F.3d 46, 59 (D.C. Cir. 2015).

under its organic statute,"[16] or "fails to respond to relevant and significant public comments."[17] Finally, consideration of a regulation's economic impacts and "costs and benefits" is a necessary part of reasoned decision making.[18]

Both the proposal and the process by which it has been issued fall well short of all of these basic standards of administrative law, for the reasons explained below and in our forthcoming companion letter. Those defects can be cured only through issuance of a new proposal and accompanying rulemaking process.

III. The proposal violates both the procedural and substantive standards of the APA because it lacks a sufficient evidentiary basis, ignores the evidence that is available, fails to explain the methodology and assumptions that underlie the proposal, and improperly fails to disclose underlying data and analysis from the public.

As we describe in Part II, among the agencies' most fundamental obligations under the APA is the duty to formulate rules on the basis of analysis and available evidence and to make that evidence and analysis public for review and comment. The proposal clearly violates these core legal obligations by proposing significant changes without providing any evidentiary basis, ignoring material evidence that is available, and by repeatedly relying on either undisclosed data, analysis, and methodologies not shared with the public or unsubstantiated, undocumented, and unverifiable "supervisory experience." It also remains unclear whether the agencies intend to base parts of any final rule on data collected only *after* the proposal was issued, without providing the public an opportunity to comment on such data or resulting analysis of that data.[19]

A. The proposal's framework of proposed risk weights is not supported by sufficient data, evidence, or analysis; nor is it based on any standard of risk against which data, evidence, or analysis could be judged.

The proposed rule would assign risk weights to all bank assets and off-balance-sheet exposures, the sum of which (total risk-weighted assets) would serve as the denominator in calculating the bank's risk-based capital ratio. Thus, the core focus of the proposal is the methodologies by which the risk of various assets, exposures, and activities are estimated and calculated for purposes of the denominator.[20] Under the proposal, the total risk weight for each asset or exposure is in turn produced by adding up weights for up to four different types of risks under the ERBA: credit risk, market risk, operational risk, and CVA risk.

---

[16] *Lindeen v. SEC*, 825 F.3d 646, 657 (D.C. Cir. 2016).

[17] *Lilliputian Sys., Inc. v. Pipeline & Hazardous Materials Safety Admin.*, 741 F.3d 1309, 1312 (D.C. Cir. 2014).

[18] *See Mexican Gulf Fishing Co. v. U.S. Dep't of Commerce*, 60 F.4th 956, 973 (5th Cir. 2023) (citing *Michigan v. EPA*, 576 U.S. 743, 751 (2015)).

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

[20] Although principally focused on the denominator, the proposal would also revise how the "numerator" of risk-based capital ratios are calculated for Category III and Category IV banking organizations, which would become subject to (i) the deductions framework, (ii) the requirement to include in capital most elements of accumulative other comprehensive income (AOCI), and (iii) minority interest limitations that currently apply only to Category I and Category II banking organizations.

(Thus, for example, the total risk weight for a mortgage loan would comprise the sum of weights for two of those risks (credit risk and operational risk); the total risk weight for a derivatives transaction would include all four risk weights.) Those RWA amounts are then summed and compose the denominator of the risk-based capital ratio.

1. The proposed credit, operational and CVA risk weights are untethered to any articulated objective standard against which the public could assess their calibration.

Despite the clear function of these risk weights – to reflect an asset or exposure's *risk of loss* – the proposed rule does not set forth a standard for determining what the appropriate risk weight or risk weight methodology should be for three of these risk types – credit risk, operational risk, and CVA risk. 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. For example, the proposal does not explain whether or how these risk weights and risk methodologies are intended to reflect (i) likely losses under ordinary economic conditions, (ii) likely losses over a one-year period under severe but plausible economic stress, (iii) likely losses over a longer period under extremely severe and highly implausible economic stress, or (iv) likely losses under some other set of circumstances.

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. Without an articulated standard, one must assume that these elements of the proposed rule rely on no standard at all, making it arbitrary and capricious. And if there is some unannounced standard underlying the risk weighting for credit risk, operational risk, and CVA risk – some of the most important aspects of the proposal – it is impossible to meaningfully assess the assumptions underlying the agencies' proposal and comment on these areas without that information.

Indeed, the closest the proposal comes to establishing a standard for review is a conclusory statement that "[t]he revisions set forth in the proposal would strengthen the calculation of risk-based capital requirements to *better reflect the risks* of these banking organizations' exposures."[21] But it does not explain how or why it does so, or how a "better" reflection of risk was or should be determined. Furthermore, our analysis demonstrates that in many cases the proposal is not well calibrated to risk and, in fact, is in many cases demonstrably far *worse* at reflecting risk than existing capital requirements. Without more detailed explanation from the agencies, it is difficult to understand, much less assess, verify, and comment on, their assertion that the proposal improves risk sensitivity.

The concept of a standard against which to measure risk is not novel or difficult. In the context of credit risk, the proposal abandons without explanation an existing standard. The current "Advanced Approaches" to credit risk – the internal models-based approach to calculating credit risk that the proposal would eliminate with only cursory discussion (*see* Part III.C below) – uses as its standard of risk potential credit losses in a given year at a 99.9 percent confidence interval,[22] and then employs a combination of

[21] Proposal at 64030.

[22] *See* Board of Governors of the Federal Reserve System et al., *Risk-Based Capital Standards: Advanced Capital Adequacy Framework*, 71 Fed. Reg. 55830 (July 29, 2008) at 55833 ("the IRB framework for assessing credit risk

bank internal models, regulatory parameters and constraints, and supervisory review, and approval processes to assign risk weights commensurate with that level of risk. It is not clear whether the agencies believe this standard is no longer appropriate – there is considerable evidence that such a standard is unnecessarily high – but the proposal would eliminate it in favor of no standard at all. Thus lacking any articulated standard of risk, the proposal's risk weights appear to be inherently arbitrary. Furthermore, as explained in more detail below and in the forthcoming companion letter, assessing the proposal as compared to the existing standard suggests that, in many cases, the proposed risk weights for a given asset or off-balance-sheet exposure are too high and unreasonably so.

The proposal's approach to operational risk is similarly standardless and arbitrary. As we describe in Part III.B below, the proposed approach to calculating operational risk RWA would first estimate a firm's operational risk capital charge by assessing the operational risk of an organization in its entirety, based on a series of complex financial statement proxies for exposure to operational risk. It would then convert this notional capital charge amount into phantom risk-weighted assets for purposes of including operational risk in the denominator of a firm's risk-based capital ratio calculations. Crucially, there is no evidence that the proxy used to assess operational risk accurately and reliably reflects operational risk. But the proposed approach's defects are even more fundamental – the proposal is guided by no standard as to "how much" operational risk should be capitalized, making the process by which that proxy is converted into a capital requirement completely arbitrary. Neither the proposal nor the final 2017 Basel Committee agreement on which it is based contains *any* discussion of how the proposed approach to operational risk was calibrated or what standard of risk was used.

As with credit risk, the absence of discussion on this point is particularly glaring because both the *current* U.S. operational risk capital rules and the Basel II standard on which it was based (the so-called "Advanced Measurement Approach") are based on a very 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, as generated by the Board-regulated institution's operational risk quantification system over a one-year horizon (and not incorporating eligible operational risk offsets or qualifying operational risk mitigants)."[23] One could certainly argue whether this standard is appropriate, but the proposal does not even bother to mention it; instead, it simply eliminates this clear existing standard altogether, without any discussion or analysis of why, and replaces it with no standard at all.

The absence of any standard of risk also undermines the proposal's numerous descriptions of particular decisions or aspects of the proposal as "conservative." The 44 separate references in the proposal to such "conservative" choices are meaningless in the absence of any standard of risk by which

---

capital requirements is based on a 99.9 percent nominal confidence level, a one-year horizon, and a supervisory model of credit losses embodying particular assumptions about the underlying drivers of portfolio credit risk, including loss correlations among different asset types") and 55834 ("[t]he nominal confidence level of the IRB risk-based capital formulas (99.9 percent) means that if all the assumptions in the IRB supervisory model for credit risk were correct for a bank, there would be less than a 0.1 percent probability that credit losses at the bank in any year would exceed the IRB risk-based capital requirement"). This confidence interval was based on the confidence level endorsed by the Basel Committee in 2005. *See* Basel Committee on Banking Supervision, *An Explanatory Note on the Basel II IRB Risk Weight Functions*, 11 (July 2005), *available at* https://www.bis.org/bcbs/irbriskweight.pdf ("[t]he confidence level is fixed at 99.9%, i.e. an institution is expected to suffer losses that exceed its level of tier 1 and tier 2 capital on average once in a thousand years").

23 *See, e.g.*, 12 C.F.R. § 217.101(b).

one could measure whether an approach is "conservative" or not. Furthermore, the proposal's references to such conservatism are entirely one-sided; every policy choice described as "conservative" results in more stringent capital requirements, and the proposal does not once express a corresponding desire to be "conservative" in ways that eliminate or reduce the extent to which the costs of providing banking products or services are increased for banks and the consumers and businesses that they serve.

2. The agencies cite no data or information to support the calibration of the proposed risk weights.

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 those risk weights*.

The omission of any support whatsoever for the proposal's core elements would be notable – and a violation of the APA – under any circumstances, but it is especially notable because, as concerns the basic question of risk, the agencies possess voluminous amounts of historical loss data they could and should have considered, but of which the proposal makes no mention at all. For example:

- Supervisory and private sector databases with which the agencies are well familiar provide plentiful data to establish appropriate credit risk weights for many categories of exposures.
  - Banks regularly 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.[24] The data include delinquency and default rates.
  - OCC researchers have previously used a supervisory dataset that includes comprehensive, historical account-level data on credit cards, including detailed information on borrower characteristics along with delinquency and default performance.[25]
  - The Federal Housing Finance Agency houses the National Mortgage Database, described as "credit, administrative, servicing, and property data for a nationally representative five percent sample of closed-end first-lien residential mortgages in the United States," which includes loan-level information on default and loss experience as well as detailed property and borrower characteristics.
  - Credit rating agencies maintain robust databases of corporate credit performance from which risk-weight benchmarks could rationally be derived.
  - The Mortgage Bankers Association and private data vendors such as Trepp maintain historical, segment-level databases on performance of commercial real estate loans.

---

[24] 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.

[25] *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.

- The Federal Reserve's stress testing models that project losses across a wide range of loan categories have been developed using regulatory databases. Although details on these data have not been publicly disclosed (in another violation of the APA), clearly if these data are appropriate for stress test modeling, they could be applied to determine risk weights. Exposure categories include (i) corporate loans, including graded commercial and industrial loans, agricultural loans, domestic farm loans, international farm loans, loans to foreign governments, loans for purchasing and carrying securities, other non-consumer loans, and other leases; (ii) commercial real estate loans, including domestic and international non-owner-occupied multifamily or nonfarm, nonresidential property loans, and construction and land development loans; (iii) domestic first-lien residential mortgages; (iv) domestic home equity loans (HELs) and home equity lines of credit; (v) domestic credit cards; and (vi) domestic auto loans. This information is directly used by the Federal Reserve to estimate the relative risks of these assets and exposures under its stress testing framework, yet nothing in the proposal suggests it was reviewed or considered at all for purposes of determining risk weights.

- Banks have been submitting data to the banking agencies to support the risk weights across all portfolios under the Advanced Approaches since at least 2014.[26] This information contains detailed and granular historical and other data concerning the credit risk of various loans and other exposures.

- The Federal Reserve collects historical data on operational risk losses for stress testing purposes.[27] 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. Additionally, ORX – the largest operational risk management association in financial services – has collected a massive dataset on operational risk losses, which also extends back to the early 2000s. This information would be more than sufficient to appropriately calibrate a capital standard for operational risk.

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 more or less completely in calculating the risk weights it proposes.

The proposal's failure to take account of these data sets is impossible to understand; after all, because risk weights are intended to reflect risk of loss, one would presume that risk weights would be determined by the historical loss experience of each category of assets or exposures across the relevant risk types – that is, the probability of default or loss event, and loss given that default or loss event, on any given asset or exposure over time. In this regard, the proposal's establishment of risk weights and risk-weighting methodologies without considering a wide range of highly probative risk data patently violates

---

[26] *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.

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

the agencies' requirement to "examine the relevant" and available evidence.[28] An agency has "no license to ignore the past when the past relates directly to the question at issue."[29]

The failure to articulate a standard and consider historical experience leads in certain parts of the proposal to an unworkable outcome – instances in which the capital required for certain exposures would exceed the maximum potential economic loss associated with those exposures. For example, there is at least one instance in which a bank would have to hold CVA risk capital in a situation in which it faces *zero* risk of CVA-related losses. Specifically, where a client of a bank is not a member of a central clearing party, the client will clear its trades through its bank, with the bank guaranteeing the client's performance to the central clearing party in the event of default. In this situation, although the bank faces counterparty credit risk with respect to its client (against which it must hold capital under other aspects of the capital rules), the bank has no risk of *CVA* loss with respect to its client's position and that client's own counterparty. GAAP rules do not recognize CVA for client cleared transactions and banks do not calculate it for these transactions. However, the proposal would require a bank in this situation to hold capital against a risk of CVA loss that it economically does not and could not bear.[30] In analogous situations, the agencies recognize the absence of CVA risk and do not require CVA capital. Specifically, the agencies acknowledge that it is not bank practice to calculate CVA for securities financing transactions ("SFTs") or cleared transactions and so they do not require a CVA capital charge for these cases. But they inconsistently fail to recognize the same principle for client cleared transactions, and would require banks to hold CVA capital for them.

B. The proposal's approach to operational risk is based on unsubstantiated assertions about the general nature of operational risk, the relationship between operational risk and business activity, and the relative operational risk of fee-based activities.

The proposal includes a new standardized measure of operational risk, developed by the Basel Committee as part of its 2017 revisions, that would be included within the proposal's new ERBA. Rather than attempt to quantify and estimate operational risk across banks, the proposed approach to operational risk would rely entirely on a proxy – selective financial statement measures of income and expenses as adjusted by various regulatory changes to those figures. That approach first calculates a bank's "business indicator" as the sum of three components, each of which is calculated based on the income (and in some cases, expenses or assets) associated with the relevant activities: (i) an interest, lease, and dividend component; (ii) a services component; and (iii) a financial component. The approach then multiplies a bank's business indicator by a coefficient that increases from 0.12 to 0.18 as the business indicator rises to generate a "Business Indicator Component." Finally, there is a scaling factor – the internal loss multiplier – that is applied to the business indicator component. This multiplier depends on each bank's average historical losses over the last 10 years and is floored at 1 in the U.S. proposal (but not in the standard adopted by the Basel Committee).

---

[28] *State Farm*, 463 U.S. at 43; *cf. Ariz. Public Serv. Co. v. EPA*, 562 F.3d 1116, 1124 (10th Cir. 2009) ("Because the EPA failed to address the area's air problems and did not examine the relevant data or articulate a rational basis for its decision, the federal plan is arbitrary and capricious.").

[29] *BellSouth Telecomms., Inc. v. FCC*, 469 F.3d 1052, 1060 (D.C. Cir. 2006).

[30] Proposal at 64230 (defining "CVA risk covered position" (for which a firm must hold capital against CVA risk) as any "position that is a derivative contract that is not a cleared transaction").

For such a definite and mathematical approach, one would presume that the agencies would have performed and provided for public comment some empirical analysis about the performance of their chosen proxy methodology as a measure for operational risk. Consistent with the proposal's approach elsewhere, however, the proposal does not contain any such analysis. Instead, the agencies' entire justification for this measurement approach is based on the following types of conclusory assertions:

- The proposal asserts that "[e]xperience shows that operational risk is inherent in all banking products, activities, processes, and systems."[31] As described in Part III.A above, this experience is wholly undocumented and unquantified, and no evidence, support, or data is provided to describe that experience.

- To justify its use of business volume as a proxy for operational risk, the proposal asserts that "[b]anking organizations with higher overall business volume are larger and more complex, which likely results in exposure to higher operational risk," that "[h]igher business volumes present more opportunities for operational risk to manifest," and that "the complexities associated with a higher business volume can give rise to gaps or other deficiencies in internal controls that result in operational losses."[32] Here, the proposal makes reference by footnote to three academic papers that examine the relationship between bank size/complexity and operational risk, but these papers are insufficient to form the empirical basis of the proposal. First, business volume is at best a very rough indicator of operational loss exposure, and there can be significant differences in operational risk losses between banks with similar business volumes. Indeed, one of the cited papers, Curti, Frame and Mihov (2022), shows in Table 3 that the revenues from most bank activities are *unrelated* to operational risk.[33] Second, other important elements of the operational risk framework that drive the size of the capital charge also lack empirical support. For instance, the proposal provides no empirical support for (i) the methodology for treating revenues (whether reported gross or netted against expenses), (ii) the calibration of the regulatory coefficients, or (iii) the internal loss multiplier. And the proposal provides no indication of how the calibration of these parameters is tied to a given percentile of the distribution of historical operational risk losses.

