Regulatory Capital Rule: Revised Framework for Determining Risk-Based Capital Requirements for Large Banking Organizations and Banking Organizations With Significant Trading Activity

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I am writing as a private individual and banking customer to provide my comments on the proposed rule that would revise the capital requirements for large banking organizations and banking organizations with significant trading activity, as published in the Federal Register. I appreciate the opportunity to share my views on this important and complex issue.

INTRODUCTION

The banking sector is the backbone of the economy, providing essential financial services and intermediation to households, businesses, and governments. However, the banking sector is also vulnerable to various risks and shocks, such as credit risk, operational risk, market risk, and credit valuation adjustment risk. These risks can materialize in different ways, such as defaults, frauds, losses, or valuation changes, and cause significant damage to the banks' balance sheets and capital positions. When these risks become too severe or widespread, they can trigger banking failures and collapses, which can have devastating consequences for the financial stability and economic growth of the nation.

The history of the U.S. banking sector is marked by several episodes of banking failures and collapses that have exposed the weaknesses and gaps in the regulatory and supervisory framework. Some of the most notable examples are:

The Savings and Loan Crisis of the 1980s and early 1990s, which involved the failure of more than 1,000 savings and loan associations (S&Ls) due to risky lending practices, high interest rates, deregulation, fraud, and mismanagement. The crisis cost taxpayers about $132 billion and contributed to the recession of 1990-1991.

The Subprime Mortgage Crisis and the Global Financial Crisis of 2007-2009, which involved the collapse of several large banks and financial institutions due to their exposure to subprime mortgages and complex derivatives. The crisis triggered a global credit crunch, a severe recession, and a massive government intervention. The crisis cost the U.S. economy about $22 trillion in lost output and wealth.

The Archegos Capital Management Collapse of March 2023, which involved the failure of a family office that had leveraged positions in several stocks through derivatives contracts with multiple banks. When the stock prices declined sharply, Archegos was unable to meet its margin calls, triggering a fire sale of its assets and causing billions of dollars of losses for its lenders.

The Wells Fargo bank issues involved the creation of millions of unauthorized accounts and credit cards by Wells Fargo employees to meet aggressive sales targets and earn incentives. The scandal, which was revealed in 2016, resulted in regulatory fines, legal settlements, reputational damage, and customer defections for Wells Fargo. The proposed rule would have addressed this issue by requiring banking organizations to use a standardized approach for operational risk capital requirements, which would capture some aspects of operational risk, such as fraud, litigation, or misconduct. The standardized approach would also reduce the complexity and variability of the capital framework and enhance the comparability and reliability of capital ratios across banking organizations. This would facilitate more effective supervisory and market assessments of capital adequacy and deter or detect any unethical or illegal practices by banking organizations.

These banking failures and collapses have revealed some of the common causes and factors that have undermined the safety and soundness of the banking sector, such as:

- Inadequate capital requirements that do not reflect the actual risks and impacts of banks' exposures.

- Complex and inconsistent capital framework that allows for manipulation, + variability, or lack of validation of capital calculations. +

- Lack of transparency and comparability of capital ratios across banks and over time.

- Incentives for regulatory arbitrage and capital optimization that may increase systemic risk or undermine financial stability.

- Competitive disadvantages for U.S. banks relative to their foreign counterparts due to differences in regulatory treatment or standards.

To address these issues and challenges, the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, and the Federal Deposit Insurance Corporation (collectively, the agencies) have issued a proposed rule that would revise the capital requirements for large banking organizations (those with total assets of $100 billion or more) and banking organizations with significant trading activity. The proposed rule aims to:

- Improve the calculation of risk-based capital requirements to better reflect the risks of these banking organizations' exposures, such as credit risk, operational risk, market risk, and credit valuation adjustment risk.

- Reduce the complexity of the framework by replacing the current internal model approaches for credit and operational risk with standardized approaches that are more transparent and consistent.

- Enhance the consistency of requirements across these banking organizations by applying the same treatment of unrealized gains and losses on certain securities and other components of accumulated other comprehensive income (AOCI), capital deductions, and rules for minority interest.

- Facilitate more effective supervisory and market assessments of capital adequacy by aligning the U.S. capital framework with the international capital standards issued by the Basel Committee on Banking Supervision.

The proposed rule seems to be well crafted to reduce the chances of future banking failures and collapses without impairing the vitality of the banking sector. The proposed rule would ensure that these banking organizations hold more and higher quality capital to withstand potential shocks and reduce their likelihood or severity of failure. The proposed rule would also improve the alignment of regulatory requirements with actual risks and impacts, which would increase the efficiency and effectiveness of the capital framework. The proposed rule would also promote financial stability and market discipline by reducing regulatory arbitrage opportunities and increasing global consistency of capital requirements.

