GIBSON DUNN

Federal Banking Agencies Issue Basel III Endgame Package of Reforms

Client Alert | August 3, 2023

On July 27, 2023, the federal banking agencies (the Board of Governors of the Federal Reserve System ("Federal Reserve" or "Federal Reserve Board"), the Federal Deposit Insurance Corporation ("FDIC") and the Office of the Comptroller of the Currency ("OCC")) jointly issued the long-expected notice of proposed rulemaking that would replace the federal banking agencies' risk-based capital framework for large banking organizations with a new framework—commonly referred to as the Basel III endgame reforms—that would implement international capital standards issued by the Basel Committee on Banking Supervision.[1] In parallel, the Federal Reserve Board issued a notice of proposed rulemaking that would revise the surcharge calculation applicable to U.S. global systemically important banks ("GSIBs").[2]

The Proposed Rule would materially increase capital requirements applicable to **banking organizations with total assets of $100 billion or more** and would align the regulatory capital calculation (the numerator of regulatory capital ratios) and the calculation of risk-weighted assets (the denominator of regulatory capital ratios) across large banking organizations subject to the Proposed Rule. Although the Proposed Rule would apply directly to large banking organizations, it would have far broader indirect impacts on bank counterparties and customers and the broader financial markets.

Section 165 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), as amended by the 2018 Economic Growth, Regulatory Relief, and Consumer Protection Act ("EGRRCPA"),[3] requires the application of enhanced prudential standards[4] to bank holding companies and foreign banking organizations with $250 billion or more in total consolidated assets. Section 165 authorizes the Federal Reserve to apply enhanced prudential standards to banking organizations with assets between $100 billion and $250 billion, taking into consideration their capital structure, riskiness, complexity, financial activities (including those of their subsidiaries), size, and any other risk-related factors the Federal Reserve deems appropriate. In 2019, the federal banking agencies issued final rules establishing four categories for determining the applicability and stringency of prudential standards:[5]

Category I	Category II	Category III	Category IV
U.S. GSIBs (and their depository institution subsidiaries)	**Banking organizations with ? $700 billion in total assets or ? $75 billion in cross-jurisdictional activity (and their depository institution subsidiaries)**	**Banking organizations with ? $250 billion in total assets or ? $75 billion in weighted short-term wholesale funding, nonbank assets, or off-balance sheet exposure (and their depository institution subsidiaries)**	**Banking organizations with ? $100 billion to $250 billion in total assets (and their depository institution subsidiaries)**

The Proposed Rule would significantly reduce the differences that apply across the four categories established by the federal banking agencies in 2019 for determining the applicability and stringency of regulatory capital requirements for large banking organizations. In that connection, consistent with statements made by Federal Reserve Vice Chair for Supervision Barr during the spring turmoil promoting the application of standardized enhanced capital and liquidity requirements to a broader set of firms (see our

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prior Client Alert), large banking organizations should reasonably expect the federal banking agencies will issue additional proposals that would align standardized liquidity requirements applicable to banking organizations with total assets of $100 billion or more in a similar manner.

The Proposed Rule was not adopted unanimously. Members of both the Federal Reserve Board and the FDIC Board of Directors—including those who voted in favor of the Proposed Rule, like Federal Reserve Chair Powell and Governor Jefferson—raised concerns with specific aspects of the Proposed Rule as well as potentially significant unintended consequences to the financial system and broader U.S. economy. Concerns were also raised that the Proposed Rule would not comply with the tailoring requirements of Section 165 of the Dodd-Frank Act, as amended by EGRRCPA.[6]

Statements made by voting members accompanying the release of the Proposed Rule encourage robust industry engagement during the 120-day comment period and **highlight the critical role that engagement in the rulemaking process with the federal banking agencies and other policymakers will play in shaping the substance of the final rule** and in the federal banking agencies' consideration of the myriad issues raised by the Proposed Rule, and **may also form the basis for any future court challenges to the federal banking agencies' final rule** (see below under the section heading "*Dissenting Votes*" for additional discussion).

As with prior rulemakings, the Proposed Rule, if finalized, would include a **three-year transition period** beginning **July 1, 2025** and the capital requirements under any final rule would not be fully phased in until **July 1, 2028**.

Comments on the Proposed Rule are due by November 30, 2023. The agencies have included 176 questions as prompts (almost all of which include multiple related sub-prompts) to solicit comments and data on all aspects of the Proposed Rule and its potential impacts—both intended and unintended—on large banking organizations, their counterparties and customers, the financial markets, financial stability and the broader U.S. economy, among others.

I. Key Aspects of the Proposed Rule

The Proposed Rule includes several notable changes that would materially increase capital requirements applicable to large banks.[7] In particular, the Proposed Rule would:

- Apply revised, enhanced capital requirements to all banking organizations[8] with total consolidated assets of $100 billion or more and their depository institution subsidiaries (referred to herein as "banking organizations" or "large banks"), and to banking organizations with significant trading activity, while retaining the current U.S. standardized approach applicable to all banking institutions.
- Align regulatory capital requirements for banking organizations with total consolidated assets of between $100 billion and $700 billion (Category III and IV firms) with those currently applicable to the largest banking organizations (Category I and II firms).
- Expand application of the supplementary leverage ratio requirement to banking organizations subject to Category IV capital standards and apply the countercyclical capital buffer, if activated, to banking organizations subject to Category IV capital standards.
- Subject Category III and IV banking organizations to the same treatment of accumulated other comprehensive income ("AOCI"), capital deductions and minority interest treatments as Category I and II banking organizations, including taking into account unrealized gains or losses on available-for-sale securities in their common equity tier 1 capital.