- With respect to the interest, lease, and dividend component, which would capture a banking organization's interest income and expenses from financial assets and liabilities, the proposal asserts that "[n]et interest income is a useful indicator of a banking organization's operational risk because a higher volume of business is associated with higher operational risk," but caps the net interest income input relative to interest-earning assets because "operational risk does not necessarily increase proportionally to increases in net interest income."[34] No data or evidence concerning the relationship between net interest income and operational risk is provided.

---

[31] *See* Proposal at 64082.

[32] *See* Proposal at 64083.

[33] *See* Filippo Curti, W. Scott Frame and Atanas Mihov, *Are the Largest Banking Organizations Operationally More Risky?*, 54 J. of Money Credit and Banking, 1223–59 (Apr. 18, 2022).

[34] *See* Proposal at 64084.

- The services component would capture fees and commissions and other financial activities not captured by the other components of the business indicator; it would be calculated as a gross amount, reflecting the larger of either income or expense. Here, the proposal provides no explanation whatsoever of why this component has any relationship to operational risk at all. It simply asserts that its approach "would account for the different business models of banking organizations better than a netting approach, which may lead to variances in the services component that exaggerate differences in operational risk."[35] This claim is impossible to assess, of course, in the absence of any analysis or data explaining how the services component reflects operational risk in the first place. This claim also wholly ignores the well-known problem that, in the words of the Basel Committee, this approach "does not lend itself to accurate application in the case of banks engaged predominantly in fee-based activities" and would result in "overcapitalization of banks with high fee revenues and expenses."[36] To give a similar example, if a bank raised the price for processing a payment or managing an account or notarizing a document, the proposal would assume the bank's operational risk would rise correspondingly; that simply makes no sense. Although this problem was left unaddressed in the Basel Committee's own work on operational risk capital, the Basel Committee at least acknowledged its existence; the proposal ignores it, and instead, as one FDIC director noted in his dissent from the proposal, "take[s] an approach that its own Basel Committee authors have said does not work."[37]

- The financial component would capture trading activities and other activities associated with a bank's assets and liabilities by summing (i) its net profit or loss on trading activities and (ii) its profit or loss on assets and liabilities not held for trading. Here, the proposal asserts that "these inputs would be measured in terms of their absolute value to better capture business volume (for example, negative trading revenue would not imply that a banking organization's trading activities are small in volume), which is associated with higher operational risk."[38] Here again, no actual data or evidence concerning the relationship between these inputs and operational risk is provided.

- The proposed approach would employ an "internal loss multiplier" that would be based on the ratio of a bank's historical operational losses to its business indicator component and adjust that bank's operational risk capital requirement to reflect its own historical operational losses, on the theory that "[h]igher historical operational losses are associated with higher future operational risk exposure."[39] Unlike the 2017 Basel Committee agreement, however, the proposal would employ the internal loss multiplier only to adjust the capital requirement upward. The proposal asserts that this asymmetric approach "help[s] ensure the robustness of

[35] *See* Proposal at 64084.

[36] Basel Committee on Banking Supervision, *Consultative Document: Operational risk – Revisions to the simpler approaches* (2014 at 16); Basel Committee on Banking Supervision, *Consultative Document: Standardised Measurement Approach for operational risk* (2016) at 4.

[37] Statement by Jonathan McKernan, Member, FDIC Board of Directors, on the Proposed Amendments to the Capital Framework (July 27, 2023), n.5, https://www.fdic.gov/news/speeches/2023/spjul2723c.html [hereinafter, "McKernan Dissent"].

[38] *See* Proposal at 64085.

[39] Proposal at 64086.

> the operational risk capital requirement,"[40] but it does not explain why or how it helps, and would simply punish a bank for high historical losses without providing any recognition of low historical losses. If (as the agencies assert) it is true that "[h]igher historical operational losses are associated with higher future operational risk exposure," then it conversely *must* be true that lower historical losses are associated with lower future operational risk exposure. To ignore the relevance of historical losses in all cases that would lead to lower capital requirements, and yet emphasize the relevance of those losses in all cases that would lead to higher requirements, practically defines the concepts of arbitrary and capricious.

Industry is not alone in recognizing the severe deficiencies in the analytical justifications of the new operational risk framework. Professor Anthony Saunders, John M. Schiff Professor of Finance at New York University Stern School of Business and member the Federal Reserve Board's own Board of Academic Consultants, similarly highlights ways in which the proposed standardized approach to operational risk "lack[s] explanation and [is] inconsistent with the economic evidence."[41]

The proposal's lack of rigor in measuring operational risk stands in stark contrast with the enormous practical consequences of that choice. As stated above, in practice, the proposal converts operational risk (as measured in this way) into a capital charge by creating phantom bank assets – not loans or securities but "assets" that represent solely the theoretical risk of losses caused by operational risk, and which exist only to produce a capital charge. And under the proposal these phantom assets would be *massive*; the proposal would require that large U.S. banks hold regulatory capital against a total of $1.95 trillion in phantom "operational risk" assets, which in turn would require those banks to maintain nearly $170 billion in additional regulatory capital (compared to the current U.S. standardized approach) – significantly raising those banks' costs of lending to businesses or individuals and providing liquidity in capital markets.[42] The agencies' failure to rely on any studies, data, or methodology to make these critically important decisions is inconsistent with the APA's baseline requirement of reasoned decision-making.

In fact, available evidence suggests that the operational risk charge generated by the proposed method would be far too high. A comprehensive dataset on operational risk losses dating back to the early 2000s that was compiled by ORX shows annual operational risk losses for U.S. banks rarely exceed 30 percent of the capital required under the proposed new approach to operational risk. For example, during the global financial crisis, average operational risk losses were consistently less than 30 percent of the capital required under the new approach. Furthermore, this ORX data likely already overstates actual historical operational risk losses, as ORX loss data are reported at the event level, meaning that losses

---

40 Proposal at 64083.

41 Anthony Saunders, *Comments on the Department of Treasury Office of the Comptroller of the Currency, Federal Reserve System, and Federal Deposit Insurance Corporation's Proposal on "Regulatory Capital Rule: Amendments to Large Banking Organizations and to Banking Organizations with Significant Trading Activity*,*"* 26 (Jan. 12, 2023) [hereinafter, "Saunders Comment"]. BPI provided financial support for Prof. Saunders's study, but he retained and exercised editorial control, and the views expressed therein are his own and do not necessarily reflect the views of BPI and/or its members.

42 The impact of this proposal is compounded by the additional capital that large banks are required to hold with respect to operational risks under the Federal Reserve's stress testing framework, as described in detail in Part VI.A, which effectively require banks to maintain an additional $138 billion in capital against an additional $1.725 trillion (i.e., 12.5 x $138bn) in phantom "operational risk" assets.

spanning multiple years are consolidated into a single year for reporting purposes. As a result, the operational risk losses during the global financial crisis (largely consisting of large settlements, fines and litigation judgments pertaining to banks' handling of mortgages) appear considerably higher than what banks actually experienced (i.e., paid or established reserves for) in those years, since many of the litigation and supervisory processes resulting in those losses took several years to complete – and some are only being resolved now. Yet the proposal's methodology would result in operational risk capital requirements that are more than *three times greater* than even this highly overstated estimate of corresponding financial crisis-era losses.

In addition to the proposal's impact on minimum capital requirements for operational risk, one must also consider the additional capital charge for operational risk that is imposed under the Federal's Reserve stress testing framework. Taking that into account, the cumulative effect of these two operational risk capital charges leads to overall capital requirements for operational risk that is *2.6 times* the amount of the worst year of industry operational risk losses. However, this method significantly overestimates the operational risk losses incurred in the worst year. The more accurate accounting date-based method shows that the expected charge would be closer to 3.5 times those losses. As a result of the arbitrary and arbitrarily high calibration of these cumulative operational risk capital charges, nearly 24 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. This too is an important aspect of the problem that the agencies have ignored, contrary to the requirements of the APA.

The agencies' "[u]nsubstantiated or bare assumptions" are not "credited" in assessing the legality of their decision to impose these massive new charges.[43] Rather than making unexplained assertions of the sort that appear in the proposed rule (which are unsupported by the available evidence), agencies must "articulate a rational connection between the data in the record and its determination."[44] The agencies have failed to do so here.

C. The proposal would eliminate any role for internal models in calculating credit risk capital on the basis of conclusory, unsupported assertions that are belied by a massive body of evidence and conflict with current agency practice and past agency statements.

One of the most striking aspects of the proposal is that, while purporting to implement the accord the agencies reached in 2017 at the Basel Committee, it chooses not to adopt the most important aspect of that agreement: a framework that permits the continued use of internal models to assess credit risk.[45] This aspect of the agreement reflected a carefully considered decision that weighed the benefits of internal models – far more granular, risk-sensitive, and firm-specific analysis – against a potential cost – the potential for a bank to misuse its models to systematically understate risk, outside the notice of its risk,

---

[43] *NRDC v. EPA*, 31 F.4th 1203, 1207 (9th Cir. 2022) (quotation marks omitted).

[44] *Nat'l Parks Conservation Ass'n v. U.S. EPA*, 788 F.3d 1134, 1143 (9th Cir. 2015); *Greater Yellowstone Coal., Inc. v. Servheen*, 665 F.3d 1015, 1020 (9th Cir. 2011); *see State Farm*, 463 U.S. at 43.

[45] Although the Basel Committee provides that implementing only the standardized approaches would not, in and of itself, constitute noncompliance with the Basel framework, 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. *See* Basel Committee on Banking Supervision, *High-level summary of Basel III reforms* (Dec. 2017), *available at* https://www.bis.org/bcbs/publ/d424_hlsummary.pdf.

compliance and internal audit functions and its external auditors and examiners. And this aspect of the agreement has been adopted in the European Union, the United Kingdom, and every other major jurisdiction.

In contrast, the proposal would eliminate the use of internal models for credit risk from U.S. capital regulation altogether in favor of a standardized approach that seriously misstates risk. It would make the U.S. credit risk framework entirely dependent on simplistic and uniform risk weights and thus effectively shift core risk management decisions from the private sector to the government, with profound consequences for the U.S. banking and economic system.

1. The proposal ignores the relevant data on the performance of internal models, which Is voluminous.

Before taking such a radical step, the agencies should have been expected to focus on a key question: historically, which are a more accurate measure of credit risk, the agency-supervisory internal bank models that have been used in the United States, or standardized risk weights reflected in either the existing standardized approach or the proposal's new ERBA? As noted in Part III.A above, the agencies have gathered a wealth of data since 2014 on the performance of banks' internal credit models. Thus, the agencies *could* have analyzed some or all of that data to determine how predictive each approach was, how much systematic variance there was among banks for the same or similar exposures, and whether such variance was warranted. They chose not to do so. Furthermore, the agencies could have produced that data on an anonymized basis and allowed commenters to do that work. But they did not. Finally, the agencies also could have used historical data to assess and quantify in the proposal how accurately their "expanded risk-based approach" would have performed over the past 20 years, both in absolute terms and relative to other approaches. They did not.

Rather, the proposal states that "empirical verification of modeling choices can require many years of historical experience because severe credit risk and operational risk losses can occur infrequently."[46] This statement is plainly not true for most types of credit risk: losses on credit cards, mortgages, commercial loans, and numerous other types of loans occur quite frequently. For consumer loans, *an entire industry exists to use this data to predict future defaults* – most notably, the credit reporting agencies, Experian, Transunion, and Equifax. A parallel industry has been more recently established with respect to commercial loans.[47] And, as noted above, the agencies have in their possession several databases of detailed data on loss experience collected for well over a decade. Although large corporate defaults happen infrequently, the agencies also have substantial data and models available to them that they could use to benchmark and set guidelines for internal model estimates if necessary. While the agencies are prohibited by U.S. laws from using ratings from the credit rating agencies to determine capital

---

[46] Proposal at 64031.

[47] For example, the company Credit Benchmark generates consensus-based credit ratings and analytics calculated based on contributed risk views from more than 40 leading global financial institutions, almost half of which are GSIBs. These institutions are domiciled in the US, Continental Europe, Switzerland, the UK, Japan, Canada, Australia, and South Africa. The contributions are anonymized, aggregated, and published twice monthly in the form of Credit Consensus Ratings and Credit Indices. *See* Credit Benchmark, https://www.creditbenchmark.com/ (last visited Nov. 11, 2023). Additionally, the agencies also gather quarterly data on syndicated loans, where multiple banks lend to a single company. This data also enables the investigation of systematic differences in banks' estimates of the probability of default and the loss given default. Similarly, the FR Y-14Q corporate schedule, employed for stress testing, could extend this analysis beyond syndicated loans.

requirements, nothing prevents them from using documented loss experience from those entities to backtest internal or standardized models.

2. The proposal ignores an entire regulatory regime established by the agencies for model validation, which appears to have worked well.

The failure to consider historical data and experience is all the more remarkable given the extraordinary resources that the agencies have required banks to devote to the internal model process. The proposal nowhere acknowledges that in the United States, the agencies have required a rigorous model risk management regime. 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.[48] 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.[49] The guidance was expressly designed to mitigate potential issues with model uncertainty, and by all accounts has served fit for that purpose.[50] 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.

---

[48] *See* Board of Governors of the Federal Reserve System and the Office of the Comptroller of the Currency, *Supervisory Guidance on Model Risk Management* (Apr. 2011), *available at* https://www.federalreserve.gov/supervisionreg/srletters/sr1107a1.pdf.

[49] Model development groups review whether they have met all the requirements that independent model validation has specified, based on the Federal Reserve and OCC's 2011 supervisory guidance, which would include a review of the justification for the model, the adequacy of documentation and testing, review of empirical outcomes analysis, whether model uncertainty was sufficiently accounted for, and whether model governance policies were followed. The model validation group will independently verify that all the same standards have been met and will issue findings on any shortcomings that must be remediated. The model will typically be reviewed for suitability and fitness for purpose. Internal Audit will conduct its own review on the effectiveness of both the model development as well as the independent validation process and whether all model governance policies have been followed. Independent Audit may issue findings of deficiencies that must be rectified. Finally, the regulatory supervisory review team will review the entire bank process from front to back and may issue its own findings that must be addressed by the appropriate bank departments.

[50] The 2011 guidance notes that "it can be prudent for banks to account for model uncertainty by explicitly adjusting model inputs or calculations to produce more severe or adverse model output in the interest of conservatism. Accounting for model uncertainty can also include judgmental adjustments to model output to avoid understating risks, placing less emphasis on that model's output, or ensuring that the model is only used when supplemented by other models or approaches." *Id.* at 8.

3. As their sole support for eliminating internal models in the U.S., the agencies rely on two dated studies, the scope and findings of which they seriously misstate.

Instead of anything resembling an evidence-based approach to evaluating the past performance of bank internal models in determining credit risk weights, the proposal justifies discarding a system that has functioned well for nearly a decade on an unsupported assertion that there is variability of internal model estimates and that such variability is "unwarranted," undermining confidence in the use of internal models and makes comparisons across banks difficult.[51] To justify its claim that variability of internal model estimates is unwarranted, the proposal cites two Basel studies, the first performed in 2013[52] and the second in 2016.[53] Reliance on those studies is clearly insufficient.

First, it is no substitute for reviewing voluminous actual experience in the United States – particularly, evidence in the ten and seven years since those studies were produced.

Second, those studies focused overwhelmingly on non-U.S. banks.[54] And none of the underlying data for the studies is provided in either the proposed rule or the studies themselves, so there is no meaningful opportunity for commenters to verify their analysis or findings, including the experience of U.S. banks versus other banks.

