Meeting Between Staff of the Federal Reserve Board, Federal Deposit Insurance Corporation, and Office of the Comptroller of the Currency and Representatives of the Bank Policy Institute, American Bankers Association, and Others
April 3, 2024

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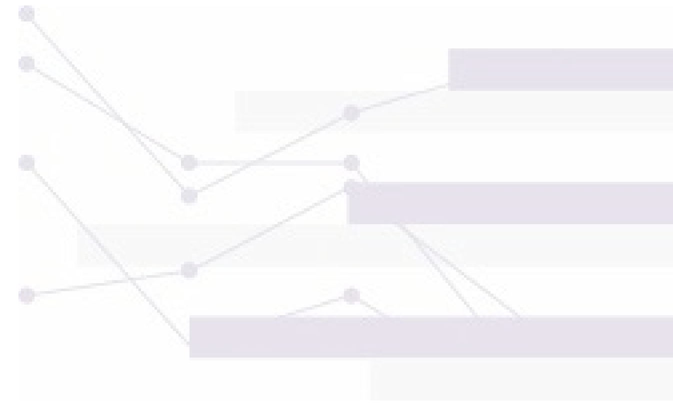
Amrit Sekhon, Margot Schwadron, Venus Fan, Benjamin Pegg, JungSup Kim, Nadia Gerasimova, Diana Wei, and Carl Kaminski (OCC)

Benedetto Bosco, Merritt Pardini, Richard Smith, David Riley, Brian Cox, Olga Lionakis, Peter Yen, Huiyang Zhou, Lauren Brown, Iris Li, Michael Maloney, Ernest Barkett, Kyle McCormick, and Catherine Wood (FDIC)

Brett Waxman, Francisco Covas, Gregory Hopper, and Jack Stump (BPI); Hu Benton and Warren Hrung (ABA); Emma Tong (FSF); Marc Tourangeau (ISDA); Carter McDowell (SIFMA); Amy Fainsbert (UBS); Tim Becker, Karl Reitz and John Allen (Wells Fargo); Andrew Nash and Sarah Lantz (Morgan Stanley); Bengt Redlinger and Garrett Ahitow (Bank of America); Andrew White (RBC); Mike Bonafide and Anderson Lee (American Express); Noah Cuttler (Barclays); Beth Cleland, Alistair Webster, and Jason Fachler (JPMC); Joseph Hwang, Ben Katz, Avijit Praveer, and Kyle Russ (Goldman Sachs); Robert McKeon (State Street); Erik Soderberg (Deutsche Bank); Nitish Chamania (BNY Mellon); Sarah Flowers (US Bancorp); Bobby Bean (Truist); Benjamin Weiner, and Leanne Van Allen (Sullivan and Cromwell)

Summary: Staff of the Federal Reserve Board, Federal Deposit Insurance Corporation, and Office of the Comptroller of the Currency (agencies) met with representatives of the Bank Policy Institute, American Bankers Association, and additional trade associations and member companies (Trade Groups), regarding the agencies' Basel III endgame notice of proposed rulemaking. Representatives of the Trade Groups discussed the impact of the proposal with a particular focus on the proposed credit risk framework. Topics from the proposal that were covered included the risk weights for residential mortgage exposures, the risk weights for corporate exposures, and the framework for credit cards and other lines of credit, as described in the attached presentation.

Attachment



Basel III End Game

April 2024

Agenda

1. Why a reproposal is the path forward
2. Credit risk
   - Retail credit
   - Bank exposures
   - Investment grade corporates/small businesses
   - Defaulted loans
   - Subordinated debt
   - Differences in business models and circumstances
   - Selected results from QIS
3. Equity risk in the banking book
   - Risk weight for national legislated programs
   - Non-significant equity exposures
   - Hedge pair treatment
   - Look-through approaches
4. Operational risk
   - Adjustments to the internal loss multiplier
   - Adjustments to the services component
   - QIS on potential adjustments

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Why a reproposal is the path forward

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Resolving concerns expressed with the proposal requires fundamental reassessment and reproposal.

- The breadth of feedback from sectors outside the banking industry underscores the need to conduct a robust cost-benefit analysis of the proposal.
- It is also imperative that the agencies reconsider the proposal in the context of other elements of the capital framework, including the interplay with the G-SIB surcharge and stress tests.
- The agencies should also analyze the impact of revised bank capital standards on the U.S. economy and capital markets.
- Any revised or expanded analyses or adjustments to the proposal must be made part of the record and available for public comment.