- Replace internal-models-based capital requirements for credit and operational risk[9] (the advanced approaches) currently applicable to banking organizations subject to Category I and II capital standards with new standardized requirements (the "expanded risk-based approach") that would apply to all banking organizations with $100 billion or more in total assets and replace the current market risk and credit valuation adjustment ("CVA") risk requirements with revised approaches.
- Maintain the current capital rule's dual risk-based capital structure but expand its application to all banking organizations with total assets of $100 billion or more.
    - Under the Proposed Rule, a banking organization would calculate two sets of risk-based capital ratios (common equity tier 1 capital ratio, tier 1 capital ratio, and total capital ratio) under both the (i) new expanded risk-based approach[10] and (ii) current standardized approach.[11] A banking organization's common equity tier 1 capital ratio, tier 1 capital ratio, and total capital ratio would be the lower of each ratio of the two approaches to satisfy its minimum capital requirements. All capital buffer requirements would apply regardless of which approach produces the binding risk-based capital ratio.
- With respect to credit risk, the Proposed Rule would eliminate the practice of relying on a banking organization's internal models for credit risk and instead use the expanded risk-based approach. The Basel Framework and the UK and EU proposals limit—but do not eliminate entirely—banks' ability to use internal credit risk models.
- With respect to operational risk, the Proposed Rule would remove the advanced measurement approaches based on a banking organization's internal models and introduce a standardized approach to capture a broad range of operational risks, such as fraud and litigation, but excluding strategic, reputational and climate risk.
    - A banking organization's operational risk capital requirement would be equal to its business indicator component multiplied by its internal loss multiplier. Similar to the current capital rule, risk-weighted assets for operational risk would be equal to 12.5 times the operational risk capital requirement.
    - Under the Proposed Rule, the operational risk capital requirements would be higher for larger, more complex banking organizations under the business indicator component and those "that experienced larger operational losses in the past" under the internal loss multiplier, that "increases operational risk capital requirements based on a banking organization's historical operational loss experience."[12]
- With respect to market risk, the Proposed Rule would introduce a (i) standardized methodology for calculating risk-weighted assets for market risk and (ii) new models-based methodology to replace the framework in the current capital rule. A banking organization's total capital requirements for market risk would equal the market risk capital requirement multiplied by 12.5.
    - The standardized measure for market risk would be the default methodology for calculating market risk capital requirements for all banking organizations subject to market risk requirements.
    - A banking organization would be required to obtain prior approval to use the models-based measure for market risk to determine its market risk capital requirements. The Proposed Rule would restrict the use of internal models by requiring internal models to be subject to supervisory approval at the trading-desk level, and would introduce additional controls.
    - The additional capital requirements for market risk would apply to all banking organizations (regardless of asset size) for which average

aggregate trading assets and trading liabilities over the previous four calendar quarters equal or exceed $5 billion, or represent 10% or more of total assets at quarter end as reported on the most recent quarterly regulatory report.

    - Any holding company subject to Category I, II, III, or IV standards or any subsidiary thereof, if the subsidiary engaged in *any* trading activity over any of the four most recent quarters, would be subject to the market risk capital rule.

- With respect to CVA risk, the Proposed Rule would provide a (i) basic measure for CVA risk[13] and (ii) standardized measure for CVA risk[14] to calculate the risk-based capital requirement for CVA risk. After calculating the CVA capital requirement using either the basic measure or the standardized measure, a banking organization's total capital requirements for CVA risk would equal the CVA capital requirement multiplied by 12.5.
    - A banking organization would be required to use the basic measure for CVA risk unless it has received prior approval to use the standardized measure for CVA risk.
- Amend the capital plan rule so that institutions subject to the capital plan rule—bank holding companies, U.S. intermediate holding companies, and savings and loan holding companies with total consolidated assets of at least $100 billion—would be subject to a single capital conservation buffer requirement which would include (i) the stress capital buffer, (ii) any applicable countercyclical capital buffer and (iii) any applicable GSIB surcharge. The capital conservation buffer would apply to the institution's risk-based capital ratios whether such ratios were calculated under the expanded risk-based approach or the standardized approach.
- Revise the calculation of the stress capital buffer to be calculated using the binding common equity tier 1 capital ratio as of the final quarter of the previous capital plan cycle regardless of whether such ratio was calculated under the expanded risk-based approach or the standardized approach.
    - The Proposed Rule would require banking organizations subject to Category I, II, or III standards to calculate their risk-based capital ratios in company-run stress tests and capital plans using the method that results in the binding ratios as of the start of the projection horizon. Banking organizations subject to Category IV standards would be required to calculate baseline risk-based capital ratios in their capital plans and FR Y-14A submissions using the risk-weighted assets calculation that results in the binding ratios as of the start of the projection horizon.
- Include a three-year transition period beginning July 1, 2025 for two provisions: (i) the expanded risk-based approach; and (ii) the AOCI regulatory capital adjustments for banking organizations subject to Category III or IV capital standards.
    - All other elements of the calculation of regulatory capital would apply upon the effective date of the final rule.
    - Any banking organization not subject to Category I, II, III, or IV standards that becomes subject to Category I, II, III, or IV standards during the proposed transition period, would be eligible for the remaining time that the transition provisions provide.
    - Beginning January 1, 2028, no transition would be provided to banking organizations that become subject to Category I, II, III, or IV standards.

II. Issues with the Proposed Rule

There are several issues with the Proposed Rule that stakeholders should identify and seek to quantify with data during the 120-day comment period, some of which include:

- The Proposed Rule would materially increase:
  - risk-weighted assets across large holding companies by 20% and across depository institutions by 9% (25% for holding companies subject to Category I or II standards, 6% for domestic holding companies subject to Category III or IV standards, and 25% for intermediate holding companies of foreign banking organizations subject to Category III and IV standards);[15]
  - common equity tier 1 capital requirements for large holding companies, including minimums and buffers, by an estimated 16% (19% for holding companies subject to Category I or II capital standards, 6% percent for Category III and IV domestic holding companies, and 14% for Category III and IV international holding companies of foreign banking organizations), and by an estimated 9% across depository institutions;[16]
  - risk-based capital ratios related to lending activities by 30 basis points across large banking organizations;[17]
  - risk-based capital ratios related to trading activities by 67 basis points across large holding companies;[18] and
  - Total loss-absorbing capacity, or “TLAC,” requirements for U.S. GSIBs by an estimated 15.2%;[19]

These increased costs on large banks are likely to be passed on to bank counterparties and customers and could lead to a reduction in the provision of banking and financial services by large banks or a pullback by large banks from certain critical financial markets activities, which could have material adverse impacts to financial stability and the broader U.S. economy, particularly during times of stress.