Third, those studies do not find what the proposal claims: neither Basel study concluded that variability in estimates from internal models was unwarranted. The 2013 Basel study explicitly refrained from attempting to define an acceptable level of variation of internal model estimates, while the 2016 Basel study noted that it was unable to differentiate variability caused by differences in bank or supervisory practices from variability produced by differences in risk.[55]

More specifically, the 2013 study noted that its analysis was limited by the constraint that true levels of risk were unknown and so it could not be determined how much variability could be explained by actual variance in risk levels across banks.[56] The 2013 study went on to point out the difficulties of disentangling variation caused by poor estimates of internal model parameters from variation produced by other differences, noting that consistent internal model estimates are not necessarily a sign of robust modeling: for example, two banks could have incorrect internal model estimates, but if they are the same

---

[51] Proposal at 64031.

[52] Basel Committee on Banking Supervision, *Regulatory Consistency Assessment Programme (RCAP): Analysis of risk-weighted assets for credit risk in the banking book* (July 2013) [hereinafter the "2013 RCAP Study"], *available at* https://www.bis.org/publ/bcbs256.pdf.

[53] Basel Committee on Banking Supervision, *Regulatory Consistency Assessment Programme (RCAP): Analysis of risk-weighted assets for credit risk in the banking book* (Apr. 2016) [hereinafter the "2016 RCAP Study"], *available at* https://www.bis.org/bcbs/publ/d363.pdf.

[54] The 2013 Basel Committee study used data collected by the Basel Committee's Capital Monitoring Group, which was collected from 102 large banks from 15 jurisdictions as well data from 32 large international banking groups from 13 jurisdictions. The 2016 Basel Committee study was based on primary data from 35 major internationally active banks from 13 jurisdictions and supplemented with further data from 37 banks across 17 jurisdictions.

[55] 2013 RCAP Study at 4.

[56] *Id.* at 12.

wrong estimate, there would be no variability.[57] Thus, the absence of variability could engender the misleading conclusion that the banks' models are effective.

The proposal claims that the sole causes of variability are the use of subjective assumptions in internal credit models and the difficulty of empirically verifying model estimates.[58] The first assertion is incorrect and the second is highly exaggerated. The two Basel Committee studies show that the reasons for the variability are much more complex. Differences in examination practices across different jurisdictions alone cause a significant amount of variation of internal model estimates. For example, variability can be caused by rollout of different models-based regimes at different times in different jurisdictions; by regulatory rules that permit some discretion in how default is defined; by Basel Committee rules that give banks flexibility in how "loss given default" ("LGD") data during a downturn are calculated; and, significantly, by variability in the level of conservatism imbedded in internal model estimates that each agency's numerous examiners require as part of their own model validation. Thus, the proposal's claim that variability is solely produced by subjective modeling assumptions is inconsistent with the studies the proposal cites on this point.

4. <u>The proposal ignores a potential alternative that the agency staff themselves supported at the Basel Committee, and that the rest of the world is adopting.</u>

The simplest proof that the agencies have misconstrued the conclusions of the 2013 and 2016 Basel studies is the fact that *the Basel Committee – based on these same studies – decided in 2017 to retain, not eliminate the use of bank models.* According to the Basel Committee, the core purpose of its 2017 revisions to the framework was to "restore credibility in the calculation of [RWAs] and improve the comparability of banks' capital ratios," which it accomplished by retaining the use of bank internal models to determine credit risk weights but (i) "constraining the use of the internal model approaches, by placing limits on certain inputs used to calculate capital requirements under the internal ratings-based approach for credit risk" and (ii) imposing "a more robust risk-sensitive floor based on the Committee's revised Basel III standardised approaches" that ensures that modeled risk weights do not fall unacceptably below the risk weights produced by standardized measures.[59] This compromise was designed to balance two competing concerns: a desire for accuracy (i.e., risk sensitivity) and a desire for uniformity.

Despite the fact that agency representatives spent years developing this part 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

---

[57] *Id.*

[58] *See* Proposal at 64031.

[59] Basel Committee on Banking Supervision, *High-level summary of Basel III reforms*, *(*Dec. 2017), *available at* https://www.bis.org/bcbs/publ/d424_hlsummary.pdf. The output floor sets a floor on how low the RWAs calculated using internal models may be for purposes of assessing firms' risk-based capital ratios. Under the output floor agreed upon by the Basel Committee in 2017, bank RWAs must be calculated as the higher of either: (i) total RWAs calculated using the approaches that the bank has supervisory approval to use, in accordance with the Basel capital framework (including both standardized and internal risk-based approaches); or (ii) 72.5 percent of total RWAs calculated using all the Basel framework's standardized approaches, including those for operational risk and CVA. The output floor generally applies to all regulatory capital minimums and buffer requirements of the Basel Committee's capital framework, including the capital conservation buffer and GSIB surcharge.

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.[60] In sum, for APA purposes, the proposal fails to consider not only a "significant and viable" alternative to its approach, but also an approach that would help to address the significant gaps in empirical support that undermine the proposal. In the Basel Committee, the agencies negotiated and agreed to that approach and deemed it appropriate for adoption by every other country in the world. It is difficult to imagine a clearer violation of the APA's requirements.

The conclusion here is inescapable: the agencies possess no evidence whatsoever to suggest that variability of internal model estimates is significant or unwarranted or that the new approach in the proposal is a better measure of risk; they have provided no evidence to suggest that the robust regime that is already in place for validation and revalidation of credit risk models, overseen by their own examiners, is incapable of ensuring integrity in the bank modeling process; and they have provided no evidence whatsoever to suggest that the heavily revised framework for internal models that their staffs supported at the Basel Committee in 2017 would not serve as a better way to balance accuracy and their perceived (though undocumented) desire for greater uniformity. This failure to thoughtfully evaluate the relevant evidence and consider key aspects of the problem and potential alternatives is arbitrary, capricious, and an abuse of agency discretion.

D. The proposal's punitive treatment of loans and other exposures to small- and medium-sized businesses that do not issue public securities is based on no data or analysis at all.

Under the proposed ERBA, loans to, and other transactions with, businesses that do not issue public securities receive punitive treatment. The proposal would generally assign a 65 percent risk weight to corporate loans where (i) the bank's credit underwriting process classifies the loan as investment grade and (ii) the business (or its parent) issues publicly listed securities, and a 100 percent risk weight to all other business loans. This approach to establishing risk weights for a large and important segment of U.S. business loans is deeply flawed for several reasons.

First, the proposal provides no data or analysis to support its 65 percent risk weight for investment grade loans as a general matter. As we detail in our forthcoming companion letter, existing data on probability of default and loss given default for such loans demonstrates that an accurate risk weight would be less than 40 percent. The sole (albeit unstated) basis for the 65 percent risk weight appears to be that it was included in the 2017 Basel Committee agreement. As explained in Part IV below, that fact carries no legal weight.[61]

---

[60] *See* Basel Committee on Banking Supervision, *Basel III standards adoption as of Sept. 30, 2023, available at* https://www.bis.org/bcbs/implementation/rcap_reports.htm [hereinafter the "Basel Adoption Report"]. Countries that have already implemented the 2017 agreement's revised internal-ratings-based approach to credit include Australia, Brazil, Canada, Japan, Korea, Russia, and Singapore; the United Kingdom, the European Union, and Switzerland are currently in the process of implementing that approach through local rulemaking or legislative processes. *Id.*

[61] Furthermore, the 2017 Basel Committee agreement itself provided no data to support that risk weight, and while much has changed in the ensuing six years, there has been no effort by U.S. regulators or Basel Committee staff to review and/or revalidate that risk weight.

Second, the sole support offered for the requirement that a borrower issue public securities in order to qualify for the 65 percent risk weight is the assertion that "publicly-traded corporate entities are subject to enhanced transparency and market discipline as a result of being listed publicly on an exchange."[62] The proposal contains no analysis of (i) the differing degrees and types of transparency and market discipline to which publicly traded and non-publicly traded companies are subject; or (ii) whether such differences in transparency and market discipline actually result in higher average credit risk among non-publicly traded companies. Here again, the lack of analysis may reflect obeisance to the Basel Committee's 2017 agreement, which included this same securities listing requirement, but that is no substitute for analysis. Indeed, further analysis has already led both the European Commission and the Bank of England to reject the securities listing requirement, at least initially, in their own planned implementations of the 2017 agreement. In doing so, a senior Bank of England official explained that "there are material numbers of [corporate borrowers that are neither rated nor publicly traded] and the 100% risk weight for them is particularly risk-insensitive."[63] The proposal fails completely to explain why it has chosen the opposite course.

The consequences of these requirements are extraordinary. According to the Federal Reserve's *2023 Stress Test Methodology*, approximately 47 percent of bank loans are internally rated as investment grade, and therefore should be receiving a lower risk weight than 65 percent.[64] Small- and mid-sized businesses, as well as mutual and pension funds, do not list securities on exchanges, and therefore would become subject to the more punitive 100 percent risk weight. For example, pension and other highly regulated funds are subject to leverage, asset diversification, and other restrictions that tend to bolster their creditworthiness, and as a result, the vast majority of mutual funds and pension funds have ratings that are well above the investment-grade designation.[65] But under the proposal, loans to these entities would nevertheless be categorically excluded from the preferential risk weight. Applying the 100 percent risk weight to such funds would greatly exaggerate the capital banks are required to hold against these types of exposures. Similar conceptual and practical problems are posed by the proposal's application of the higher 100 percent risk weight to other private borrowers. The overall impact of this choice is material, as will be discussed in our forthcoming companion letter.

---

[62] *See* Proposal at 64054.

[63] Phil Evans, *Implementing Basel 3.1 in the UK* (Dec. 7, 2022), *available at* https://www.bankofengland.co.uk/speech/2022/december/phil-evans-speech-at-uk-finance-on-basel-3-1-consultation; *see also* Bank of England, *CP 16/22 – Implementation of the Basel 3.1 Standards: Credit risk – standardized approach*, § 3.101 (Nov. 2022), *available at* https://www.bankofengland.co.uk/prudential-regulation/publication/2022/november/implementation-of-the-basel-3-1-standards/credit-risk-standardised-approach.

[64] *See* Board of Governors of the Federal Reserve System, *2023 Stress Test Methodology*, 69 (2023) [hereinafter the "2023 Stress Test Methodology"], *available at* https://www.federalreserve.gov/publications/files/2023-june-supervisory-stress-test-methodology.pdf.

[65] According to Credit Benchmark, about 98 percent of fund domiciled in the United States have a credit rating of A- or above. *See* https://www.creditbenchmark.com/wp-content/uploads/2020/07/Basel-IV-Rules-02.07.20.pdf and Covas and Stepankova (2022).

The absence of any supporting data to justify this important part of the proposal is particularly remarkable given that there is voluminous historical data on credit defaults (as we describe in Part III.A above). Thus, this is not a case where an agency lacked data and had to make a rough estimate; to the contrary, it is a case – perhaps an unprecedented one – where the agencies completely failed to consider a wealth of directly relevant data. It is not clear whether this choice reflects excessive deference to the Basel Committee, a concern that actual data would produce a lower capital charge than they might prefer, or some other rationale, but in any case, it is arbitrary, capricious, and an abuse of agency discretion.

E. Key parts of the proposal's approach to market risk and CVA risk lack justification or explanation.

Numerous aspects of the proposal's capital requirements for market risk and CVA risk are expressly predicated on conclusory assertions unsupported by data or analysis. With respect to market risk, the proposal would establish two new frameworks for calculating market risk capital – a "standardized measure" and a "models-based measure" – both of which contain numerous parameters and formulas for which little or no explanation has been provided. The unjustified parameters generally fall into four categories: risk weights, liquidity assumptions, correlations, and testing parameters. The calculation of CVA risk involves the use of supervisory risk weights that are similarly unjustified and unexplained in the proposal.

We provide below a few examples from each category to illustrate the extent of this problem, many of which have also been highlighted by commenters outside the industry.[66] These and similar aspects of the proposal rest on conclusory assertions without supporting data or analysis, and are plainly inconsistent with an agency's obligation under the APA to identify and make available technical studies and data that it has employed in reaching the decisions to propose particular rules; to explain the assumptions and methodology underlying a proposed rule; and to provide critical factual material related to its proposal.[67]

1. <u>Problems with risk weights</u>

As a fundamental element of the proposal's new standardized measure for market risk, the proposal would establish a new "sensitivities-based" capital requirement for market risk, pursuant to which a bank would be required to identify several types of risk for each trading portfolio, including interest rate risk, credit spread risk, equity risk, commodity risk, and foreign exchange risk.[68] Although these calculations are complex, they basically require a bank to calculate and aggregate three specific risk measures (delta risk, vega risk, and curvature risk) pursuant to a methodology that includes both prescribed mathematical formulas and an intricate array of risk weights. To that end, the proposal specified different risk weights to be used for this purpose, which vary based on remarkably fine distinctions in risk type.[69] For example, in the context of commodity risk, the risk weight to be applied

---

[66] For example, Professor Saunders has detailed several elements of the proposal with respect to market risk that lack empirical justification. *See* Saunders Comment at 31-35.

[67] *See* Part II above.

[68] *See* Proposal at § _.206 *et seq.* This "sensitivities-based" requirement is then aggregated with separate capital requirements for default risk and residual risk, which together form the basis of the "standardized measure for market risk." *See id.*

[69] *See* Proposal at § _.207.

varies depending on whether an energy commodity is liquid or combustible; in the context of an equity security, the risk weight varies depending on whether the company issuing the security is in an “emerging” or “liquid” (i.e., developed) market and on the sector in which the company operates (e.g., the consumer goods and services, telecommunications, or mining and quarrying sectors).[70]

However, *the proposal provides no discussion of how those risk weights were determined*. Nor does it explain what data the agencies consulted or what kinds of assumptions these choices reflect about the volatility of these risks, the time horizon over which risks should be measured, or the relative confidence interval adopted for measurement. In the absence of any data or analysis provided to support them, these risk weights appear entirely arbitrary. To the extent the proposal is the product of an analysis that is not disclosed, it is impossible for the public to meaningfully comment on the key assumptions underlying the agencies’ choices.

Similar issues arise in the context of the proposal’s approach to CVA risk. For example, in order to calculate capital requirements for CVA risk under the proposed “Basic Approach,” banks would be required to determine the industrial sector of the counterparty (e.g., financial, technology, or health care), each of which would be assigned a different risk weight under the proposal. The applicable risk weight then factors into the calculation of the CVA risk associated with the exposure, and thus would be a determinant of the exposure’s capital requirement for CVA risk.[71] To support the risk weights assigned to each sector, the proposal simply provides that “[the proposed risk weights] reflect the potential variability of credit spreads based on a combination of the sector and credit quality of the counterparty or of the eligible hedge reference entity,”[72] but fails to explain how the agencies measured such variability or calibrated the risk weights based on it.[73] Thus, there is no way to know how the agencies have concluded, as either an absolute or relative matter, that technology counterparties present one level of risk and health care counterparties present a different level of risk. Absent this information, it is impossible for the public to assess whether the risk weights are appropriate or to understand why the agencies chose them.

2. <u>Problems with liquidity assumptions</u>

The proposal’s new “models-based measure” for market risk contains several assumptions about the length of time, measured in days, that would be required before a particular asset or exposure could be sold or hedged—the “liquidity horizon” of a position. Put simply, the liquidity horizon is a measure of the liquidity of the general market for that asset or exposure, with less liquid assets or exposures drawing a higher capital charge. For example, equity securities issued by large companies are assumed to have a liquidity horizon of 10 days – meaning, they can be sold within 10 days under stress – and equity securities issued by small companies are assumed to have a liquidity horizon of 20 days.[74] Debt securities issued by investment grade borrowers are assumed to have a liquidity horizon of 40 days, and those issued by non-

---

[70] *See id.*

[71] Proposal at § _.211.

[72] Proposal at 64156.

[73] The Proposal notes that the proposed risk weights “match the risk weights set out in the SA-CVA for counterparty credit spread risk class,” but fails to articulate the connection between these two sets of risk weights, or to independently justify the calibration of the SA-CVA weights. *See* Proposal at 64119.

[74] *See* Proposal at § _.215.

investment grade borrowers are assumed to have a liquidity horizon of 60 days.[75] The proposal offers no data, historical experience, or analysis to justify either these liquidity horizons or the assumptions about the liquidity of the relevant markets they reflect, which are more stringent than current rules, and so they appear to be entirely arbitrary. Yet the impact of the choices about liquidity are highly consequential; for example, in the context of market risk for an equity security issued by a small company, the proposed 20-day liquidity horizon would produce a 40 percent increase in the capital requirement relative to the current rules, which are based on a 10-day period.