The proposed rule is a significant step forward in strengthening the resilience and performance of the U.S. banking sector. It is based on the lessons learned from past banking crises and failures, as well as on the current and emerging risks and challenges that the banking sector faces.

RESPONSES TO POTENTIAL CRITICISMS

The proposed rule may face some criticism from some industry commenters, as discussed below. This is in spite of the many historic banking incidents that have occurred, and the vulnerabilities that the financial industry has from increased interrelationships, linkages, and scenarios such as derivatives counterparty risks.

Standardized Approach versus Internal Model Approaches

The proposed rule would replace the internal model approaches for credit and operational risk capital requirements with standardized approaches that are more transparent and consistent. However, some might argue that this would also reduce the risk sensitivity and accuracy of the capital framework, as the standardized approaches may not capture the specific risk profiles and diversification benefits of different banks. Further, they would say that the agencies should allow banks to use internal models for credit and operational risk capital requirements, subject to appropriate validation and calibration standards, to better reflect the actual risks and impacts of their exposures.

In fact, **the proposed rule would improve the transparency and consistency of the capital framework, as the internal model approaches have been subject to manipulation, inconsistency, or lack of validation.** The standardized approaches would also enhance the comparability and reliability of capital ratios across banks, which would facilitate more effective supervisory and market assessments of capital adequacy. The agencies have calibrated the standardized approaches to be broadly consistent with the internal model approaches in terms of aggregate capital requirements, and they have also provided some adjustments and options for banks to account for their specific risk profiles and diversification benefits.

Alignment With International Capital Standards

The proposed rule would align the U.S. capital framework with the international capital standards issued by the Basel Committee on Banking Supervision, which have introduced new methodologies and parameters for market risk and credit valuation adjustment risk. However, some would argue that this would also introduce new sources of volatility and complexity in the capital calculations, which would affect the hedging strategies and risk management practices of banks. They would say that the agencies should review the calibration and design of the revised market risk and credit valuation adjustment risk frameworks to ensure that they are consistent with the objectives of the proposal and do not introduce undue volatility or complexity in the capital calculations.

In fact, the proposed rule would improve the risk sensitivity and transparency of the capital framework, as the revised market risk and credit valuation adjustment risk frameworks would better reflect the potential losses from market movements and counterparty credit risk. **The alignment with the international capital standards would also promote financial stability and market discipline, as it would reduce regulatory arbitrage opportunities and increase global consistency of capital requirements.** The agencies have considered the impact of volatility and complexity in the calibration and design of the revised frameworks, and they have also provided some simplifications and exemptions for banks to reduce their operational and compliance costs.

Expansion of Risk Based Approach

The proposed rule would expand the risk-based approach to capture all material sources of risk that banks face, such as credit risk, operational risk, market risk, and credit valuation adjustment risk. Some might argue that this would also create incentives for regulatory arbitrage and capital optimization, as banks may try to avoid or reduce their exposures to certain types of risk or shift their activities to less regulated or more favorable jurisdictions. They would prefer that the agencies monitor and address any potential incentives for regulatory arbitrage and capital optimization that may arise from the expanded risk-based approach, such as by applying additional supervisory measures or adjusting the risk weights or capital buffers as needed.

In fact, **the proposed rule would ensure that banks hold sufficient capital to absorb potential losses from any source of risk, which would enhance their resilience and reduce their likelihood or severity of failure.** The expanded risk-based approach would also improve the alignment of regulatory requirements with actual risks and impacts, which would increase the efficiency and effectiveness of the capital framework. The agencies have taken into account the potential incentives for regulatory arbitrage and capital optimization in the design and calibration of the expanded risk-based approach, and they have also established some safeguards and constraints to prevent or mitigate such behavior.

Treatment of Unrealized Gains and Loses Compared with Foreign Counterparts

The proposed rule would apply the same treatment of unrealized gains and losses on certain securities and other components of AOCI, capital deductions, and rules for minority interest across all large banking organizations. Some may argue that this would also create competitive disadvantages for U.S. banks relative to their foreign counterparts, especially in terms of operational risk capital requirements and the treatment of AOCI. They would prefer that the agencies coordinate with their international counterparts to ensure a level playing field for U.S. banks, especially in terms of operational risk capital requirements and the treatment of AOCI.

In fact, **the proposed rule would enhance the consistency and simplicity of the capital framework, as it would eliminate some of the differences in treatment that currently exist across large banking organizations.** The consistent treatment of AOCI, capital deductions, and rules for minority interest would also improve the quality and comparability of capital across large banking organizations. The agencies have coordinated with their international counterparts to ensure that the U.S. capital framework is broadly consistent with the international capital standards, while also taking into account some specific characteristics or circumstances of U.S. banks.