- Specific aspects of the trading book components of the Proposed Rule could lead to reduced large bank participation in certain financial markets—which would increase risk to financial stability and the broader U.S. economy by concentrating derivatives-related products and services in less transparent markets. As highlighted in the Coalition for Derivatives End-Users July 6, 2023 letter to the federal banking agencies (“Coalition Letter”),[20] a copy of which is attached hereto, the Proposed Rule would significantly increase capital requirements for the largest U.S. and non-U.S. banks that provide the bulk of derivatives-related products and services to corporations of all sizes and across many different, diverse sectors of the economy.
  - Significant increases in capital requirements in recent years preceding the Proposed Rule already have caused banks to pull back from key capital markets activities, resulting in higher costs for borrowers, derivatives end-users and their customers, and other market participants, reduced competition and transparency in those markets, and signs of diminished liquidity and efficiency in some markets, particularly during periods of stress—all of which increase risk to financial stability. The Proposed Rule, as currently contemplated, could exacerbate these issues.
  - Several members of the Federal Reserve Board and the FDIC Board cited similar concerns in their statements accompanying the release of the Proposed Rule (see below under the section heading “*Dissenting Votes*” for additional discussion).
- It is anticipated the Proposed Rule would result in significant unintended consequences for large banks and the broader markets, the full extent of which are still under consideration. Federal Reserve Board staff acknowledged during the open meeting the “very important tradeoff between the benefit of increased

resilience and the potential costs" of increased capital requirements and, in that connection, is actively seeking comment on all aspects of the Proposed Rule and undertaking an additional data collection—a process not always undertaken within the normal rulemaking process—to determine whether or not the Proposed Rule appropriately captures the risks identified in the proposal or a recalibration may be needed.

  - In general, though, the federal banking agencies largely justified substantial increases in capital, increased costs to counterparties and bank customers, reductions in bank lending, large banks pulling back from critical financial markets activities, and other consequences of the Proposed Rule by summarily justifying those costs as being "offset by the expected economic benefits associated with the increased resiliency of the financial system."[21]

- As noted by FDIC Director McKernan in his statement accompanying the release of the Proposed Rule, the proposal "does not propose a fix to address the apparent issue, which was acknowledged in the Basel consultative documents, that the business-indicator approach overcapitalizes banking organizations with high fee revenue and expense."[22] Similarly, Federal Reserve Governor Bowman highlighted in her statement the "punitive treatment for noninterest and fee-based income through the proposed operational risk requirements, exacerbated by the use of an internal loss multiplier that may result in an excessive overall capital charge for operational risk."[23]
- The Proposed Rule differs in certain respects from the implementation of the Basel III endgame reforms in other jurisdictions. Most notably, the Proposed Rule would eliminate large banks' ability to use internal models when determining risk-weighted assets for credit risk, whereas, as noted above, the Basel Framework and the UK and EU proposals limit—but do not eliminate entirely—banks' ability to use internal credit risk models. In addition, FDIC Director McKernan highlighted additional differences in his statement, including:
  - The Proposed Rule would increase the risk weights for residential real estate exposures (by 20 percentage points to each of the corresponding Basel III risk weights), other real estate exposures not dependent on cash flows generated by the real estate (by 25 percentage points for exposures to individuals, 15 percentage points for exposures to small- or medium-sized entities), and retail credit exposures (by 10 percentage points);
  - The Proposed Rule would require that, for a corporate exposure 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 public securities exchange, (although included in the Basel Framework, this was not included in the UK and EU proposals);
  - The Proposed Rule "would not adopt the reduced Basel III credit-risk-capital requirements for exposures to small businesses, securities firms and other nonbank financial institutions, or highly capitalized banking organizations; or for short-term exposures to banking organizations;"
  - The Proposed Rule's operational risk capital requirements under the standardized approach for operational risk would establish a baseline of the internal-loss multiplier at "no less than one," while other proposals have set the internal-loss multiplier equal to one; and
  - With respect to CVA-risk-capital requirements, Director McKernan also raises concerns regarding the impact of the Proposed Rule on end-users: "The capital requirements for CVA risk would not include a tailored approach to commercial end-users. Some other implementing authorities have proposed a commercial end-user exemption for CVA-risk-capital

requirements. What considerations should inform whether a commercial end-user exemption is appropriate? Is the absence of an alpha factor under [SA-CCR] for uncleared derivatives with commercial end-users sufficient to address any issues under the proposed capital requirements for CVA risk?"[24]

- The Proposed Rule would effectively eliminate the tailoring requirements of Section 165 of the Dodd-Frank Act, as amended by EGRRCPA, which requires the Federal Reserve Board "*shall …* differentiate among companies on an individual basis or by category,"[25] and would result in consistent regulatory capital measures for all large banking organizations, without properly taking into account risk, size, business models and complexity. The elimination of the tailoring requirements could result in the final rule being subject to challenge if adopted substantially as proposed.
    - By significantly reducing the differences that apply across the four categories for determining the applicability and stringency of regulatory capital requirements for banking organizations, large banks may be incentivized to combine with other large banks because any impacts from a regulatory capital standpoint of "stepping up" in category (*e.g.*, Category IV to III) are significantly diminished. Indeed, the material increases in risk-weighted assets and costs associated with complying with the new capital requirements may incentivize more Category III and IV institutions to consider combinations.
    - On the other hand, those banking organizations currently below the $100 billion asset threshold may be incentivized to remain below the $100 billion threshold given the significant consequences from a regulatory capital perspective of transitioning to Category IV. Institutions with less than $100 billion in total assets that are growing in size and are positioned to transition into Category IV must be prepared to adhere to the increased capital requirements, including on a *pro forma* basis, reflecting any remaining transition period. An inability to demonstrate adherence to the enhanced capital requirements would slow growth, either through prolonged merger application review and approval timelines or regulators throttling growth through other means.
- *GSIB Surcharge Proposal*. The Proposed Rule would change how cross-jurisdictional exposure is calculated by including derivatives exposures in cross-jurisdictional claims and cross-jurisdictional liabilities, as applicable. This would materially increase the cross-jurisdictional exposure of many foreign banking organizations with operations in the U.S. which would result in seven foreign banking organizations that are currently subject to Category III or IV standards becoming subject to Category II standards, which would be materially impactful from a liquidity risk management and reporting standpoint.[26]