3. Problems with correlation assumptions

A crucial part of the proposal's new "models-based measure" for market risk is the calculation of a special capital measure for "non-modellable risk factors," which is presumably intended to capture various market risks that cannot be estimated using bank models.[76] In simplified terms, this aspect of the proposal requires a bank to calculate this capital measure for each non-modellable risk factor using a stress scenario that is intended to capture certain tail risks using a standardized mathematical formula specified in the proposal. That formula is in turn based on seven identified inputs, one of which is referred to as the "ρ factor" – effectively, a uniform multiplier that is set in the proposal at 0.6. While seemingly arcane and minor, this supervisory ρ factor is a crucial determinant of the actual capital measure produced by this formula; however, the proposal contains no discussion, explanation, or justification for how or why a ρ factor of 0.6 was chosen. Instead, the proposal simply asserts that the calculation "would allow for a limited and appropriate diversification benefit that depends on the level of ρ parameter."[77] Commenters have no basis whatsoever on which to assess whether that factor is too high or too low. This arbitrary and unsupported choice has major practical consequences; for a large set of non-modeled risk factors with market risk losses of about the same magnitude, a small change in this supervisory factor from 0.6 to 0.4 would decrease the resulting market capital requirement by about 33 percent.

4. Problems with testing parameters

An important aspect of the proposal's new "models-based measure" for market risk is a series of testing parameters. Those parameters determine whether a bank may obtain and retain approval to use the models-based measure for particular trading desks. A bank must conduct both "backtesting" and "profit and loss attribution testing" at the trading desk level. For this purpose, backtesting generally involves the comparison of actual trading results with model-generated risk measures in order to test the accuracy of the models used by the bank to measure its market risk, and looks to identify backtesting "exceptions" where actual losses exceed losses predicted by the bank's models. Similarly, a profit and loss attribution ("PLA") test generally involves a comparison of the daily profit and loss estimates produced by a bank's trading desks models and the risk management models it uses to calculate the models-based measure for capital purposes, again with the goal of identifying material discrepancies between the two. If a bank fails either test, it may (i) become subject to a punitive supervisory increase in the models-based capital requirements, or (ii) be required to use the "standardized measure" for market risk for the relevant trading desk, which will generally be significantly higher.

---

[75] *See id.*

[76] We say "presumably" because the proposal includes no explanation whatsoever of why the agencies chose to impose a separate capital charge for non-modellable risk factors, or why those risk factors cannot be modelled.

[77] *See* Proposal at 64141.

Notwithstanding the significant stakes of these tests, the proposal provides no explanation of how these tests were designed and calibrated, or how the consequences of "failing" either test were determined. For example, in the context of backtesting, the proposal would require a bank to apply a capital multiplier, ranging from 1.5 to 2, based on the number of backtesting exceptions it has identified.[78] The proposal provides no explanation for the calibration of this range of multipliers, and no explanation of the relationship between the number of backtesting exceptions and actual market risk measurements. Here again, the stakes of this arbitrary and unsupported choice are high – application of the agencies' chosen multiplier can cause market risk capital requirements to vary by 33 percent.

In addition, failure to meet the PLA test compels a firm to switch from the models-based measure to a standardized method, with potentially sudden large changes in market risk capital requirements. Yet the proposal provides no discussion of how or why the PLA test's parameters were chosen; the agencies' decision as to when trading desk and risk management-level PLA models have diverged sufficiently to justify vastly higher standardized measures of capital is entirely unexamined and unexplained. These elements of the proposal are therefore arbitrary and capricious.

F. Other key elements of the proposed rule rely on a wide variety of data, analyses, and methodologies that appear to exist, but have not been made available to the public for review and comment.

Many aspects of the proposal employ mathematical and quantitative formulas, the purported goal of which is to accurately reflect the relative financial risk of various bank assets and exposures. Thus, one would expect that in formulating and issuing the proposal, the agencies would have clearly explained how they derived those formulas, including what data they relied upon in developing the formulas, how they tested those formulas for accuracy, and what key assumptions were made in establishing the methodology.

In many cases, as we have described above, the proposal contains no such supporting data or analysis at all. In others, however, the proposal suggests that the agencies made policy decisions on grounds that they have not made public, making meaningful review and comment impossible. For example:

- The proposal's new approach to operational risk employs a multiplier of 15, whereby a bank's average annual total net operational losses is multiplied by 15 in the course of calculating the "Internal Loss Multiplier" element of the firm's operational risk capital charge. The only explanation for choosing 15, as opposed to any other number, as the multiplier is that the rule "extrapolates from average annual total net operational losses the potential for unusually large losses," to "ensure" that banks "maintain[] sufficient capital."[79] But the proposed rule does not disclose to the public the analyses used to support a multiplier of 15; nor does it reveal what the agencies mean by "sufficient" and how they came to the conclusion that a multiplier of 15 would result in "sufficient" capital. And the consequences of this choice are high; changing the multiplier from 15 to 10 would reduce the capital requirements for operational risk by approximately 10 percent.

---

[78] *See* Proposal at 64141-64142.

[79] *See* Proposal at 64086.

- The proposal imposes counterparty credit risk capital requirements for SFTs (e.g., repo and securities lending transactions). The proposed rule includes "minimum haircut floors" that are calibrated based on "observed historical price volatilities as well as existing market and central bank haircut conventions."[80] These underlying data and analyses have not been made available to the public,[81] yet the consequences are significant; for most asset types, the minimum haircut floors create a cliff effect in which the resulting capital requirement can increase significantly if the minimum haircut is not met.

- Under the proposal's revised capital requirements for securitization exposures, the proposed rule would increase the "supervisory parameter p for securitizations that are not resecuritization exposures from 0.5 to 1.0" to offset the decrease in "risk weights applicable to certain underlying assets under the proposal . . . and the proposed reduction in the risk-weight floor under SEC-SA for securitization exposures that are not resecuritization exposures."[82] No analysis used to calibrate the increase in the "p" parameter to offset the decrease in credit risk weights has been made available to the public. The consequences are again significant, as changing the parameter p from 0.5 to 1 would approximately reduce the resulting capital requirement for securitizations in the banking book by more than 30 percent.

- Under another aspect of the proposal's revised capital requirements for securitization exposures, the proposed rule states that "[p]urchased credit protection through nth-to-default derivatives often does not correlate with the hedged exposure which inhibits the risk mitigating benefits of the instrument."[83] The agencies' data or analysis underlying this assertion about correlation has not been made available to the public.

These and other aspects of the proposal that rely on data, analysis, or conjecture that have been withheld from public view and comment are inconsistent with the agencies' obligation under the APA to identify and make available all studies, data, assumptions, methodologies, and critical factual information on which the proposal is based.

G. The proposed rule repeatedly relies on non-public analyses that are said to arise from the agencies' "supervisory experience" and related conclusory assertions.

The proposal's reliance on undisclosed data is compounded by its reliance on unexplained and unverifiable "supervisory experience" and related conclusory assertions for various aspects of the proposal.

For example, to justify using lower real estate valuations for purposes of calculating loan-to-value ratios (thereby resulting in higher risk weights), the proposed rule states that "[s]upervisory experience has shown that market values of real estate properties can be temporarily impacted by local market forces and

---

80 *See* Proposal at 64064.

81 In this instance, the reliance on secret data and/or experience is particularly puzzling, as public data is readily available that could be used to justify volatility assumptions in securities' values, and central bank haircut conventions are available on public websites.

82 *See* Proposal at 64070.

83 *See* Proposal at 64071.

using a value figure including such volatility would not reflect the long-term value of the real estate."[84] That experience is unexplained, as is the need for reliance on unexplained experience given that there is an enormous wealth of detailed public data concerning real estate values under a range of conditions and circumstances.

The proposed rule also relies on "supervisory experience" for specific changes, such as to justify applying higher risk weights to acquisition, development, and construction loans[85] than to other categories of real estate loans.[86] No analysis or any specifics of the agencies' "supervisory experience" have been made available to the public.

These and other aspects of the proposal that rely on undisclosed and unexplained supervisory experience are plainly inconsistent with the agencies' obligation under the APA to identify and make available all studies, data, assumptions and methodology, and critical factual material on which the proposed rule is based. An agency can "rel[y] on its own experience as factual support for its decision to promulgate a rule" only if the agency "adequately record[s] and explain[s] that experience on the record."[87]

H. Any data collected and analyzed by the Federal Reserve cannot support any final rule unless the agencies make that data and analysis available for public comment.

More than two months after the comment period began, the Federal Reserve distributed to the banks subject to the proposed rule a template to submit data on how much capital the rule would require them to hold against a range of loans and other exposures. That information is an essential prerequisite to (i) determining what effects a higher (or in theory, but only in theory, lower) capital would have on the cost and availability of bank credit and intermediation, and (ii) the resulting costs of the proposed rule.[88] Indeed, the agencies themselves noted how preliminary estimates of the impact of the proposed rule were insufficient for these purposes:

> First, these estimates heavily rely on banking organizations' Basel III QIS submissions. The Basel III QIS was conducted before the introduction of a U.S. notice of proposed rulemaking, and therefore is based on banking organizations' assumptions on how the Basel III reforms would be implemented in the United States. For market risk, the impact of the proposal further depends on banking organizations' assumptions on the degree to which they will pursue the internal

---

[84] *See* Proposal at 64047.

[85] An ADC exposure is an exposure secured by real estate for the purpose of acquiring, developing, or constructing residential or commercial real estate properties, as well as all land-development loans and all other land loans.

[86] *See* Proposal at 64051 (asserting that "supervisory experience has shown that ADC exposures have heightened risk compared to permanent commercial real estate exposures."); *see also, e.g.*, Proposal at 64056 (asserting that "supervisory experience suggests that obligors similar to those with charge cards have average credit utilization rates equal to approximately 10 percent").

[87] *Nat'l Tour Brokers Ass'n v. ICC*, 671 F.2d 528, 533 (D.C. Cir. 1982).

[88] While necessary, the data collection described by the agencies is not remotely sufficient in scope to remediate all procedural and substantive concerns with the rule, as described elsewhere in the letter.

> models versus the standardized approach and their success in obtaining approval for modeling.
>
> Second, for banking organizations that do not participate in Basel III monitoring exercises, the agencies' estimates are primarily based on banking organizations' regulatory filings, which do not include sufficient granularity for precise estimates. In cases where the proposed capital requirements are difficult to calculate because there is no formula to apply (in particular, the proposed market risk rule revisions), impact estimates are based on projections of the other banking organizations that submitted QIS reports.
>
> Third, estimates are based on banking organizations' balance sheets as of year-end 2021, and do not account for potential changes in banking structure, banking organization behavior, or market conditions since that point.[89]

Such an admittedly incomplete and crude assessment of the impact and effects of a proposed rule falls well short of what is required by the APA for a rulemaking, particularly one as consequential as the capital proposal. This presumably is why the agencies committed at the time the proposal was issued to undertake a QIS to produce data necessary to understand the effects of this proposal.[90]

The agencies, however, then took nearly three months to actually undertake such a data collection, and chose to set a deadline for bank submissions that is the same day on which public comments on the proposal are due.[91] This necessarily means that, absent reopening of the comment

---

[89] Proposal at 64168.

[90] For example, the staff memorandum provided to the Board of Governors requesting approving of the proposal stated that "[t]o refine the estimates of the effect of the proposals on capital requirements, staff expects to undertake a data collection following issuance of the proposal. Information gathered through this data collection would inform finalization of the rule." Memorandum from Staff of the Board of Governors of the Federal Reserve System to the Board of Governors of the Federal Reserve System (July 18, 2023), *available at* https://www.federalreserve.gov/aboutthefed/boardmeetings/gsib-memo-20230727.pdf. At the Board meeting where the proposal was discussed and approved, multiple staff members also described the need for further data collection, stating at various points that: (i) "[f]ollowing issuance of the proposal, staff plans to undertake a data collection. Such data collection would allow us to refine our estimates of the impact of the proposal. This information will inform finalization of the rule"; (ii) "[t]here's a very important trade-off between the benefit of increased resilience and the potential costs of having very strong capital requirements for all large firms. For that reason, we are going out and actively seeking comment on all aspects of the proposal . . . [and] we're also doing this additional data collection, which is not always something we do with every rulemaking. It is planned to be a fairly robust data collection, and that will really help us ensure that what we have proposed, whether or not that appropriately captures the risks of large firms' activities or if recalibration may be needed"; and (iii) "I would just emphasize and go back to the data collection that we are planning. So, the idea of trying to get estimates of the increases in capital for specific trading areas and sort of views from the industry and the public for particular areas where there might be a disproportionate impact would be certainly an emphasis that we would be looking to analyze subsequent to that data collection." Tr. Of July 27, 2023 Open Board Meeting, at 13, 15, and 17, *available at* https://www.federalreserve.gov/mediacenter/files/open-board-meeting-transcript-20230727.pdf. The Board's Vice Chair for Supervision stated to the Board at the meeting that "[w]e also intend to collect additional data to refine our estimates of the rule's effects." *Id.* at 4.

[91] *See* Press Release, Board of Governors of the Federal Reserve System, *Federal Reserve Board launches data*

period, the aggregate results of the QIS – which the agencies have already noted will inform the final rule – would not be made available to us (or any other commenters) for public review and comment prior to adoption of a final rule. Such a rushed and improper sequence is especially hard to understand in the broader context of the 2017 reforms to the Basel capital framework; after all, the agencies have taken *more than five years* to gather the requisite data and develop a proposal to implement those reforms.

As we have repeatedly noted to the agencies,[92] the current process would clearly violate the procedural standards of the APA.[93] Thus, unless such data and analysis is made public and the comment period reopened, any data collected and analysis performed on that data cannot provide any part of the basis for a final rule, and reliance on that data or analysis would constitute a violation of the APA.

Notably, the results of the data collection, even if included in a subsequent request for comment, would not remedy numerous other procedural and substantive flaws in the proposal. For example, although the requested data would quantify an estimate of how much additional capital the agencies are requiring banks to hold, it would do nothing to explain the legal or policy basis underpinning those requirements – for example, what legal standard the agencies are applying (e.g., what probability of default they are trying to achieve) or what historical data or other analysis was used to calibrate the risk weights. Thus, if the data collection shows that the proposed rule would increase capital requirements for a given exposure by, say, 15 percent, that information could be useful in determining the cost of the proposed rule; however, it does nothing to inform the question of whether 15 percent is an appropriate amount of capital to protect the bank from loss on that exposure. In other words, determining how much capital the proposal would require does not answer the question of how much capital the proposal ought to require. To answer that question, one would also need to know what historical loss rates on the exposure were, and what standard that loss history would be measured against.

We also note that an accurate data collection is necessary but not sufficient for conducting any type of reliable analysis of the proposal's broader economic impact, which would require estimating – after the data is collected – the behavior of banks as well as other economic actors in response to the proposal, and determining what impact that behavior would have on U.S. consumers and businesses and the

---

collection to gather more information from the banks affected by the large bank capital proposal it announced earlier this year (Oct. 20, 2023), *available at* https://www.federalreserve.gov/newsevents/pressreleases/bcreg20231020b.htm.

[92] *See* Letter of Oct. 13, 2023 from the Bank Policy Institute et al. to the Board of Governors of the Federal Reserve System et al.; Letter of Sept. 12, 2023 from the Bank Policy Institute et al. to the Board of Governors of the Federal Reserve System et al. [hereinafter the "Sept. 12 Letter"].

[93] As we explain in Part II above, under the APA's notice-and-comment requirements, all agencies have the "duty to identify and make available technical studies and data that [they] ha[ve] employed in reaching the decisions to propose particular rules." *Owner-Operator Independent Drivers Ass'n v. FMCSA*, 494 F.3d 188, 199 (D.C. Cir. 2007) (Garland, J.) (quotation marks and citation omitted) (applying 5 U.S.C. 553(b)(3), (c)). Agencies "must explain the assumptions and methodology" underlying a proposed rule "and, if the methodology is challenged, must provide a complete analytic defense." *Small Refiner Lead Phase-Down Task Force v. EPA*, 705 F.2d 506, 535 (D.C. Cir. 1983). And, where an agency omits some of the "critical factual material" and analyses from a proposed rule, it must disclose the material and then provide "further opportunity to comment." *Chamber of* Commerce *v. SEC*, 443 F.3d 890, 900–01 (D.C. Cir. 2006). Indeed, "[a]n agency commits serious procedural error when it fails to reveal portions of the technical basis for a proposed rule in time to allow for meaningful commentary." *Owner-Operator Independent Drivers Association*, 494 F.3d at 199 (quotation marks and citation omitted); *see also* Sept. 12 Letter at 6–7.

economy as a whole. Thus, the agencies' failure to properly conduct and sequence its data collection not only violates the procedural requirements of the APA but also renders any final rule arbitrary and capricious, as we describe in Part VI below, because the agencies have not conducted any meaningful assessment of the proposal's economic impacts. Simply, the agencies' collection and analysis of relevant data should have preceded and informed development of the proposal. The cart-before-the-horse process followed here compels reformulation and re-publication of a proposed rule – accompanied, next time, by the necessary supporting data and justification.