Credit risk

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Risk weights for real estate exposures are overstated and would harm LMI borrowers.

- Numerous commenters have highlighted the harms the proposal would inflict, particularly on disadvantaged communities and low- and moderate-income borrowers. Among the many advocates for those communities are:
  - https://www.federalreserve.gov/SECRS/2023/October/20231017/R-1813/R-1813_101023_154739_416882729609_1.pdf
  - https://www.federalreserve.gov/SECRS/2023/December/20231201/R-1813/R-1813_110423_156301_540712497269_1.pdf
  - https://www.federalreserve.gov/SECRS/2023/December/20231214/R-1813/R-1813_102223_154748_516319846050_1.pdf
  - https://www.federalreserve.gov/SECRS/2023/December/20231229/R-1813/R-1813_121123_156569_351687792589_1.pdf
- We urge the agencies to heed these concerns in addressing changes to the proposal.

Risk weights for retail loans are substantially overstated.

- The agencies should recalibrate the proposal's risk weights for retail exposures based on an empirical analysis of their risk profile.
  - Doing so would be more risk-sensitive and also result in more affordable, available credit, thus mitigating the adverse effects of the proposal on consumers and the economy.
- For credit card loans, experience supports a risk weight of 73 percent, vs proposed effective risk weight of 111 percent.
- Proposed credit conversion factors on unused credit card lines are based on no analysis and in conflict with historical data.
  - The 73 percent risk weight noted above already takes account of unused lines.
  - Increasing required capital for rarely used credit card lines will hurt consumers, because banks will reduce available credit.
- Adding the proposed operational risk charge would mean a total risk weight of approximately 140 – 190 percent.

Risk weights for retail loans are substantially overstated. (Cont.)

- For other consumer loans, data from the Advanced Approaches supports a risk weight of 50 percent.
  - The proposal would introduce a risk weight of 85 percent - 10 percentage points higher than what the U.S. agencies agreed to in Basel.
  - Other consumer loans may also face an additional surcharge through the stress tests.
- Risk weights for loans where a bank offers borrowers forbearance would rise to unjustifiably high levels.
  - For auto loans to borrowers experiencing temporary financial hardship, banks may offer a one- or two-month extension.
  - The proposal – based on no historical loss experience or analysis – would apply in a 150 percent risk weight.

Risk weights for corporate exposures are also overstated.

- The agencies propose a general risk weight of 100 percent.
  - A 65 percent risk weight would be available only to businesses that are both rated investment grade by the bank and have (or whose parent has) securities listed on a recognized exchange (the “listing requirement”).
  - With no analytical basis, the listing requirement would mean a 100 percent risk weight on loans to tens of thousands of creditworthy small and mid-sized businesses, sharply and unfairly reducing the number of corporates that would otherwise qualify for the 65-percent risk weight, based on an objective assessment of their transparency, structure and credit profile.
  - Same effect for highly regulated mutual funds, mutual insurance companies and pension funds that are low credit risk and are subject to transparency and disclosure obligations which are as least as rigorous as those which apply to listed securities.
- Research demonstrates that the listing requirement does not result in more consistent risk weights across banks lending to the same entity, or lower credit risk, and would produce highly inconsistent and potential disruptive outcomes; an ETF and a mutual fund with identical investment mandates would be assigned different risk weights.

Risk weights for corporate exposures are also overstated. (Cont.)

- Federal Reserve data from bank stress tests show that the banks in question lend to 155,589 unique U.S. corporations.
  - Of these, 153,000 are private, with only 2,589 being publicly listed.
  - Based on this sample, the overwhelming majority of U.S. corporations would not be able to satisfy the securities listing requirement and would be subject to a 100 percent risk weight, even if they are investment grade.
- Moreover, regulated investment funds (mutual funds and pension plans) and mutual insurance companies typically do not list their securities as part of their function but are more likely to qualify as investment grade based purely on creditworthiness. This reflects legal and regulatory structure, including:
  - Detailed asset quality, asset coverage and asset diversification mandates,
  - Robust valuation and investor disclosure requirements.