III. Dissenting Votes

The Proposed Rule was not unanimously approved by either the Federal Reserve Board or the FDIC Board, with the Federal Reserve voting 4-2 and the FDIC split along partisan lines with a 3-2 vote.[27]

An absence of unanimity and consensus among Federal Reserve Governors is rare and highly unusual. According to the Federal Reserve Board's voting record on proposed and final regulations, including implementation of the Dodd-Frank Act, as well as banking applications, enforcement actions and supervisory matters on which the Federal Reserve Board has acted, since 2012, only 29 of 652 votes (4.45%) for proposed or final regulations, banking applications, enforcement actions and supervisory matters have not been unanimous.[28]

Even more unusual, though, were Chair Powell's public statements citing certain concerns with the Proposed Rule—although voting in support thereof. In particular, Chair Powell raised concerns that the costs of higher capital could diminish large banks' roles as financial intermediaries and liquidity providers in critical markets and push those activities to less regulated markets.[29] He also voiced concerns that the scope of the Proposed Rule "exceeds what is required by the Basel agreement, and exceeds as well what we know of plans for implementation by other large jurisdictions" and noted "the need to strengthen supervision and regulation for firms with assets between $100 billion and $250 billion" by tailoring rules to "reflect the size and risks of individual institutions."[30] Chair Powell welcomed public comments on the Proposed Rule, noting that he would "be particularly interested in reviewing public feedback and analysis" in certain areas.[31]

Governor Bowman, who has been a consistent opponent of higher capital requirements for the sake of higher capital requirements, was more direct in her criticism of the Proposed Rule, saying "[i]n my view, there is insufficient evidence that the benefits produced by this proposal would justify the costs."[32] Governor Bowman has consistently argued that banking organizations need better supervision and greater transparency in supervisory expectations with enforceable and timely consequences when expectations are not met, and reaffirmed this viewpoint in her statement accompanying the release of the Proposed Rule: "… capital charges are an indirect and inefficient tool to encourage strong risk management, particularly in the area of operational risk. I would appreciate hearing from the public on this issue, but in my mind, it would be preferable to address risk management concerns through improved supervision, demanding prompt remediation of risk management shortcomings, and taking enforcement actions when firms fail to remediate known issues."[33]

Like Chair Powell and others, Governor Bowman also focused on the unintended economic consequences of the Proposed Rule and its potential significant impacts to large banks and their counterparties participating in critical financial markets activities:

> The United States has deep debt and equity markets and supports businesses with a wide range of other products and services, including risk-management tools. These products and services are central for business financing and risk management and contribute to an efficient economy. Those who rely on these products and services will bear the cost of capital increases. For example, when a local government issues municipal bonds to finance local infrastructure, they may find that financing is more expensive, or in some cases unavailable. Manufacturers may find it harder to get loans to invest in equipment or facilities. Companies that operate on the international stage may find it more challenging to hedge their foreign exchange risks. Businesses may find it difficult to manage their interest rate risk exposures, or manage the risks of fluctuating commodity prices. We should be cautious about the disruption that capital increases could cause and look critically at whether these increases are justified by risks. And we should ask whether there are more efficient alternatives—like improved supervision—that could address some of the same underlying concerns.[34]

FDIC Vice Chair Hill raised substantially similar concerns in his statement, stating:

> Altogether, when also considering – among other things – the impact of (1) the new operational risk charge, which is entirely new and additive to what will often be the binding stack, and (2) the revised market risk charge, which is expected to increase market risk-weighted assets by more than double for the large banks most heavily engaged in capital markets activities, the proposal would have a substantial impact on how banks allocate capital. The result will be some combination of higher prices for consumers, less availability of products and services, migration of U.S. activities out of the regulated banking sector, migration of international activities out of U.S. banks, and more fragile financial markets.[35]

Finally, FDIC Director McKernan, among other issues raised, noted that key aspects of the Proposed Rule were "driven by a single focus" of "pushing capital levels yet higher and higher" and included 29 additional questions with his statement for commenters to address, focused on issues including the dual-requirement structure; regulatory capital deductions for mortgage servicing assets for Category III and Category IV banking organizations; credit risk and credit risk mitigants; and market risk, operational risk and credit valuation adjustment risk.[36]

Each of Federal Reserve Governors Bowman and Waller and FDIC Vice Chair Hill and Director McKernan raised concerns with the authority for the Proposed Rule being in conflict with the tailoring requirements under Section 165 of the Dodd-Frank Act, as amended by EGRRCPA, and the federal banking agencies' tailoring rules implementing Section 165.[37]

- *Governor Bowman*: "The proposed revisions under consideration have not been directed by Congress and are not compelled by a new evolution or identified weakness in the U.S. banking system. … A core strength of our current bank regulatory framework is risk-based, tailored regulation. Today's proposal represents a reversal of this longstanding approach. … I am also concerned that today's proposal moves one step closer to eliminating the tailoring required by [EGRRCPA] from the prudential capital framework."
- *Governor Waller*: "Finally, as this proposal applies to all firms with more than $100 billion in assets, I am concerned that we are headed down a road where we would be no longer in compliance with section 165 of the Dodd-Frank Act, as amended by the [EGRRCPA], which mandates tailoring for firms above $100 billion in assets and provides that firms with between $100 billion and $250 billion in assets are not subject to enhanced prudential standards unless a standard is affirmatively applied to such firms based on specific factors set out by Congress. It is unclear to me whether this proposal meets that statutory bar."[38]
- *Vice Chair Hill*: "I oppose unwinding the tailoring of the capital framework for large banks. … Today's proposal repudiates these concepts, by 'aligning' the capital rules for all banks with $100 billion or more in assets. … The proposal undoes almost all of the tailoring of the capital framework for large banks, and is a repudiation of the intent and spirit of [EGRRCPA]. It is further a troubling sign for future policymaking, a signal that regulators intend to treat all large banks alike, in defiance of Congressional directives and in contradiction to the objective of a diverse banking sector with banks of varying sizes, niches, and business models."[39]
- *Director McKernan*: "What requirements or restrictions on each agency's authorities are implicated by the proposal? Does the proposal tailor or otherwise differentiate among banking organizations to the extent required by law?"[40]