IV. The proposed rule's treatment of Basel Committee agreements is improper and arbitrary for multiple reasons.

A. The proposed rule unjustifiably incorporates most aspects of the Basel Committee's 2017 and 2019 revisions without any independent analysis, explanation, or support offered by the agencies themselves, and without revealing the data (if any) relied upon in reaching those agreements.

Nearly the entirety of the proposal relies in whole or in part upon decisions made by the Basel Committee in 2017 and 2019. This includes, for example, nearly all of the risk weights and associated criteria the proposal would establish for credit risk under the ERBA and nearly every formula, methodology, and detail of its proposed new market risk and operational risk capital requirements. 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 offered by the agencies themselves as part of the U.S. rulemaking process under the APA. This approach is arbitrary, capricious, and an abuse of agency discretion because 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, it was conducted more than five years ago, averaged results among quite different banks around the world, and included no analysis of the impact on a large number of 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.
>
> Take for example the business-indicator approach to operational-risk capital. The first Basel consultative document acknowledged that this approach 'does not lend itself to accurate application in the case of banks engaged predominantly in fee-based activities.' The second consultative document reiterated that the approach resulted in 'overcapitalization of banks with high fee revenues and expenses.' It also proposed a fix. But that fix was then quietly dropped from the

> final Basel III standards without public explanation. That leaves this proposal to take an approach that its own Basel Committee authors have said does not work.
>
> Another example: The specification of the operational-risk-capital formula and the sizing of the scaling factor and other coefficients have a significant impact on capital requirements. Helpfully, the annexes to the two consultative papers provide good insight into the early thinking of the subject-matter experts who participated in the Basel process. Unhelpfully, the Basel Committee quietly made considerable changes to the formula's coefficients between the last consultative paper and the final Basel III standards without public explanation. That leaves this proposal unable to offer any rationale for the sizing of these coefficients.
>
> A final example: To be eligible for the reduced credit-risk-capital requirement for investment-grade corporate exposures, the company (or its parent) must have securities outstanding on a recognized securities exchange. The Basel Committee has offered no rationale for concluding that having a publicly listed security correlates strongly with a company's capacity to meet financial commitments. [94]

The Basel Committee agreements are not treaties. The 2017 and 2019 agreements were never reviewed by Congress; nor were they even subject to any formal review or approval by the full Federal Reserve Board, the OCC, or the Federal Deposit Insurance Corporation. Nonetheless, the agencies very clearly indicated in public statements that they had already determined to implement the Basel Committee agreements well in advance of rulemaking under the APA. [95] Because the agencies have proposed to do so

---

[94] McKernan Dissent (internal citations omitted).

[95] For example, in a joint press release in September of 2022, the Federal Reserve, OCC, and FDIC stated that "Federal bank regulatory agencies today reaffirmed their commitment to implementing enhanced regulatory capital requirements that align with the final set of 'Basel III' standards issued by the Basel Committee on Banking Supervision in December 2017. The implementation of these standards for large banking organizations would strengthen the resilience of the domestic banking system and is a priority for the agencies." Board of Governors of the Federal Reserve System et al., *Agencies reaffirm commitment to Basel III standards* (Sept. 9, 2022), *available at* https://www.federalreserve.gov/newsevents/pressreleases/bcreg20220909a.htm. Similarly, in a September 2022 speech, Federal Reserve Board Vice Chair for Supervision Michael Barr indicated that "[w]ithin [the context of a holistic capital review], I am also committed to implementing enhanced regulatory capital requirements that align with the final set of 'Basel III' standards or the so-called the 'Basel endgame.'"[95] Michael Barr, Vice Chair for Supervision, Board of Governors of the Federal Reserve System, *Speech at the Brookings Institution: Making the Financial System Safer and Fairer* (Sept. 7, 2022), *available at* https://www.federalreserve.gov/newsevents/speech/barr20220907a.htm. In a June 2023 speech, FDIC Chairman Martin Gruenberg noted "Basel III finalization and implementation is a top priority for the FDIC and all of the federal banking agencies."[95] Martin J. Gruenberg, Chairman, Fed. Deposit Ins. Corp., *Speech at the Peterson Institute For International Economics on the Basel III Endgame* (June 22, 2023), *available at* https://www.fdic.gov/news/speeches/2023/spjun2223.html. And in May 2023 Senate testimony, Acting Comptroller of the Currency Michael Hsu indicated that "[t]he OCC remains committed to implementing the enhanced regulatory capital requirements that align with the final set of Basel III standards, and it is important that we move forward as soon as possible." *Oversight of Financial Regulators: Financial Stability, Supervision, and Consumer Protection in the Wake of Recent Bank Failures: Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs*, 118th Cong. 5 (2023) (statement of Michael J. Hsu, Acting Comptroller of the Currency), *available at* https://www.banking.senate.gov/imo/media/doc/Hsu%20Testimony%205-18-23.pdf.

without any independent analysis, explanation, or support offered by the agencies themselves as part of the U.S. rulemaking process, the proposal is arbitrary, capricious, and in violation of requirements for notice and comment.[96]

Furthermore, the Basel Committee in 2017 and 2019 considered only a small subset of U.S. banks that would be subject to the proposal. The very different frame of reference used by the Basel Committee to reach its decisions is perhaps best illustrated by the "quantitative impact study" that the Basel Committee conducted to inform and calibrate its 2017 agreement and released in December 2017 when that agreement was published. The Basel Committee noted that this study was based on "[d]ata [that] were provided for a total of 248 banks, including 96 large internationally active ('Group 1') banks and 152 other ('Group 2') banks."[97] Of this cohort, only *12* of the 96 Group 1 banks were U.S. institutions, and *none* of the Group 2 banks were U.S. institutions.[98] As a result, U.S. banks composed *less than 5 percent* of the sample set of the Basel Committee's principal empirical work to analyze the impact and inform the final shape and calibration of its 2017 agreement. The agencies' implementation of Basel Committee decisions made in such a radically different context and frame of reference, without any independent analysis of the appropriateness of those decisions for U.S. banks and under U.S. law, is arbitrary and capricious.[99]

Finally, any evidence relied on by the Basel Committee is seriously outdated in light of intervening changes in the banking industry and the broader economy, and therefore would be insufficient basis for this rulemaking, if explicitly relied upon by the agencies.[100] These changes are significant in scale and scope, and include the economic, labor market, and supply chain shocks of the COVID-19 pandemic and recovery, significant inflation and rising interest rates in the U.S. and abroad, major changes in asset prices and risks, and significant geopolitical events. Thus, the agencies should have considered how the Basel

---

[96] The agencies' reliance on Basel Committee processes is inconsistent with the agencies' obligations under the APA because those processes do not meet, and may not act as a substitute for, the rulemaking procedures required by the APA. The Basel Committee's deliberations occur outside any U.S. notice and comment process, and although the Basel Committee frequently issues "consultative proposals" on which public comments are accepted, it has no legal or other obligation to consider or address these comments. Its deliberations do not occur in public, and there is no public record of what is said or of which member representatives support or oppose its decisions. Several of these key differences between the Basel Committee's processes and what the APA requires are highlighted above in FDIC Director McKernan's dissent.

[97] Basel Committee on Banking Supervision, *Basel III Monitoring Report: Results of the cumulative quantitative impact study*, 1 (Dec. 2017).

[98] *Id.* at 31. Notably, even this overstates the extent to which U.S. banks were considered in the study, as the study's analysis of credit risk impacts included data from only seven U.S. banks, its analysis of market risk impacts included data from only six banks, and its analysis of operational risk impacts included data from only 11 banks.

[99] For this reason, it also worth noting that while the largest U.S. banks were aware of the Basel process and in some cases commented on it, the great majority of banks subject to the current proposal did not, as it was never envisioned that banks as small as $100 billion in assets would be subjected to it. Furthermore, other commenters affected by the proposal never commented because in all likelihood they never knew such a process was under way. This is why *notice* as well as comment is a requirement of the APA. And of course, as noted above, the Basel Committee's processes are not a legal substitute for the procedural requirements of the APA.

[100] *Dow AgroSciences LLC v. Nat'l Marine Fisheries Serv.*, 707 F.3d 462, 473 (4th Cir. 2013) ("The Fisheries Service recognized that it was relying on outdated data and that it had been presented with more recent data, but it chose to continue relying on the outdated data without explaining why."); *Sierra Club v. EPA*, 671 F.3d 955, 966 (9th Cir. 2012) ("[An agency] stands on shaky legal ground relying on significantly outdated data.").

Committee's conclusions align (or not) with updated data and analysis that was unavailable to the Basel Committee, but the agencies failed to undertake any such work notwithstanding the nearly six intervening years they have had to do so. It is worth nothing that, as we describe in Part III.D above, other jurisdictions have made sensible changes to the Basel agreement in their adoptions. It is only the U.S. agencies that have generally treated the agreement as a floor, and departed from it in ways that almost always results in more stringent requirements for banks operating in the U.S.

In sum, despite the APA's requirement that *the agency* "consider[] the relevant factors,"[101] the banking regulators appear to have wholly relied on deliberations and decisions of a separate body – a body that reached its decisions in a very different context–rather than themselves offer independent analysis, explanation, and support in accordance with U.S. law and the U.S. rulemaking process. That is not only arbitrary and capricious, but also in violation of the APA's procedural obligations. And even if the regulators had conducted an independent assessment, none of that analysis and reasoning has been made available for public review, comment, and challenge, as the APA demands.

B. The proposed rule also departs from the requirements of the Basel agreements in unexplained and inconsistent ways.

The extent to which the proposal relies on Basel Committee decisions and analysis (rather than provide the agencies' own independent analysis and support) is all the more curious when juxtaposed with the significant ways in which the proposal deviates from the 2017 Basel Committee standards without explanation. Put another way, the proposal does not appear to reflect any consistent and intentional policy to align with international standards, but rather a haphazard approach whereby the decisions of the Basel Committee are sometimes invoked and sometimes repudiated with no explanation whatsoever, with the result almost always (and arbitrarily) in favor of increasing capital requirements.

For example, the proposal states that "[r]equirements under the proposal would generally be consistent with international capital standards issued by the Basel Committee, commonly known as the Basel III reforms" – presumably endorsing such consistency as a policy goal – but then asserts that "[w]here appropriate, the proposal differs from the Basel III reforms to reflect, for example, specific characteristics of U.S. markets, requirements under U.S. generally accepted accounting principles (GAAP), practices of U.S. banking organizations, and U.S. legal requirements and policy objectives."[102] Yet nowhere in the proposal is there any description of any specific characteristics of U.S. markets, accounting standards, banking practices, or legal requirements to justify deviations from the Basel standard. Instead, where the proposal differs from international standards, no explanation, analysis, or support for those deviations is provided. There are numerous examples in the proposal of such inconsistencies:

- As we discuss in greater detail in Parts III.C above and IX.A below, the proposal wholly ignores the principal element of the 2017 Basel Committee standards, which is the preservation of an internal models–based approach to calculating RWAs for credit risk, subject to improvements to that approach and an "output floor" designed to constrain overall variability in modeled bank outcomes. This approach was adopted by the Basel Committee in 2017 and has been (or is in the process of being) implemented in the United Kingdom, the European Union, and every

---

[101] *State Farm*, 463 U.S. at 43.

[102] *See* Proposal at 64030.

other major banking center.[103] It is incredible that a proposal that purports to implement the Basel Committee's 2017 agreement and seeks to "be consistent" with that agreement does *not even discuss*, let alone thoughtfully consider, a central element of that agreement. And the consequences are massive, as this decision ultimately increases the regulatory costs of more than $8.3 trillion in loans of all types made by affected banks. It is difficult to imagine a clearer violation of the APA's requirement to consider "significant and viable and obvious alternatives" than the agencies' failure to consider the use of internal models as provided for in an agreement *that their own staff members negotiated and supported at the Basel Committee, and which has been implemented by every other major jurisdiction to consider the matter.*

- In an arbitrary way, the proposal begins with the risk weights assigned to mortgage loans by the Basel Committee in 2017 and then adds 20 percentage points to each. As a result, credit-risk-capital requirements for a residential real estate exposure would be up to twice as large as those contemplated by the Basel III standards.[104] Yet no data is provided to explain or justify either use of Basel Committee risk weights as a starting point or the added 20 percentage points for U.S. mortgage loans only, notwithstanding the wealth of data available on the relative risks of such loans (as described in Part III.A above). The stakes of this decision are again meaningful, as the agencies' decision to deviate from Basel standards results in higher regulatory costs for more than $2 trillion in residential mortgage loans made by affected banks.

- The proposal would establish risk weights for retail exposures, which include credit and charge card loans, student loans, and auto loans. Yet here again, the agencies took unsupported Basel Committee risk weights and arbitrarily added 10 percentage points to each, on the basis of no evidence or data that has been provided to the public, notwithstanding the plentiful data available (as described in Part III.A above). The decision to deviate from Basel standards results in higher regulatory costs for more than $1.6 trillion in consumer loans made by affected banks.

Of course, each and every one of these deviations has the result of *increasing* the capital requirements applicable to covered U.S. banks relative to the 2017 Basel Committee agreement and, in many cases, relative to the status quo (particularly when the effective risk weights associated with the operational risk charge are considered). This result is impossible to square with the Basel Committee standards the proposal purports to implement, as increasing overall capital requirements was *not* a goal of the Basel Committee's 2017 changes; indeed, *avoiding such an increase* was a primary objective. As Mario Draghi (then-ECB President and Chair of the Group of Governors and Heads of Supervision) emphasized at the press conference announcing the 2017 Basel agreement, "[t]he focus of the exercise was not to increase capital. As a matter of fact, the [the governors of the central banks and heads of supervision at the agencies represented at Basel] 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."[105] At the time the agreement was announced, Secretary Mnuchin stated that it would "help level the playing field

---

[103] *See* Basel Adoption Report.

[104] *See* McKernan Dissent.

[105] *Global Heads of Supervision media conference*, Bank for Int'l Settlements (Dec. 7, 2017), https://www.bis.org/bcbs/b3/ghos_20171207_2.htm.

for U.S. firms and businesses operating internationally." [106]

Although most international jurisdictions moved promptly to implement the Basel Committee's 2017 changes, [107] the agencies took more than five years to propose to do so. Yet the result of that long process, represented by the proposal here, reflects a strange, hodgepodge approach to implementation that in many cases adopts the provisions of Basel agreement without providing any support or analysis, but deviates from the agreement (almost always upwards) without explanation in others. The result is a dramatic increase in capital requirements for U.S. banks – precisely the type of increase that the Basel Committee's 2017 revisions were conditioned on avoiding.

It is also impossible to square the proposal with the Basel Committee's foundational goal as defined in its charter – "ensuring [the] timely, consistent and effective implementation [of the Basel Committee standards] and contributing to a 'level playing field' among internationally active banks"[108] – as well as other articulated goals of the 2017 Basel Committee agreement. For example, in announcing the 2017 agreement, the Basel Committee noted that it would "reduce excessive variability in risk-weighted assets and [would] improve the comparability and transparency of banks' risk-based capital ratios."[109] Yet the proposal's deviations from the 2017 standards frustrate that very goal, as U.S. banks would have different (and almost always higher) risk weights for many assets and exposures. Similarly, the Basel Committee also emphasized the "important task of ensuring the standards are implemented consistently around the world."[110] The proposed U.S. deviations would undermine any such consistency.[111] And finally, the Basel Committee also noted that a key objective of its revised risk weights for credit risk was to "allay level-playing-field concerns and ensure equal risks attract similar capital requirements."[112] This objective, too, would be undermined by the proposal, as imposing higher risk weights on banks in the United States would necessarily result in higher capital requirements for them compared to international peers.

The proposed rule's approach to the Basel standards – adopting some while forgoing others without elaboration – renders the rule arbitrary and capricious for at least two reasons. First, the approach leaves the rule with arbitrary and "unexplained inconsistencies."[113] Second, the regulators have adopted standards that *increase* the regulatory burdens on banks operating in the U.S., thus putting them

---

[106] Press Release, U.S. Dep't of the Treas., Treasury Secretary Mnuchin's Statement on Basel III (Dec. 7, 2017), https://home.treasury.gov/news/press-releases/sm0232.