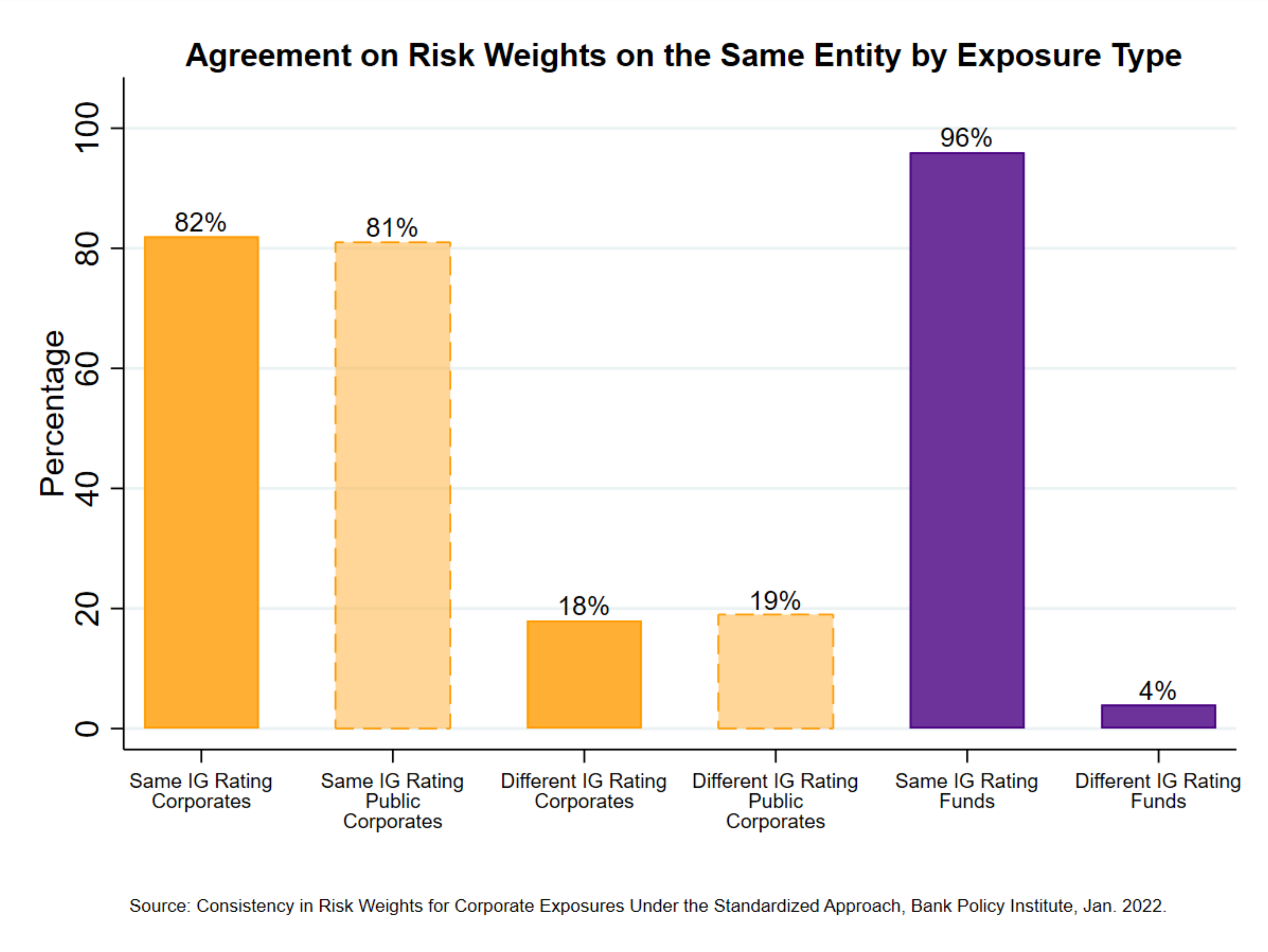
Small- and medium-sized entity exposures should bear a separate risk weight.

- The Basel framework provides for an 85 percent risk weight for SME general corporate exposures.
- General corporate exposures to an SME would default to a 100 percent risk weight under the proposal, unless they qualify as investment grade (and the obligor or its parent has listed securities) or as a regulatory retail exposure.
- Small business loans are subject to steep capital add-ons in the stress tests.
- The agencies offer no empirical analysis to demonstrate that a higher risk weight is warranted for SME exposures.
- Absent such evidence, the agencies should include a separate 85 percent risk weight for corporate exposures to SMEs.