These statements highlight a central issue with the Proposed Rule that raises the prospects that the Proposed Rule, if adopted substantially as proposed—particularly as it relates to the effective elimination of tailoring between and among Category I, II, III and IV banking organizations of varying capital structures, riskiness, complexity, financial activities, size and other risk-related factors—could be challenged under the Administrative Procedure Act.

In summary, the statements by Federal Reserve Chair Powell, Governors Bowman and Waller, FDIC Vice Chair Hill and Director McKernan, as well as various comment letters submitted by leading industry trade groups prior to the release of the Proposed Rule—the tone and tenor of which are reflected in the various dissenting statements, underscore both the significance of the Proposed Rule and the range and magnitude of the concerns raised thereby, for large banks, their counterparties and institutional and retail customers, potential homeowners, other industry stakeholders and the broader U.S. economy alike. If finalized as proposed, the Proposed Rule would impose significant "costs on banks, their customers, and the economy”[41] and “would create more economic instability, restrict job growth, decrease productive investment and hamper U.S. competitiveness in the global economy.”[42] If large banks reduce their participation in critical financial markets activities, the effect would be to increase risk to financial stability and the broader U.S. economy by reducing competition and pushing more activities to the unregulated nonbank sector. Moreover, as voiced by several dissenters, the Proposed Rule “undoes almost all of the tailoring of the capital framework for large banks, and is a repudiation of the intent and spirit of [EGRRCPA],”[43] which could result in the final rule being subject to potential challenge if adopted substantially as proposed.

IV. Conclusions

The Proposed Rule would have significant implications and costs for banks and the broader financial system. It is imperative that all stakeholders actively engage in the rulemaking process with the federal banking agencies and other policymakers to facilitate a thoughtful approach to the final Basel III endgame reforms that carefully weighs the costs and benefits of the Proposed Rule and to help design an adjusted and balanced framework that, on the one hand, promotes safety and soundness and resolvability, bolsters financial stability, provides clarity to the markets and reduces complexity and, on the other hand, does not diminish large banks’ critical roles as financial intermediaries, reduce bank participation in critical financial markets activities or the provision of banking services, increase concentration risk in less regulated, more opaque markets, increase costs to consumers and the real economy, and impede large bank counterparties’ and end-users’ ability to safely and efficiently mitigate and manage their commercial risks. Any approach failing to take into account and balance these various considerations and factors could have severe unintended consequences and long-term negative impacts to the broader U.S. economy.

Ultimately, the comment process will play a critical role in shaping the substance of the final rule and the federal banking agencies’ consideration of these matters, and may also form the basis for any future court challenges to the federal banking agencies’ final rule.

Annex A

Proposed Enhanced Capital Requirements

(changes to the capital requirements are shown in red below)

Category I		Category II	Category III
U.S. GSIBs		**? $700 billion total assets or ? $75 billion in cross-jurisdictional activity**	**? $250 billion $75 billion in w term wholesal nonbank asse sheet exposu**
TLAC/Long-term debt			
G-SIB surcharge			
Standardized and ~~advanced approaches~~ expanded risk-based approach*		Standardized and ~~advanced approaches~~ expanded risk-based approach*	Standardized a expanded risk-

Countercyclical buffer		Countercyclical buffer	Countercyclica
No opt-out of AOCI capital impact		No opt-out of AOCI capital impact	No opt-out of A impact**
Enhanced supplementary leverage ratio		Supplementary leverage ratio	Supplementary
Enhanced public disclosure and reporting requirements		Enhanced public disclosure and reporting requirements	Enhanced publ reporting requi
Operational risk management function that is independent of business line management		Operational risk management function that is independent of business line management	Operational ris function that is business line m

* expanded risk-based approach subject to a 72.5% output floor; binding ratio would expanded risk-based approach subject to three-year transition period according to th

Transition Expanded Total Risk-Weighted Asset	
Transition period	**Percentage of expa**
July 1, 2025 to June 30, 2026	
July 1, 2026 to June 30, 2027	
July 1, 2027 to June 30, 2028	
July 1, 2028 and thereafter	

** AOCI adjustment subject to three-year transition period according to the following

Transition AOCI Adjustment	
Transition period	**Percentage applicable to**
July 1, 2025 to June 30, 2026	
July 1, 2026 to June 30, 2027	
July 1, 2027 to June 30, 2028	
July 1, 2028 and thereafter	

Attachment

Coalition for Derivatives End-Users

Coalition for Derivatives End-Users July 6, 2023 Letter to the Federal Banking Agencies, "*Consideration of the Basel III Endgame Reforms and their Impact on the End-User Community*"

July 6, 2023

Ms. Ann E. Misback Secretary Board of Governors of the Federal Reserve System 20th Street and Constitution Avenue NW Washington, DC 20551

Ms. Debra Buie Decker Executive Secretary Federal Deposit Insurance Corporation 550 17th Street NW Washington DC 20429

Mr. Michael J. Hsu Acting Comptroller of the Currency Office of the Comptroller of the Currency 400 7th Street SW Washington, DC 20219

Re: Consideration of the Basel III Endgame Reforms and their Impact on the End-User

Community

The Coalition for Derivatives End-Users (the "Coalition") respectfully submits this letter to express its concerns about aspects of forthcoming changes to capital requirements for large banks commonly referred to as the Basel III Endgame package of reforms, and to emphasize the need for the Federal Banking Agencies[1] to consider carefully the numerous effects the implementation of certain changes could have on the end-user community.