[107] *See* Basel Adoption Report.

[108] Basel Committee Charter (updated June 2018) at § 2.e.

[109] Press Release, Basel Committee on Banking Supervision, Governors and Heads of Supervision finalise Basel III reforms (Dec. 2017).

[110] *Id.*

[111] While it is true that Basel Committee standards are generally styled as minimum requirements, such that individual jurisdictions may impose more stringent requirements and still be deemed "compliant" with Basel Committee standards, this does not change the simple fact that when any jurisdiction does so, the result are local requirements that are different than, and thus plainly inconsistent with, the requirements of the relevant Basel Committee standard and of other jurisdictions that have implemented those standards without making them more stringent.

[112] Basel Committee on Banking Supervision, *Revisions to the Standardised Approach for credit risk* (Dec. 2015) at 22.

[113] *Dist. Hosp. Partners, L.P. v. Burwell*, 786 F.3d 46, 59 (D.C. Cir. 2015).

at a competitive disadvantage relative to foreign banks. This will have harmful effects on banks operating in the U.S., investors, and markets, and conflicts with Basel III's core purpose of achieving greater international harmonization. Yet the agencies have failed to acknowledge, much less "consider," this "important aspect of the problem."[114] That too is arbitrary and capricious and likely to result in a final rule's vacatur if the agencies do not correct these mistakes.

Finally, it is worth noting that there are several important "U.S. legal requirements" of the type identified by the agencies that argue for a different approach than that agreed in Basel but that have not been adequately considered by the agencies. These include the existence of a stress testing and stress capital buffer framework unique to the U.S.; a more stringent enhanced supplementary leverage ratio in the U.S.; and a U.S. GSIB surcharge that effectively doubles the Basel Committee standard. Of course, each of these U.S. regulatory requirements argues for a lower, not higher, U.S. calibration than that agreed to by the Basel Committee. It is patently arbitrary for the agencies to ignore these unique U.S. facts after noting that they are relevant, while simultaneously deviating from Basel in other ways designed to increase capital requirements above what Basel would require.

V. The proposed rule is arbitrary, capricious, and an abuse of agency discretion because it fails to consider many other important aspects of the problem.

A separate but significant way in which the proposal is arbitrary and capricious is the remarkable extent to which it fails to consider important and readily apparent policy matters directly relevant to the proposal. This letter provides below some of the most significant examples, but numerous other examples are also identified and discussed in our forthcoming companion letter.

A. The proposed rule does not account for the fact that the new capital requirements would largely duplicate the capitalization of risks that are already captured by the Federal Reserve's stress-test framework.

The proposal would result in significantly higher effective capital requirements under the ERBA 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. The only acknowledgement of the overlap is this statement:

> As part of the capital buffer framework, the stress capital buffer requirement helps ensure that a banking organization can withstand losses from a severely adverse scenario, while still meeting its minimum regulatory capital requirements and thereby continuing to serve as a viable financial intermediary. Because this proposal aims to better reflect the risk of banking organizations' exposures in the calculation of risk-weighted assets, without changing the targeted level of conservatism of the minimum capital requirements, the Board is not proposing associated changes to the targeted severity of the stress capital buffer requirement. The Board evaluates the minimum risk-based capital requirements, which are largely determined by risk-weighted assets, and the stress capital buffer requirement individually for their specific intended purposes in the capital

[114] *State Farm*, 463 U.S. at 43.

> framework, and holistically as they determine the aggregate capital banking organizations hold in the normal course of business.[115]

Thus, the agencies appear to maintain that because the proposal is designed to define minimum capital requirements while the stress capital buffer is designed to ensure that banks can survive a severely adverse scenario, the two elements serve different purposes and their calibration can be handled separately.[116] This framing is inaccurate. Risk-weighted assets are the denominator both for minimum requirements and for buffer requirements, and are therefore relevant for each and every risk-based requirement, including the stress capital buffer. Both elements (binding ratios and total risk-weighted assets) jointly determine the total capital requirement. A bank's total capital requirement is based on risk-weighted assets under both the static measure and the stress capital buffer. Therefore, calibrating them independently is arbitrary and capricious.

The agencies' contention that the ERBA and the Federal Reserve's stress test are doing different work is belied by the basic purposes of those regimes. As defined by the Federal Reserve, market risk is "the risk of loss on a position that could result from movements in market prices."[117] Both the existing Global Market Shock ("GMS") component of the Federal Reserve's stress testing framework and the proposed rule are designed to require firms to capitalize for this risk. The respective designs of the proposal's approach to market risk and the Federal Reserve's GMS bear striking similarities: both are designed to assess a bank's ability to withstand a period of extreme market stress over a long duration; both are designed to shock trading positions at high confidence levels; and both have bigger shocks for asset classes with longer assumed liquidation periods.[118] Analysis based on publicly available data supports the view that the proposal's approach to market risk and the GMS are duplicative – that is, they are expressly 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 over.[119] Professor Saunders also highlights ways in which the GMS and the proposed market risk elements of ERBA are redundant and concludes, "it is

---

[115] Proposal at 64035.

[116] Under the newly proposed framework, risk-weighted assets for market risk will be determined based on stress conditions. Consequently, should the economy enter a period of severe stress, the risk-weighted assets for market risk would remain stable under the proposed framework and banks' capital ratios would not decline. Therefore, the lack of procyclicality of the proposed framework for market risk would necessitate a lower stress capital buffer for market risk, assuming all other factors are unchanged.

[117] *See* 12 C.F.R. § 217.202.

[118] 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.

[119] 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/.

unclear why market risk capital requirements need to increase so drastically, further reducing liquidity, market making activity, and depth of the U.S. securities markets."[120] Despite these similarities and the important questions raised by stakeholders, the proposal does not consider the interplay between the GMS and the proposed rule and thus arbitrarily "fail[s] to account" for an important aspect of the problem.[121]

Similar issues arise in the context of the proposal's treatment of operational risks relative to the capitalization of those risks 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 maybe incurred by a firm.[122] 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.[123] Professor Saunders highlights a similar issue in his comment.[124]

B. The proposal fails to consider the lack of correlation or negative correlation among the credit, market, operational, and others risks for which it would impose capital charges on a summary bias.

The proposal would impose capital charges for a wide range of risks, including credit risk, operational risk, market risk, and CVA risk, on a purely aggregate basis. That is, it would assume that all of such risks would arise and impose losses on covered banks at the same time under a single set of conditions, effectively assuming that all such risks are perfectly correlated. As we describe below, this assumption is inconsistent with the available evidence, which strongly suggests a fatal problem with the proposal that it does not acknowledge, let alone thoughtfully consider and resolve.

The proposed rule's calculation of regulatory capital involves summing risk-weighted assets arising from credit risk, market risk, operational risk, and CVA risk. This method presumes that extreme losses in credit, market, operational, and banks' counterparties will all occur simultaneously, with a correlation of 1.0. Under the 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' counterparties. This scenario is extraordinarily unlikely and without historical precedent, and not justified in the proposal.[125]

---

[120] *See* Saunders Comment at 40.

[121] *Alliance for Hippocratic Medicine v. FDA*, 78 F.4th 210, 246–47 (5th Cir. 2023).

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

[123] 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/.

[124] *See* Saunders Comment at 37-38.

[125] Rosenberg and Schuermann estimate that risk-weighted assets and therefore capital requirements could be overstated by about 30 to 40 percent. Joshua Rosenberg and Til Schuermann, *A general approach to integrated risk management with skewed, fat-tailed risks*, 79 J. of Fin'l Economics 3, 569-614 (2006).

In dissenting from the proposed rule, one governor of the Federal Reserve Board explained the problem clearly:

> Just to put some numbers on it, consider operational risk. Operational risk expense projections in the stress test have been just under $200 billion over the past few years. The impact analysis in the proposal suggests the enhanced standardized capital stack will have operational risk weighted assets that are nearly $2 trillion higher than in the current U.S. standardized stack, which could lead to a more than doubling of the operational risk capital required relative to just the stress test-based requirement.
>
> More importantly, there 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 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.[126]

The proposal's failure to consider the relationship among different risk types also represents a marked change in the agencies' policy, as the proposal would introduce, for the very first time, an operational risk capital charge that is added to credit risk capital charges calculated using standardized risk weights rather than internal models. In prior rulemakings, the agencies have expressly declined to add incremental operational risk capital charges to risk-weighted assets calculated using 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."[127] 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. But it would deviate from that approach by adding, under the new ERBA, an additional direct operational risk capital charge to risk weighted assets

---

[126] 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.

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

calculated using the ERBA's new standardized risk weights for credit risk, without recalibration of those risk weights to reflect the fact that operational risks would now be subject to a dedicated capital charge.

If operational risk remains implicitly covered by the ERBA's new credit risk weights, then the addition of an operational risk charge is duplicative, illogical, and inappropriate. Yet the proposal provides no evidence or explanation that suggests that the ERBA's new credit risk weights have been calibrated to quantify and subtract from those risk weights any portion of the risk weight that is captured by the ERBA's operational risk capital charge. Neither the proposal nor the Basel Committee's work in connection with its 2017 revisions contains any description of the relationship between the ERBA's risk weights and operational risk, nor does the proposal contain any statement addressing how these risk weights were calibrated to remove implicit coverage of operational risk. Indeed, as we detail in Part III.A above, *the proposal contains no discussion of how the ERBA's risk weights were calibrated at all*. Thus, the proposal and available evidence indicate that the agencies have reversed their prior policy on the relationship between operational risk and credit risk weights for no stated reason at all. This unexplained and unwarranted change is arbitrary and capricious under the APA; as courts have recognized, agencies must "show that [a] new policy is permissible . . . , that there are good reasons for it, and that the agency believes it to be better than the previous policy."[128] Here, the agencies have failed to acknowledge the change or explain why the new policy is better than the previous policy.

C. The proposal fails to meaningfully consider the concrete competitive and market consequences of subjecting different banks to different capital requirements for identical loans, assets and activities.

Another unusual feature of the proposal is the fact that it would result in the application of different capital risk weights to identical assets and exposures depending on whether they are held by (i) a bank not subject to the proposal, which would remain subject to existing standardized risk weights only, (ii) a bank that is subject to the proposal but "bound" by the existing standardized approach (and thus its existing risk weights) because the proposal provides that the higher of the two is the binding constraint, and (iii) a bank that is subject to the proposal and "bound" by the new ERBA (and thus its new risk weights). These differences would result in very different regulatory costs for banks that wish to engage in specific lending and other activities depending on which of these categories they fall into, and indeed a bank subject to the proposal could find itself bound by one standardized approach one year (e.g., the existing standardized approach) and another the next (e.g., the ERBA). That in turn is certain to have competitive and market consequences as certain banks face higher or lower capital charges when undertaking identical activity.

Oddly, the proposal appears to acknowledge this problem on a limited basis – but as justification for its arbitrary increase of certain residential risk weights relative to the 2017 Basel Committee standards:

> [T]he proposal attempts to mitigate potential competitive effects between U.S. banking organizations by adjusting the U.S. implementation of the Basel III reforms, specifically by raising the risk weights for residential real estate and retail credit exposures. Without the adjustment relative to Basel III risk weights in this

[128] *Am. Fed'n of Gov't Emps. v. FLRA*, 25 F.4th 1, 5 (D.C. Cir. 2022); *see Physicians for Soc. Resp. v. Wheeler*, 956 F.3d 634, 644 (D.C. Cir. 2020) ("Reasoned decision-making requires that when departing from precedents or practices, an agency must offer a reason to distinguish them or explain its apparent rejection of their approach." (quotation marks omitted)).

> proposal, marginal funding costs on residential real estate and retail credit exposures for many large banking organizations could have been substantially lower than for smaller organizations not subject to the proposal. Though the larger organizations would have still been subject to higher overall capital requirements, the lower marginal funding costs could have created a competitive disadvantage for smaller firms.[129]

This statement clearly concedes that differences in risk weights among banks differently affected by the proposal can affect marginal funding costs for affected activities and thus give rise to competitive advantages. Yet the proposal does not grapple at all with the far more significant manifestation of this problem. Specifically, the proposal would systemically result in higher capital requirements for banks subject to the proposal across all their activities relative to all other banks operating in the U.S., a vastly larger source of potential competitive disadvantage than the residential risk weights. The proposal does not even acknowledge, let alone attempt to mitigate, this issue. Instead, the proposal would impose systematically higher capital requirements on one set of banks and then make a portion of those requirements higher still, all in the name of not disadvantaging banks with systematically lower capital requirements.

The proposal also does not acknowledge, let alone address, the likely impact of the availability of different banking products to different consumers as the proposal imposes significantly different regulatory costs across different bank and nonbank cohorts for the same activities and services. For example, as we discuss in more detail in Part V.E. below, the higher capital charges for banks on mortgage and retail loans will further exacerbate the migration of such lending to nonbanks.[130] The agencies' failure to consider these problems is arbitrary and capricious.[131]

D. The proposal fails to meaningfully consider the practical and policy problems associated with subjecting larger banks to two differently calculated capital requirements for identical loans, assets, and activities.

The proposal's refusal to choose a single view of how risk should be determined for purposes of risk-weighting assets also poses serious conceptual problems as applied to those banks that would become, under the proposal, subject to both (i) the existing standardized approach to calculating RWAs and (ii) the ERBA, and be bound by the more stringent of the two. One agency principal succinctly captured the cognitive dissonance of this policy choice in dissenting from the proposal's issuance:

> This dual-requirement structure forgoes an opportunity to simplify an already complicated capital framework. The dual-requirement structure also introduces internal inconsistencies that compound into incoherence. Some large banks would have one capital requirement for a securitization exposure, while other large banks would have a different capital requirement for the same exposure. Some large banks would use one set of criteria for determining when an exposure is in default, while other large banks would use a different set of criteria. Some

---

[129] Proposal at 64170.

[130] 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/.

[131] *E.g.*, *W. Watersheds Proj. v. Kraayenbrink*, 632 F.3d 472, 493 (9th Cir. 2011).

> large banks would apply one haircut to certain collateral, while other large banks would apply a different haircut. Some large banks would apply one credit-conversion factor to a commitment, while other large banks would apply a different one. And so on. Some large banks would find their holding company subject to one approach and their bank subsidiary subject to the other approach. Some large banks would find themselves alternating between the two approaches across the business cycle. Extraneous events could even lead to bizarre outcomes. Take for example a bank bound by the standardized approach. Assume that the bank incurs a large penalty under an enforcement action relating to consumer compliance issues, which would increase the bank's operational-risk capital under the expanded risk-based approach. If that increase were large enough, the bank would become bound by the expanded risk-based approach. The result? Reduced credit-risk-capital requirements for some residential real estate and retail exposures. Why should an enforcement action lead to reduced credit-risk-capital requirements?[132]

These are excellent questions, and reflect important practical and conceptual problems that the agencies can and should have considered and addressed in the proposal. Yet the proposal does not acknowledge this problem, let alone thoughtfully describe how these concerns could be mitigated or why they are justified in light of other benefits of the dual-requirement structure. Of course, this also means that the public has no meaningful opportunity to review and provide comment on the agencies' thinking as concerns this problem. By failing to consider this important part of the problem of the dual-requirement approach, the proposal is arbitrary and capricious. This failure, too, underscores that the proposed rule lacks the "reasoned decision making" that the APA requires.[133]

Although the agencies do not attempt to justify the application of different capital risk weights to different cohorts of banks, if pressed, they may attempt to assert that Section 171 of the Dodd-Frank Act, also known as the "Collins Amendment" requires this treatment, but that would not be a fair reading of the statute. The Collins Amendment required the U.S. banking agencies to establish minimum leverage and risk-based capital requirements that were not less than the generally applicable leverage and risk-based capital requirements for insured depository institutions under the prompt corrective action regulations. They could also not be quantitatively lower than the requirements in effect for insured depository institutions as of the date of enactment of the Dodd-Frank Act (July 21, 2010).

Essentially, the Collins Amendment has the effect of placing two "floors" on U.S. capital requirements – minimum standards for any subset of banks operating in the U.S. must be no less stringent than (i) those that apply to all insured depository institutions generally, which has been and remains the requirements based solely on standardized approaches; and (ii) those that applied to insured depository institutions as of July 2010. Thus, firms calculating their RWAs on the basis of internal models were (and continue to be) bound by the stack of capital requirements applicable to RWAs calculated using the existing standardized approach, which is the approach that applies to all insured depository institutions generally, thereby satisfying the first prong of the Collins Amendment. Now, the agencies are proposing to eliminate internal models, but instead of simply requiring all banks to calculate RWAs using a single standardized approach (whether that would be the existing U.S. standardized approach or the proposed

[132] McKernan Dissent.