SUGGESTIONS

Suggestion to Mitigate the Impact on Community Banks, Credit Unions, and Smaller/Less Complex Banking Organizations

The proposed rule would revise the capital requirements for large banking organizations (those with total assets of $100 billion or more) and banking organizations with significant trading activity. However, **the proposed rule may also have some indirect or spillover effects on other types of financial institutions that are not subject to the proposed rule, such as community banks, smaller or less complex banking organizations, and credit unions.** These effects may include:

- Changes in the competitive landscape and market dynamics of the banking sector, as the proposed rule may create some advantages or disadvantages for large banking organizations and banking organizations with significant trading activity relative to other types of financial institutions.
- Changes in the risk profiles and exposures of other types of financial institutions, as they may be exposed to some of the same risks or shocks that affect large banking organizations and banking organizations with significant trading activity.
- Changes in the expectations and standards of regulators, supervisors, auditors, rating agencies, investors, customers, and other stakeholders for other types of financial institutions, as the proposed rule may raise the bar for capital adequacy and risk management for large banking organizations and banking organizations with significant trading activity.

To mitigate these potential issues, I respectfully suggest that the agencies consider some possible modifications or additions to the proposed rule, such as:

- Providing some guidance or clarification on how the proposed rule would affect community banks, smaller or less complex banking organizations, and credit unions, and how they should prepare for or respond to the potential changes in the regulatory environment and market conditions.
- Monitoring and addressing any potential spillover effects or competitive pressures that may arise from the proposed rule for community banks, smaller or less complex banking organizations, and credit unions, and ensuring that they are not subject to undue costs or constraints.
- Coordinating with other regulators or supervisors that oversee community banks, smaller or less complex banking organizations, and credit unions, including the

National Credit Union Administration (NCUA), to ensure a consistent and proportionate approach to capital regulation and supervision.

Suggestion Regarding Risks of Quantum Computing on Banking Security

I acknowledge that this particular suggestion is outside the scope of the proposed rule, but it should be taken into consideration in future planning for banking regulation.

The proposed rule may not adequately address the potential risks of quantum computing on banking security and cryptography. Quantum computing is a technology that uses quantum mechanical phenomena, such as superposition and entanglement, to perform computations that are faster and more powerful than classical computers. Quantum computers can potentially break some of the cryptographic methods and protocols that banks rely on to protect their data, transactions, and customers from unauthorized access, modification, or theft.

Quantum computing poses a potential threat to banking security and cryptography, as quantum computers can potentially break some of the cryptographic methods and protocols that banks rely on. For example, quantum computers can use Shor's algorithm to factor large numbers or find discrete logarithms in polynomial time, which would render RSA and ECC encryption schemes vulnerable. Quantum computers can also use Grover's algorithm to search large databases or find collisions in hash functions in quadratic time, which would reduce the security of symmetric encryption schemes or digital signatures.

The emergence of a working quantum computer of sufficient scale (enough qubits) that can defeat cryptographic systems used by banks could have catastrophic consequences for the banking sector and the economy. Such a scenario could compromise the confidentiality, integrity, and availability of banking data, transactions, and customers, and cause massive losses, frauds, breaches, or thefts. It could also trigger a banking crisis, failure, panic, or disruption, and reduce trust and confidence in the banking system.

I suggest that the agencies do more to address this potential risk, such as:

- Providing some guidance or clarification on how quantum computing could affect banking security and cryptography, and how banks should prepare for or respond to the potential changes in the threat landscape and technology environment.
- Monitoring and addressing any developments or advances in quantum computing that could pose a threat to banking security and cryptography, and ensuring that banks are aware of and prepared for such scenarios.
- Coordinating with other regulators or supervisors that oversee banking security and cryptography, such as the National Institute of Standards and Technology

(NIST), to ensure a consistent and proactive approach to quantum-resistant cryptography.

Each financial regulator and financial institution ought to use this window of time before quantum computers appear to look at each element in their systems to identify vulnerable places to quantum computers and take steps to reduce those vulnerabilities and plan for changes that would reduce reliance on encryption schemes that would be vulnerable. This would help to enhance the resilience and preparedness of the banking sector for the potential challenges and opportunities of quantum computing.

I recognize that NIST and other agencies may already be working on developing and implementing quantum-resistant cryptography and standards, and may be coordinating with financial regulators, but this may not be sufficiently at the forefront of banking regulation to address the urgency and magnitude of the quantum computing threat. The agencies should increase their efforts and resources, and enlist the banking entities on a cooperative basis, to ensure that the banking sector is adequately prepared and protected from the potential risks of quantum computing.

Thank you for reviewing my comments.

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