The Coalition represents end-user companies that employ derivatives primarily to manage commercial risks associated with their businesses. Hundreds of companies have been active in the Coalition on both legislative and regulatory matters and our message is straightforward: financial regulatory reform measures should promote economic stability and transparency without imposing undue burdens on derivatives end-users. Imposing unnecessary regulation on derivatives end-users would create more economic instability, restrict job growth, decrease productive investment and hamper U.S. competitiveness in the global economy—and may result in less hedging by end-users.

The use of derivatives to hedge commercial risk benefits the global economy by allowing a range of businesses—from manufacturing to healthcare to agriculture to energy to technology— to improve their planning and forecasting and offer more stable prices to consumers and more stable contributions to economic growth. Banking organizations that may be subject to the new Basel III Endgame capital requirements serve as critical counterparties to end-users for their derivatives transactions. They also serve as capital markets intermediaries, sources of stable credit, underwriters of corporate debt and equity securities and liquidity providers, and play other critical financial intermediary roles. Based on public statements from the heads of the Federal Banking Agencies, independent analyses of Basel III Endgame reform proposals underway in the EU and the UK and expected proposed changes here in the U.S., these new proposals could significantly increase capital requirements for the largest U.S. and non-U.S. banks that provide the bulk of derivatives-related products and services to corporations of all sizes and across many different, diverse sectors of the economy, including many Coalition members. These corporations use derivative products to hedge and mitigate commercial risks associated with their businesses, including interest rate risk, foreign currency risk and commodities risks. Coalition members' ability to hedge and mitigate such commercial risks is crucial to their business operations and the broader U.S. economy and the Coalition has concerns that the availability and cost of and competition for the delivery of such products, could be materially adversely affected in the wake of changes implemented under the Basel III Endgame's reforms. Therefore, we urge the Federal Banking Agencies to undertake a thoughtful approach to design an adjusted and balanced framework that, on the one hand, promotes safety and soundness and resolvability, bolsters financial stability and provides clarity to the markets and, on the other hand, does not diminish large banks' critical role as financial intermediaries, mitigates potential impacts on derivatives end-users and minimizes potential downside to the broader U.S. economy.

We are particularly concerned that specific aspects of the trading book components of the Basel III Endgame reforms could lead to reduced bank participation in certain financial markets— which would increase risk to financial stability and the broader U.S. economy by concentrating these products in less transparent markets and would increase costs for end-users. If these issues are not appropriately calibrated and balanced by the Federal Banking Agencies against those bank- specific risks that the Federal Banking Agencies are intending to address through the Basel III Endgame reforms, the new rules will have serious consequences to end-users and far-reaching negative implications for the broader U.S. economy, economic growth, competition and financial stability.

It has been estimated that implementing the Basel III Endgame reforms could result in an approximately **57 percent** increase in the capital requirements for banks' trading activities.[2] This increase is planned despite the fact that Federal Reserve Vice Chair for Supervision Michael Barr has noted on several occasions in written testimony or other formal remarks, including as far back as his nomination hearing before the Senate Banking Committee and as recently as May 18, 2023, that capital and liquidity in the financial system is very strong, a sentiment echoed by current and former regulators.[3] Indeed, Common Equity Tier 1 capital (the highest quality form of bank capital) levels at the largest U.S. banks grew more than three-fold between 2007 and 2023.4 This increase, combined with a range of other post-crisis reforms, has made the largest U.S. banks far safer and has reduced risks such banks pose to the broader economic and financial system and financial stability.

As you know, large U.S. banks play a central role in the U.S. and global financial system through, among other things, capital formation and liquidity provision to the U.S. capital markets. The U.S. capital markets fund nearly three-quarters of all U.S. economic activity, making them a crucial source of financing and risk management services for a wide range of end-users. Nevertheless, significant increases in capital requirements in recent years have caused banks to pull back from key capital markets activities, resulting in higher costs for end-users and their customers, reduced competition and transparency in those markets, and signs of diminished liquidity and efficiency in some markets, particularly during periods of stress—all of which increase risk to financial stability.

In our view, the Basel III Endgame reforms' capital requirements for large banks would dramatically accelerate this trend, thereby increasing risk further. For example, the effects on trading activities resulting from the Fundamental Review of the Trading Book, Credit Valuation Adjustment and the Securities Financing Transaction minimum haircut floor portions of the Basel III Endgame reforms would force large banks to either pass on those costs of higher capital to end- users and their customers or simply withdraw from some capital markets activities altogether which, in the latter case, would increase concentration risk in less regulated, more opaque markets.

Moreover, the nearly 60 percent increase in the capital requirements for banks' trading activities is expected to significantly impact commercial hedging activities. For example, the cost of hedging foreign exchange risks would likely increase, as would the costs of entering long-dated interest rate swaps. The higher costs would at least partially negate adjustments made to the Standardized Approach to Counterparty Credit Risk rule that were designed to protect the cost savings afforded to end-users as a result of previously enacted Congressional relief. To help facilitate efficient access to the derivatives hedging market, Congress exempted end-users that are hedging business risks from having to post margin on uncleared derivatives transactions and from having to clear derivatives transactions.[5] These cost increases, coupled with the potential decrease in large bank participation in these markets, would hinder end-users' abilities to effectively hedge and reduce business risks. This, in turn, would discourage capital investments, economic growth and job creation.

As the Federal Banking Agencies consider materially increasing both the overall and trading book-related capital requirements for the largest banks as part of the Basel III Endgame reforms, it is critical that the Federal Banking Agencies remain mindful of, and account for, the strong correlation between capital markets activities and the real U.S. economy and duly consider and balance the impact of any potential increases in bank capital requirements on the ability of end-users to effectively hedge important business risks at reasonable cost in highly regulated, more transparent markets. As an example, when an end-user hedges its interest rate, foreign exchange or commodity risk with a bespoke derivative product, that activity generates a derivative exposure for a large bank, that the bank will, in turn hedge. The Basel III Endgame reforms are likely to increase hedging costs, disincentivize prudent risk-management by corporations, and ultimately increase costs and risk and reduce investment in our economy. In that connection, we also request that the Federal Banking Agencies conduct and publish a broader cost-benefit analysis and assessment of both the economic benefits and costs of significantly increasing capital requirements above their already historically robust levels.