[133] *State Farm*, 463 U.S. at 52.

ERBA), which would satisfy the Collins Amendment, the agencies are proposing, without explanation, that the largest firms calculate RWAs using two distinct standardized approaches. This is in no way required by the Collins Amendment, and, as noted above, is arbitrary and capricious in the absence of any consideration of, for example: (i) applying a single standardized approach, or (ii) other alternatives that would address the calibration and coherence issues that arise when both standardized approaches are applied as proposed.

E. The proposal fails to meaningfully consider the demonstrable financial stability risks and social costs of creating significant regulatory incentives for the shift of lending, capital markets, and other activities to less-regulated financial institutions.

Increases in capital requirements will raise the costs for banks to engage in lending and market-making activities. As a result of these higher costs, banks may cease providing the types of loans and services that are more capital-intensive, leading to the unintended consequence of incentivizing intermediation activities to shift to the less regulated shadow banking sector. Moreover, the transition of credit intermediation from banks to nonbanks can amplify the cyclicality of credit supply, as nonbank lenders do not make use of the same types of stable funding as banks and, consequently, may scale back lending during economic downturns.

The agencies should carefully study if risks will migrate outside the banking system if it increases capital requirements for banks as proposed. Cyclicality of the credit supply has been observed in nonbank lending within the syndicated loan market,[134] where nonbanks exhibit funding instability and hence much higher cyclicality in lending. It is also evident among small businesses, where nonbank lenders were unable to fund loans due to rising financing constraints.[135] Additionally, it has been demonstrated that shadow banks were less likely to provide a suspension of household debt payments during the COVID-19 pandemic.[136] Furthermore, the Financial Stability Board's holistic review of the March 2020 market turmoil noted that sales of U.S. Treasuries by leveraged nonbank entities exacerbated market dysfunction during the pandemic.[137]

The banking agencies have failed to consider this logical consequence of the approach in the proposed rule, which is yet another reason the proposed rule is arbitrary and capricious.[138]

---

[134] *See* Quirin Fleckenstein et al., *Nonbank Lending and Credit Cyclicality*, NYU Stern School of Business (June 17, 2020); Iñaki Aldasoro, Sebastian Doerr and Haonan Zhou, *Non-bank lending during crises* (BIS Working Paper No. 1074, February 2023).

[135] *See* Itzhak Ben-David, Mark Johnson and René Stulz, *Why Did Small Business FinTech Lending Dry Up During the COVID-19 Crisis?* (NBER Working Paper No. 29205, Nov. 2022).

[136] *See* Susan Cherry et al., *Government and Private Household Debt Relief During Covid-19*, Fall 2021 Brookings Papers on Economic Activity.

[137] *See* Financial Stability Board, *Holistic Review of the March Market Turmoil* (Nov. 2020).

[138] *State Farm*, 463 U.S. at 43.

F. The proposal fails to meaningfully consider potential tensions and inconsistencies between what the proposal would require and other existing legal requirements for banks.

Certain specific aspects of the proposal are inconsistent or in tension with other legal requirements imposed on banks, a problem the proposal does not identify or discuss. The most problematic example of this oversight arises in the context of the proposed minimum haircuts on SFTs. Specifically, the proposal would establish minimum haircut floors—in other words, a minimum amount of collateral a bank must receive from its counterparty—for certain SFTs with unregulated financial institutions; if a transaction does not satisfy these minimum haircut floors, it would be treated effectively as an uncollateralized exposure (notwithstanding the clear presence of risk-mitigating collateral), which would significantly increase the amount of capital banks would be required to hold in connection with the exposure. For certain SFTs, this requirement would directly conflict with both the Federal Reserve's Regulation T and the Securities and Exchange Commission's Rule 15c3-3, which require banks to *provide* rather than *receive* a haircut on certain SFTs. The proposed minimum SFT haircuts under the proposal would mean that a bank must face a dramatic and punitive increase in capital requirements as a consequence of doing precisely what these other regulations require.[139] The agencies' failure to acknowledge or analyze this conflict with existing regulatory requirements in the proposal represents another failure of the agencies to consider an important aspect of the problem, which is arbitrary and capricious.

VI. The proposed rule is based on economic analysis that is deficient and inconsistent with the evidence, and thus arbitrary and capricious.

Perhaps no aspect of the proposal is more emblematic of the overall lack of analysis supporting the agencies' policy choices than the mere *one-and-a-half pages* with which the proposal purports to discuss the economic impact of the proposal on lending and trading activities. It is helpful to approach this question by keeping in mind the stakes of the proposal, which would substantially revise the regulatory costs of trillions of dollars in loans to consumers and business and trillions of dollars in capital markets activity supporting the U.S. economy. The paucity and weakness of the economic analysis supporting choices of this magnitude violates the requirement that agencies adequately consider the "costs and benefits" of their action.[140] Professor Saunders also highlights the inadequacy of the proposal's economic impact analysis and concludes, "the incremental economic benefits of the Proposal may be low to none, which does not justify the very high incremental costs of implementing the Proposal."[141] Several points here bear emphasis.

First, it is useful to remember that none of the proposal's economic analysis actually takes as its starting point an accurate understanding of how the proposal would change banks' capital requirements because, as we describe in Part III.H above, the estimates of those first-order impacts provided in the proposal are by the agencies' own admission deficient and unreliable; the agencies only undertook a more reliable and accurate quantification of these impacts after the proposal was released; and the results of

---

[139] Although the proposal includes an exception for certain securities borrowing transactions, the proposed exception would not align with market conventions and industry practice under Regulation T and Rule 15c3-3, and the proposal includes no discussion analyzing or even acknowledging the conflict it would create with other regulatory requirements.

[140] *Mexican Gulf*, 60 F.4th at 973.

[141] Saunders Comment at 22.

that effort and the impact on the proposed rule will only be known after the comment period closes. This alone makes any economic analysis presented in the proposal legally deficient. To the extent that any additional economic analysis is included in the final rule, the public will have had no opportunity to review and provide comments on that analysis and underlying data, or how it might impact commenters' assessment of various elements of the proposal.

Second, the sum total of the proposal's economic analysis of the impact on *trillions of dollars in loans to American business and consumers* is as follows:

> The agencies estimate that risk-weighted assets (RWA) associated with banking organizations' lending activities would increase by $380 billion for holding companies subject to Category I, II, III, or IV capital standards due to the proposal. This increase is roughly equivalent to an increase of 30 basis points in required risk-based capital ratios across large banking organizations. While this increase in requirements could lead to a modest reduction in bank lending, with possible implications for economic growth, the benefits of making the financial system more resilient to stresses that could otherwise impair growth are greater. Historical experience has demonstrated the severe impact that distress or failure at individual banking organizations can have on the stability of the U.S. banking system, in particular banking organizations that would have been subject to the proposal. The banking organizations that experience an increase in their capital requirements under the proposal would be better able to absorb losses and continue to serve households and businesses through times of stress. Enhanced resilience of the banking sector supports more stable lending through the economic cycle and diminishes the likelihood of financial crises and their associated costs. Similarly, while increases in market risk capital requirements could have some spillover impact on lending, increases in capital requirements in general should also enhance the resilience of the banking system, supporting lending and economic activity in downturns.[142]

Notably, this analysis makes no effort whatsoever to actually (i) *quantify* the reduction in lending that might occur as a result of the proposal, (ii) identify and quantify "possible implications for economic growth" of that reduction, (iii) quantify the "benefits of making the financial system more resilient," or (iv) compare any of the foregoing. In other words, this purported analysis of the economic impact of the proposal on lending activities actually provides *no such analysis at all*.

More fundamentally, the proposal also does not articulate an appropriate starting point by which such analysis could proceed because, as we have explained elsewhere, the proposal's reference to a $380 billion increase in capital requirements for lending activities fails to account for a $1 trillion in risk-weighted assets for operational risk due to fee income that should have been allocated to either lending or trading activities for purposes of any economic analysis.[143] This $1 trillion in additional risk-weighted assets clearly arises from *some* bank activity – namely, a mix of lending and trading activity that generates

[142] Proposal at 64169–70.

[143] *See* Francisco Covas, *The Trillion Dollar Omission in Vice Chair Barr's Cost Analysis*, Bank Policy Institute (Oct. 12, 2023), *available at* https://bpi.com/the-trillion-dollar-omission-in-vice-chair-barrs-cost-analysis/.

the fee income that produces these new risk-weighted assets – but effectively falls through the cracks of the proposal's economic impact analysis, as it is simply ignored.

Third, the proposal also purports to provide an economic analysis of the proposal's impact on trading activities, noting that "the increase in RWA associated with trading activity would raise required capital ratios by as much as roughly 67 basis points across large holding companies subject to Category I, II, III, or IV capital standards."[144] Yet its actual analysis of the potential economic impact of these higher requirements contains no data or estimates whatsoever, and instead examines all of the potential sources of impact, both negative and positive, that the agencies *could* (and should) have analyzed, but for some unexplained reason chose not to:

> The academic literature documents important roles that financial intermediaries play in lowering transaction costs and improving market efficiency. Several banking organizations subject to the proposal are major market makers in securities trading and important liquidity providers in over-the-counter markets. Higher capital requirements for trading activity *could* enhance the resilience of bank-affiliated broker dealers and, therefore, benefit the provision of market liquidity, especially during stress periods. Higher capital requirements in normal times *could* also discourage the type of excessive risk-taking that resulted in large losses during the 2007–09 financial crisis. Over the long run, risk-weighted assets calibrated to better capture risks *could* support a larger role for bank-affiliated dealers in market making and enhance financial stability. On the other hand, higher capital requirements on trading activity *may* also reduce banking organizations' incentives to engage in certain market making activities and may impair market liquidity. The identification of causal effects of tighter capital requirements on market liquidity is challenging, partly because historical changes in capital regulations have often happened at the same time as changes in other factors affecting market liquidity, such as other regulatory changes, liquidity demand shocks, or the development of electronic trading platforms. The observable effects of changes in capital requirements *can* also vary depending on the measurements of market liquidity. Therefore, existing empirical studies on the relationship between capital requirements and market liquidity are limited and empirical evidence on causal effects of higher capital requirements on liquidity is mixed. *The overall effect of higher capital requirements on market making activity and market liquidity remains a research question needing further study*.[145]

This passage contains no actual analysis at all, but instead concedes that while there are many potential ways in which the proposal could affect trillions of dollars in capital markets activity, the agencies have attempted to evaluate and quantify exactly none of them. And it concludes by patently acknowledging that it is imposing new requirements on banks without attempting to understand the consequences of

---

[144] *See* Proposal at 64170. As with the proposal's economic analysis of the impact on lending activities, its analysis of trading activity impacts likewise is further undermined by the proposal's failure to account for a $1 trillion in risk-weighted assets for operational risk that should have been allocated to either lending or trading activities for purposes of any economic analysis.

[145] Proposal at 64170–71 (emphases added).

those requirements, as that is a "question needing further study." This "further study" is the agencies' job to perform *before* proposing costly and harmful changes to the capital framework.

Fourth, the proposal contains no economic analysis of the proposal's impact on asset management, custodial, and wealth management activities, which represent a substantial portion of the business activities of many banks subject to the proposal and meet important financial needs in the American economy. While the economic analysis section of the proposal includes a cursory discussion of potential impacts to lending and trading activities described above, there is no similar discussion of impacts on asset management, custodial, and wealth management activities and business models. Indeed, the QIS that the Federal Reserve chose to undertake after the proposal's release does not even collect the business line-specific information that would be needed to perform such an analysis. This is particularly notable since, by all accounts, the largest single quantitative impact from the proposal would arise from the introduction of a new operational risk capital charge under the ERBA that, as our forthcoming companion comment letter describes, would directly and disproportionately disrupt asset management, custodial, and wealth management business models that generally do not attract high credit risk or market risk capital charges. This omission of analysis, which concerns the effects of one of the most impactful elements of the proposal as concerns a large and important segment of the financial sector, is particularly glaring.

For these reasons, the agencies' failure to conduct an economic analysis sufficient to justify a rule of this magnitude is arbitrary and capricious.[146]

VII. The proposed rule is arbitrary and capricious because it would significantly increase capital requirements for large banks without evidence that current requirements are insufficient, and in the face of considerable evidence that current requirements are more than adequate.

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 under the guise of adherence to agreements made by agency staff at the Basel Committee in 2017 and 2019 that the Basel Committee publicly stressed would *not* increase capital requirements in the aggregate. In sum, the proposal would require 16 percent more capital, on average – and far more for some banks – which effectively finds that banks holding $100 billion or more in U.S. assets are undercapitalized as a group and, in some cases, significantly undercapitalized. In fact, the nation's largest banks have proven themselves highly resilient since implementing a robust package of regulatory reforms following the Global Financial Crisis of 2008–09. 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.

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,

---

[146] *Cf. Michigan v. EPA*, 576 U.S. 743, 751 (2015) (agency acts "unreasonably" when it fails to enumerate and consider costs).

independent assessments of each firm's capital adequacy under stress."[147] 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 resulting Great Recession. This result is consistent with every past outcome of this test. The proposal ignores the existence of this test and its consistent results and instead presumes that the cohort of banks subject to the test are significantly undercapitalized.

Although the proposed rule does not cite the failure of Silicon Valley Bank as a basis for its policies, one might reasonably ask whether that experience suggests that more capital is needed. But Silicon Valley Bank, First Republic Bank, and others that failed in 2023 failed for two primary reasons: interest rate risk and depositor concentration risk. Those banks incurred large unrealized losses as a result of an unprecedented series of rapid interest rate increases by the Federal Reserve following a historically long period of near zero rates and a failure by bank managers and examiners to anticipate the potential effect. The primary problem with SVB and the other failed banks was ultimately a liquidity problem, an extraordinary concentration of their depositor bases that bore no relation to the funding of the remainder of America's larger banks.[148] Yet the proposal's changes to how risk-weighted assets are calculated have nothing to do with liquidity risk or interest rate risk. They are about everything else: credit risk, market risk, operational risk, and CVA risk. None of these is related to the bank failures of early 2023. And, for the reasons discussed throughout this letter and our forthcoming companion letter, the proposal does not explain why current capital requirements are inadequate in addressing these risks or why the proposed changes would result in improvements.

The proposal justifies the substantial increase in aggregate capital requirements with a claim that "current capital requirements in the United States are toward the low end of the range of optimal capital levels described in the existing literature." To support this assertion, the proposal cites seven papers in a footnote. Of these, five papers suggest that bank capital levels ought to be higher than they are currently, whereas two papers argue for lower optimal capital requirements. However, the proposal's cited analysis presents several issues. First, two of the papers cited do not provide estimates for optimal capital levels.[149] Second, the agencies failed to conduct a comprehensive review of the seven papers they selected and neglected to include recent academic journal publications that state optimal capital levels should be lower.[150] Professor Saunders likewise highlights several deficiencies in the agencies' analysis of the

---

[147] *2023 Stress Test Methodology* at 3.

[148] *See* Katie Collard, *The Answer to Recent Bank Turmoil is Not Higher Capital Requirements for All Larger Banks*, Bank Policy Institute (June 2023), *available at* https://bpi.com/the-answer-to-recent-bank-turmoil-is-not-higher-capital-requirements-for-all-larger-banks/.

[149] Namely, Skander Van den Heuvel, *The welfare effects of bank liquidity and capital requirements,* Finance and Economics Discussion Series (FEDS) Working Paper No. 2022-72 (Nov. 2022) and Jihad Dagher, Giovanni Dell'Ariccia, Luc Laeven, Lev Ratnovski, and Hui Tong, *Benefits and costs of bank capital*, IMF Staff Discussion Note SDN/16/04 (Mar. 2016).