The Coalition stands ready to engage with the Federal Banking Agencies and other policymakers in this critically important work with the goal of ensuring that the final Basel III Endgame reforms carefully balance costs and benefits to create an adjusted and balanced framework that promotes safety and soundness and resolvability, bolsters financial stability, provides clarity to the markets and reduces complexity. At the same time, it is important that the new rules do not diminish large banks' critical roles as financial intermediaries, impede end-users' ability to safely and efficiently mitigate and manage their commercial risks or create unintended consequences to the detriment of the broader U.S. economy.

Thank you for your consideration of these very important issues to derivatives end-users.

Please contact Michael Bopp at 202-955-8256 or at mbopp@gibsondunn.com if you have any questions or concerns.

Yours sincerely, Coalition for Derivatives End-Users

cc:

The Honorable Jerome H. Powell, Chairman The Honorable Michael S. Barr The Honorable Michelle W. Bowman The Honorable Lisa D. Cook The Honorable Philip N. Jefferson The Honorable Christopher J. Waller (Board of Governors of the Federal Reserve System)

The Honorable Martin J. Greunberg, Chairman The Honorable Travis Hill, Vice Chairman The Honorable Rohit Chopra, Director The Honorable Michael J. Hsu, Director (*addressee*) The Honorable Jonathan McKernan, Director (Federal Deposit Insurance Corporation)

[1] For purposes of this letter, the "Federal Banking Agencies" consist of the Department of the Treasury's Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System and the Federal Deposit Insurance Corporation.

[2] *See* PWC, "Basel III Endgame: The next generation of capital requirements," at 1 (April 2023), *available at*: https://explore.pwc.com/baseliiiendgame/basel-iii-endgame-exsumm.

[3] *See*, *e.g.*, *Nominations of Michael S. Barr, Jaime E. Lizarraga, and Mark Toshiro Uyeda, Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs*, 118th Cong, at 15 and 18, *available at*: https://www.congress.gov/117/chrg/CHRG-117shrg48337/CHRG-117shrg48337.pdf; *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. at 1 (statement of the Honorable Michael S. Barr, Vice Chair for Supervision, Board of Governors of the Federal Reserve System), *available at*: https://www.banking.senate.gov/imo/media/doc/Barr%20Testimony%205-18-23.pdf; *see also*, *Transcript of Chair Powell's Press Conference* (March 22, 2023), *available at*: https://www.federalreserve.gov/mediacenter/files/FOMCpresconf20230322.pdf; *Remarks by Secretary of the Treasury Janet L. Yellen at Financial Stability Oversight Council Meeting* (April 21, 2023), *available at*: https://home.treasury.gov/news/press-releases/jy1431.

[4] *See* SIFMA, "Identifying an Optimal Level of Capital and Evaluating the Impact of Higher Bank Capital Requirements on US Capital Markets" (May 15, 2023), *available at*: https://www.sifma.org/resources/news/identifying-an-optimal-level-of-capital-and-evaluating-the-impact-of- higher-bank-capital-requirements-on-us-capital-markets/.

[5] *See* the Business Risk Mitigation Price Stabilization Act of 2015. "Forcing businesses to post margin not only ties up capital, but also makes it more expensive for firms to utilize the risk management tools that they need to protect their businesses from uncertainty. Today's bill clarifies in statute that Congress meant what it said when it exempted end users from margin and clearing requirements. Specifically, it ensures that those businesses which are exempt from clearing their hedges are also exempt from margining those hedges." 114th Congr. Rec. H-67- 68 (Jan. 7, 2015) (state of Rep. Mike Conaway).

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[1] Federal Reserve, FDIC, OCC, *Regulatory capital rule: Amendments applicable to large banking organizations and to banking organizations with significant trading activity* (July 27, 2023), *available at*: https://www.federalreserve.gov/aboutthefed/boardmeetings/frn-basel-iii-20230727.pdf (the "Proposed Rule"). *See also* the consolidated "Basel Framework" *available at*: https://www.bis.org/basel_framework/.

[2] Federal Reserve, *Regulatory Capital Rule: Risk-Based Surcharges for Globally Systemically Important Bank Holding Companies; Systemic Risk Report (FR Y-15)*, *available at*: https://www.federalreserve.gov/aboutthefed/boardmeetings/frn-gsib-20230727.pdf (the "GSIB Surcharge Proposal").

[3] 12 U.S.C. § 5365.

[4] Under the Dodd-Frank Act, those enhanced prudential standards include enhanced risk-based and leverage capital, liquidity, risk management and risk committee requirements, a requirement to submit a resolution plan, single-counterparty credit limits, supervisory and company-run stress testing requirements, and other prudential standards that the Federal Reserve determines are appropriate.

[5] Federal Reserve, *Prudential Standards for Large Bank Holding Companies, Savings and Loan Holding Companies, and Foreign Banking Organizations*, 84 Fed. Reg. 59032 (Nov. 1, 2019); OCC, Federal Reserve, FDIC, *Changes to Applicability Thresholds for Regulatory Capital and Liquidity Requirements*, 84 Fed. Reg. 59230 (Nov. 1, 2019).

[6] *See* 12 U.S.C. § 5365(a)(2)(A) (requiring that the Federal Reserve, "in prescribing more stringent prudential standards under [Section 165], … differentiate among companies on an individual basis or by category, taking into consideration their capital structure, riskiness, complexity, financial activities (including the financial activities of their subsidiaries), size, and any other risk-related factors that the [Federal Reserve] deems appropriate.").

[7] A visual depicting certain changes to the capital requirements applicable to banking organizations under the Proposed Rule is included as Annex A.

[8] The term "banking organizations" includes national banks, state member banks, state nonmember banks, federal savings associations, state savings associations, top-tier bank holding companies domiciled in the U.S. not subject to the Federal Reserve's Small Bank

Holding Company and Savings and Loan Holding Company Policy Statement, U.S. intermediate holding companies of foreign banking organizations, and top-tier savings and loan holding companies domiciled in the U.S., except for certain savings and loan holding companies that are substantially engaged in insurance underwriting or commercial activities and savings and loan holding companies that are subject to the Small Bank Holding Company and Savings and Loan Holding Company Policy Statement.

[9] As noted in the preamble to the Proposed Rule, "[a]lthough the proposal would remove use of internal models for calculating capital requirements for credit and operational risk, internal models can provide valuable information to a banking organization's internal stress testing, capital planning, and risk management functions. Large banking organizations should employ internal modeling capabilities as appropriate for the complexity of their activities." Proposed Rule, p. 18.

[10] Total risk-weighted assets under the expanded risk-based approach would equal the sum of risk-weighted assets for credit risk, equity risk, operational risk, market risk, and CVA risk, less any amount of the banking organization's adjusted allowance for credit losses that is not included in tier 2 capital and any amount of allocated transfer risk reserves. An "output floor" of 72.5 percent of expanded total risk-weighted assets would serve as a lower bound on the risk-weighted assets under the expanded risk-based approach. *See* Proposed Rule, p. 23-24.

[11] For calculating standardized total risk-weighted assets, the Proposed Rule would revise the methodology for determining market risk-weighted assets and would require banking organizations subject to Category III or IV capital standards to use the standardized approach for counterparty credit risk ("SA-CCR") for derivatives exposures. *See* Proposed Rule, p. 23.

[12] Proposed Rule, p. 199.

[13] The basic measure for CVA risk would include risk-based capital requirements for all CVA risk covered positions and eligible CVA hedges calculated using the BA-CVA, and any other additional capital requirement for CVA risk established by the banking organization's primary federal regulator if the regulator determines that the capital requirement for CVA risk as calculated under the BA-CVA is not commensurate with the CVA risk of the banking organization's CVA risk covered positions. *See* Proposed Rule, p. 446.

[14] The standardized measure for CVA risk would include risk-based capital requirements calculated under (1) the SA-CVA for all standardized CVA risk covered positions and standardized CVA hedges, (2) the BA-CVA for all basic CVA risk covered positions and basic CVA hedges, and (3) any additional capital requirement for CVA risk established by the banking organization's primary federal regulator if the regulator determines that the capital requirement for CVA risk as calculated under the SA-CVA and BA-CVA is not commensurate with the CVA risk of the banking organization's CVA risk covered positions. *See* Proposed Rule, p. 446-47.

[15] *See* Proposed Rule, p. 497, n. 463 and accompanying text.

[16] *See* Proposed Rule, p. 494-95, n. 465 and accompanying text.

[17] *See* Proposed Rule, p. 497.

[18] *See* Proposed Rule, p. 500.

[19] *See* Proposed Rule, p. 504.

[20] Coalition for Derivatives End-Users, "*Consideration of the Basel III Endgame Reforms and their Impact on the End-User Community*" (July 6, 2023). A copy of the Coalition

Letter is attached hereto.

[21] Proposed Rule, p. 489.

[22] Statement by FDIC Director Jonathan McKernan (July 27, 2023), *available at*: https://www.fdic.gov/news/speeches/2023/spjul2723c.html ("Director McKernan Statement"). In addition to the Proposed Rule's 176 questions as prompts (almost all of which include multiple related sub-prompts) to solicit comments and data on all aspects of the Proposed Rule and its potential impacts, FDIC Director McKernan's statement includes an additional 29 questions as prompts (almost all of which include multiple related sub-prompts) to solicit comments and data.

[23] Statement by Federal Reserve Governor Michelle W. Bowman (July 27, 2023), *available at*: https://www.federalreserve.gov/aboutthefed/boardmeetings/bowman-statement-20230727.pdf ("Governor Bowman Statement").

[24] Director McKernan Statement.

[25] 12 U.S.C. § 5365(a)(2)(A) (emphasis supplied).

[26] *See* GSIB Surcharge Proposal, p. 46-47.

[27] Federal Reserve Board vote (*votes in favor*: Chair Powell, Vice Chair for Supervision Barr, Governor Cook, Governor Jefferson; *votes against*: Governor Bowman, Governor Waller); FDIC Board vote (*votes in favor*: Chairman Gruenberg; Director Hsu; Director Chopra; *votes against*: Vice Chair Hill, Director McKernan). The Federal Reserve voted unanimously to approve the GSIB Surcharge Proposal.

[28] *See* Board of Governors of the Federal Reserve System: Board Votes*, available at*: https://www.federalreserve.gov/aboutthefed/boardvotes.htm.

[29] *See* Statement by Federal Reserve Chair Jerome H. Powell (July 27, 2023), *available at*: https://www.federalreserve.gov/aboutthefed/boardmeetings/powell-statement-20230727.pdf.

[30] *Id*.

[31] *Id.*

[32] Governor Bowman Statement.

[33] *Id*.

[34] *Id*.

[35] *See* Statement by FDIC Vice Chair Travis Hill (July 27, 2023), *available at*: https://www.fdic.gov/news/speeches/2023/spjul2723b.html ("Vice Chair Hill Statement").

[36] *See* Director McKernan Statement.

[37] As noted above, EGRRCPA amended Section 165 of the Dodd-Frank Act to raise the minimum asset threshold for application of enhanced prudential standards from $50 billion to $250 billion in total consolidated assets, while (i) providing the Federal Reserve discretion in determining whether an institution with assets of $100 billion or more must be subject to such standards and (ii) requiring a more tiered and tailored enhanced prudential standards regime for large banks. *See* 12 U.S.C. § 5365.

[38] Statement by Federal Reserve Governor Christopher J. Waller (July 27, 2023), *available at*: https://www.federalreserve.gov/aboutthefed/boardmeetings/waller-statement-20230727.pdf.

[39] Vice Chair Hill Statement.

[40] Director McKernan Statement.

[41] Governor Bowman Statement.

[42] Coalition Letter.

[43] Vice Chair Hill Statement.

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