[150] Other papers often cited include: Juliane Begenau, *Capital requirements, risk choice, and liquidity provision in a business-cycle model*, J. of Fin. Econ. 355 (May 2020); and Laurent Clerc, Alexis Derviz, Caterina Mendicino, Stephane Moyen, Kalin Nikolov, Livio Stracca, Javier Suarez, and Alexandros P. Vardoulakis, *Capital regulation in a macroeconomic model with three layers of default*, 11 Int'l J. of Central Banking 9 (Jun. 2015). *See* Covas and Nelson, *infra* note 153, for additional information.

academic literature regarding optimal capital levels and finds that "the reason for the claim in the Proposal of an 'on balance' view of the academic literature appears to be because the Agencies did not perform a systematic analysis of the seven papers they selected."[151] Contrary to the agencies, he concludes that the academic literature indicates that banks' capital is already at or around optimal capital levels.[152]

As of the end of the second quarter of 2023, the common equity tier 1 risk-based capital ratio, the best regulatory measure of loss-absorbing capacity on a going-concern basis, stood at 12.8 percent for all U.S. bank holding companies, including the largest ones, as measured using existing RWA calculation methodologies. Based on the papers cited in the proposal, the range of optimal estimates varies between 6 percent and 17.5 percent, with a midpoint of 11.8 percent, again using existing RWA methodologies.[153] Recent academic studies, which offer a more comprehensive analysis of the costs and benefits of higher capital requirements, are calibrated to match various data features, both in terms of macroeconomic quantities and prices and therefore merits greater attention from policymakers.[154] According to these academic papers, the optimal level of bank capital is that which maximizes lifetime consumption for households in the economy. In these frameworks, the primary benefit of higher bank capital is a reduced probability of bank failure and therefore higher GDP from lower bankruptcy costs. In contrast, the main cost of higher capital requirements is a smaller banking sector, resulting in decreased business borrowing and investment, along with a decline in GDP. These more recent academic papers provide estimates that range from six percent to 14.5 percent, with a midpoint of 10.3 percent. Hence, the current CET1 capital ratio of U.S. bank holding companies, as measured using existing RWA calculation methodologies, falls well-within the range of optimal capital ratios.

In summary, current bank capital levels are above the midpoint of the range of optimal estimates cited in the proposal and are close to the upper end of recent academic estimates. Therefore, the partial justification given by the banking agencies for substantially revising and increasing the capital requirements for large banks fails to meaningfully engage with the current state of academic research, which tends to support the maintenance of current capital levels, and instead appears to selectively rely on outdated analyses to support a policy preference – higher effective capital requirements achieved through higher RWA calculations the proposal would require.

Of course, these academic studies are highly theoretical, and their outcome depends on many variables. They assume that every bank has the same optimal level of capital when of course banks run very different risks and therefore should hold very different levels of capital. The best test of current

---

[151] Saunders Comment at 23.

[152] *Id.* at 22.

[153] *See* Francisco Covas and Bill Nelson, *U.S. Bank Capital Levels: Aligning With or Exceeding Midpoint Estimates of* Optimal, Bank Policy Institute (Sept. 18, 2023), *available at* https://bpi.com/u-s-bank-capital-levels-aligning-with-or-exceeding-midpoint-estimates-of-optimal/.

[154] *See* Laurent Clerc et al., *Capital regulation in a macroeconomic model with three layers of default*, 11 Int'l J. of Cent. Banking 9 (June 2015); Vadim Elenev, Tim Landvoigt, and Stijn Van Nieuwerburgh, *A macroeconomic model with financially constrained producers and intermediaries*, 89 Econometrica 1361 (May 2021); Juliane Begenau, *Capital requirements, risk choice, and liquidity provision in a business-cycle model*, 136.2 J. of Fin. Econ. 355 (May 2020); Juliane Begenau and Tim Landvoigt, *Financial regulation in a quantitative model of the modern banking system*, 84 The Rev. of Econ. Stud. 1748 (2022).

capital levels is real-world experience; the second best is a stress test using actual bank balance sheets. Both have demonstrated that banks operating in the U.S. hold more than enough capital.

We note that the view that current levels of capital among large banks are already adequate has also been endorsed by the Basel Committee itself. As we describe in Part IV.B above, *avoiding* any increase overall capital requirements was a primary objective of the Basel Committee's 2017 agreement. Moreover, as a condition of approving the 2017 agreement, the Basel Committee conducted and released a quantitative impact study demonstrating that the revisions would not do so.[155] Thus, it is especially difficult to understand why the agencies take the position that current capital requirements are insufficiently stringent in the context of implementing Basel Committee changes to international standards that were themselves predicated on the view that current capital requirements are adequate and should not be increased.

This position is also at odds with statements from agency principals themselves. For example, in testimony before the House Financial Services Committee last year, Federal Reserve Vice Chair for Supervision Michael Barr assured the public that "overall, banks have strong capital and liquidity." The Federal Reserve's most recent annual Supervision and Regulation Report, released in November, also finds that "[t]he banking system remains sound overall" and "banking organizations continue to report capital and liquidity levels above regulatory minimums."[156] Federal Reserve Board Governor Lisa Cook likewise recently acknowledged the fundamental strength of the financial system, particularly in light of post-Global Financial Crisis prudential enhancements, saying, "In my view, our financial system is substantially more resilient than it was in the mid-2000s, reflecting progress by regulators and the private sector in boosting resilience," and, with respect to banks in particular, "The banking sector remains sound and resilient overall. Most banks continue to report solid capital levels well above regulatory requirements."[157] The agencies' proposal to significantly increase capital requirements is completely at odd with policymakers' expressed views that bank capital levels are strong. This inconsistency between agency statements and actions further underscores the fundamental lack of justification for this proposal.

VIII. The proposed rule is arbitrary and capricious because it does not consider numerous viable alternatives.

The agencies' proposal would make sweeping changes to the risk-based capital framework for large banks without any meaningful consideration of a range of more appropriate approaches, which violates the agencies' core obligation under to APA to consider "significant and viable and obvious alternatives" before acting.[158] Many such alternatives are described in detail above, including (i) retention of internal models-based approaches to credit risk in any form, including incorporation of the internal models-based alternatives included in the 2017 Basel Committee agreement the proposal purports to implement, (ii) credit risk weights calibrated on the basis of available empirical data, including the calibrations we suggest in our forthcoming companion comment letter, (iii) an evidence-based

---

[155] *See supra*, note 97.

[156] Board of Governors of the Federal Reserve System, *Supervision and Regulation Report*, 1 (Nov. 2023), https://www.federalreserve.gov/publications/files/202311-supervision-and-regulation-report.pdf.

[157] Governor Lisa D. Cook, *Financial Stability: Resilience, Challenges, and Global Connections, Speech at the Central Bank of Ireland* (Nov. 8, 2023), https://www.federalreserve.gov/newsevents/speech/cook20231108a.htm.

[158] *Dist. Hosp. Partners, L.P. v. Burwell*, 786 F.3d 46, 59 (D.C. Cir. 2015).

recalibration of the proposed approach to operational risk, and (iv) appropriate changes to the Federal Reserve's stress-testing framework and/or the proposal to address potential inconsistencies and duplication between that framework and the proposed approaches to operational and market risk. The agencies also fail to consider numerous "viable and obvious" alternative approaches to many other aspects of the proposal, as we separately identify and describe in our forthcoming companion comment letter, which can and should form the basis of a new proposed rule that properly employs data and analysis to calculate risk and appropriately analyzes the costs and benefits of capital regulation. Any action by the agencies to revise their risk-based capital rules that does not thoughtfully and credibly consider each of these significant, viable, and obvious alternatives to revising the agencies' risk weights and risk-weighting methodologies would be arbitrary, capricious, and an abuse of agency discretion, and therefore violate the APA.

IX. As applied by the agencies in the proposal, the bank capital statutes would violate the non-delegation doctrine.

For the reasons explained above, the proposed rule is contrary to the agencies' governing statutes and the APA. Indeed, the proposed rule appears to be based on the agencies' erroneous belief that they have unlimited and unreviewable discretion to set capital requirements at whatever level they wish, and thus do not have to ensure that those requirements comply with any statutory standard or provide any data and analysis to show that proposed requirements meet that standard.[159] If the agencies continue to proceed based on this interpretation of their governing statutes, then any final rule will be vulnerable either under the non-delegation doctrine, the doctrine of constitutional avoidance, or under ordinary APA principles of reasoned decision-making for failure to proceed in conformity with the agencies' statutory mandates.

Article I of the Constitution states that "[a]ll legislative Powers herein granted shall be vested in Congress."[160] "Accompanying that assignment of power to Congress is a bar on its further delegation."[161] Although Congress may seek "the assistance of" the Executive Branch in "implement[ing] and enforc[ing] laws," it "*must* lay down by legislative act an intelligible principle to which the agency is directed to conform."[162] In other words, Congress must "clearly delineate the general policy, the public agency which is to apply it, and the boundaries of th[e] delegated authority."[163] An agency cannot adopt legislative rules – such as those here – unless it does so within the bounds of a statutory standard that guides and limits the agency's exercise of its rulemaking power.

Here, the proposed rule was promulgated under statutes that delegate authority to the banking regulators to "establish regulatory capital requirements."[164] For instance, the regulators invoke 12 U.S.C. § 5371, which grants them authority to "establish minimum risk-based capital requirements."[165] The

---

[159] *See* Proposal at 64182.

[160] U.S. Const. art. I, § 1.

[161] *Gundy v. United States*, 139 S. Ct. 2116, 2123 (2019) (plurality opinion).

[162] *Whitman v. Am. Trucking Ass'ns*, 531 U.S. 457, 472 (2001) (quotation marks omitted; emphasis added).

[163] *Am. Power & Light Co. v. SEC*, 329 U.S. 90, 105 (1946).

[164] Proposal at 64182.

[165] 12 U.S.C. § 5371(b)(2).

regulators also invoke the International Lending Supervision Act.[166] That statute vests the agencies with authority to "cause banking institutions to achieve and maintain adequate capital by establishing minimum levels of capital . . . and by using such other methods as [the agencies] deem[] appropriate."[167]

The approach in the proposed rule reflects the agencies' evident assumption that these statutes provide no rule of law limiting the agencies' discretion. As explained throughout this letter and our forthcoming companion letter, the rule is riddled with logical gaps, unexplained inconsistencies, and reliance on undisclosed data to which the public has not been granted access. If it is indeed the agencies' view that there are no meaningful limits to what they can do, and no standards to guide them, then their governing statutes cannot be reconciled with the non-delegation doctrine.[168] Conversely, if a court or the agencies interpreted the statutes to require a quantitative cost-benefit analysis and other standards that adequately limit the agencies' authority — as required under the doctrine of constitutional avoidance — the proposed rule would be arbitrary and capricious for failing to acknowledge and apply those standards.[169] The non-delegation concerns created by the proposal would be even more difficult for the agencies to defend under the vision of the nondelegation doctrine recently articulated by Justice Gorsuch's dissent in *Gundy v. United States*, which was joined by Chief Justice Roberts and Justice Thomas, and seemingly endorsed by Justice Alito in that case and Justice Kavanaugh soon after.[170]

X. The agencies should propose a new rule that corrects the proposal's numerous legal deficiencies.

As this letter has described in detail, the agencies' proposal to implement the 2017 and 2019 Basel Committee agreements falls well short of the basic procedural and substantive standards that govern all federal agency rulemaking under the APA. As a procedural matter, the proposal repeatedly and significantly relies on data and evidence that the agencies have improperly failed to disclose to the public and/or have failed to obtain and consider. As a substantive matter, the proposal is arbitrary and capricious because it improperly relies on Basel Committee decisions without independent analysis, substantiation, and justification by the agencies themselves, fails to consider a wide range of clear and important aspects of the policy problem at hand, lacks a sufficient evidentiary basis for many of its policy choices, ignores the evidence that is available, fails to consider a range of obvious and plausible alternatives, and is predicated on an economic analysis of the proposal's effects that is deficient and inconsistent with the evidence. These legal defects are fundamental, comprehensive, and pervasive across the proposal, and it is abidingly clear that, absent major remedial efforts, the proposal would be inconsistent with both the letter and spirit of the APA.

---

[166] 12 U.S.C. § 3901 *et seq.*

[167] *Id.* § 3907(a)(1).

[168] *See Indus. Union Dep't, AFL-CIO v. Am. Petroleum Inst.*, 448 U.S. 607, 646 (1980) (plurality) ("If the Government was correct in arguing that neither § 3(8) nor § 6(b)(5) requires that the risk from a toxic substance be quantified sufficiently to enable the Secretary to characterize it as significant in an understandable way, the statute would make such a 'sweeping delegation of legislative power' that it might be unconstitutional.").

[169] *Id.* at 646, 662 (upholding statute against non-delegation challenge, but invalidating rule because agency erroneously believed its discretion was unlimited).

[170] 139 S. Ct. 2116, 2139 (2019) (Gorsuch, J., dissenting); *id.* at 2130-31 (Alito, J., concurring in the judgment); *Paul v. United States*, 140 S. Ct. 342, 342 (2019) (Kavanaugh, J., respecting the denial of certiorari).

For that reason, we urge the agencies to issue a new proposal in a manner that includes all of the following remedial actions:

- The agencies should complete and publish for public review and comment an accurate and reliable assessment of the impact of the proposed changes on bank capital requirements, as contemplated by the Federal Reserve's QIS exercise; and
- The agencies should reconsider and re-propose any changes to U.S. rules after taking into account the results of that impact assessment, which re-proposal should, at a minimum:
    - Make public all data and evidence on which any aspect of the re-proposal is based;
    - Document, substantiate, and make public all supervisory or other "experience" on which any aspect of the re-proposal is based;
    - Provide the agencies' independent analysis and explanation for all aspects of the proposal rather than rely on those of the Basel Committee;
    - Consider and publicly address in the re-proposal all important aspects of the relevant policy problem, including all matters identified in Part V above;
    - Provide a sufficient evidentiary basis for all aspects of the re-proposal;
    - Consider all viable alternatives to the re-proposal, including those identified in Part VIII above; and
    - Complete and make public a robust, reliable, and comprehensive economic analysis of the re-proposal's impact that quantifies both negative and positive effects and addressed the re-proposal's impact on lending activities, trading activities, and asset management, wealth management, and custody activities, respectively.

Importantly, taking the above steps would not only result in a rulemaking process that comports with the basic legal standards of the APA, but would also ensure that any decisions made through this process are guided by the careful policy analysis and empirical data that all government agencies owe the American public.

* * * * *

The Associations appreciate the opportunity to comment on the Proposal. If you have any questions, please contact John Court, General Counsel, Bank Policy Institute; Sean D. Campbell, Chief Economist, Head of Policy Research, Financial Services Forum; Carter McDowell, Managing Director, Associate General Counsel, SIFMA; and Bill Hulse, Senior Vice President, Center for Capital Markets Competitiveness, U.S. Chamber of Commerce by email at *john.court@bpi.com*, *SCampbell@fsforum.com*, *CMcdowell@sifma.org*, and *BHulse@USChamber.com*, respectively.

Respectfully submitted,

Greg Baer
President and Chief Executive Officer
Bank Policy Institute

Kevin Fromer
President and Chief Executive Officer
Financial Services Forum

Kenneth E. Bentsen, Jr.
President and Chief Executive Officer
Securities Industry and Financial Markets Association

Tom Quaadman
Executive Vice President
Center for Capital Markets Competitiveness
U.S. Chamber of Commerce

Appendix

The **Bank Policy Institute** is a nonpartisan public policy, research and advocacy group, representing the nation's leading banks and their customers. Our members include universal banks, regional banks and the major foreign banks doing business in the United States. Collectively, they employ almost 2 million Americans, make nearly half of the nation's small business loans, and are an engine for financial innovation and economic growth.

The **Financial Services Forum** is an economic policy and advocacy organization whose members are the chief executive officers of the eight largest and most diversified financial institutions headquartered in the United States. Forum member institutions are a leading source of lending and investment in the United States and serve millions of consumers, businesses, investors, and communities throughout the country. The Forum promotes policies that support savings and investment, financial inclusion, deep and liquid capital markets, a competitive global marketplace, and a sound financial system. Visit our website, fsforum.com.

The **Securities Industry and Financial Markets Association** is the leading trade association for broker-dealers, investment banks and asset managers operating in the U.S. and global capital markets. On behalf of our industry's one million employees, we advocate on legislation, regulation and business policy affecting retail and institutional investors, equity and fixed income markets and related products and services. We serve as an industry coordinating body to promote fair and orderly markets, informed regulatory compliance, and efficient market operations and resiliency. We also provide a forum for industry policy and professional development. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA). For more information, visit http://www.sifma.org.

The **U.S. Chamber of Commerce** is the world's largest business federation. It represents approximately 300,000 direct members and indirectly represents the interests of more than three million businesses and professional organizations of every size, in every industry sector, and from every region of the country.