Removal of the securities listing requirement

- Banks' investment-grade rating assignments to the same entity are generally consistent regardless of whether the corporate entity meets the securities listing requirement.
- We used data from Credit Benchmark to analyze the consistency of the investment grade rating among banks that lend to the same entity.
- The sample includes banks headquartered in the U.S. and those with a significant exposure to U.S. firms (more than 1,000 U.S. entities, as of April 2021). We use PD data from 18 banks.
    - On average, the sample has 3.3 banks reporting the PD of the same entity.
- The chart on the next page splits the difference in assigned risk weights across traditional corporates and investment funds.
- Reporting banks agree with the attribution of the credit rating above/below investment grade for 82 percent of traditional corporate exposures. The share of agreement is little changed when only publicly traded corporates are included.
- There is even greater agreement with the attribution of the risk weight to investment-fund exposures across banks (i.e. 96 percent).

Removal of the securities listing requirement (Cont.)



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Risk weights for bank exposures are also overstated.

- Risk weights of loans to other banks are overstated relative to historical experience and the Basel Committee’s standard.
  - Historical experience based on data from FFIEC 101 reports from 2014 to 2022 supports a risk weight of 30.3 percent for loans to banks, vs the proposal’s minimum 40 percent risk weight, regardless of duration.
- The Expanded Risk-Based Approach is meant to be more risk-sensitive than the Standardized Approach, but…
- To be truly risk-sensitive, the Expanded Risk-Based Approach should have risk weights for the lowest risk banks that are lower than, or at least not higher than, those under the Standardized Approach and increase based on measures of risk.

Risk weights for bank exposures are also overstated. (Cont.)

- The Expanded Risk-Based Approach should include a 20 percent risk weight for exposures to banks that pose the least credit risk.
  - This would facilitate large banks' provision of credit to small banks, which they use to support their local communities.
  - It is also important for the cost and availability of derivatives for commercial end users to hedge their business risks, because banks usually hedge these exposures through transactions with other banks.
  - It would also reflect the different and unique type of risk presented by intercompany lending between a bank operating in the US and its foreign bank affiliates.
  - It would also improve the risk-sensitivity of the Expanded Risk-Based Approach and the coherence of the overall capital framework, as well as avoid putting U.S. banks at a competitive disadvantage.

Risk weights for bank exposures are also overstated. (Cont.)

- In addition, shorter-dated exposures to banks should bear a lower risk weight.
  - Undifferentiated treatment conflicts with the purported goal of making the capital framework more risk-sensitive.
  - The proposal's risk weights are up to 25 percentage points higher (depending on the grade of the exposure) than Basel framework risk weights applicable to short-dated exposures, with no supporting empirical analysis.
- Short-dated bank-to-bank exposures are key to providing intra-bank liquidity.
- This and other aspects of the proposal that overstate bank risk weights would reduce liquidity in repo markets, especially in times of stress.

Risk weights for bank exposures are also overstated. (Cont.)

- Exposures to securities firms or other financial institutions should be treated as exposures to banks, so long as the entity is subject to bank prudential standards and supervision.
  - The Basel framework permits exposures to securities firms and other financial institutions to be treated as exposures to banks if the entity is subject to prudential standards and a level of supervision equivalent to those applied to banks.
  - Under UK and EU rules, certain investment firms are subject to Basel-based prudential capital and liquidity requirements applicable to banks, and all investment firms are subject to capital requirements in general.
  - Bank and S&L holding companies and their subsidiaries (including broker-dealers).
  - Some nonbank swap dealers have elected regulation under Part 217's prudential framework.

Expanded definitions of "defaulted debt exposures" will harm SMEs and consumers.

- Expanded definitions for types of defaulted non-retail and nonresidential real estate exposures would require banks to determine defaulted status based on the obligor's performance on **any** of its credit obligations (not just those to the bank holding the exposure).

- Monitoring the status of credit obligations – including de minimis obligations – owed to entities other than the bank itself is not operationally practicable.

- Banks usually lack information that would be required to monitor obligations to other creditors, regardless of materiality. For instance, banks would have to consider, e.g.,
  - How other creditors account for credit obligations of the obligor,
  - Whether other creditors have placed obligations of the borrower in nonaccrual status, or whether they have sold a credit obligation or taken a charge-off or negative fair value adjustment.

Expanded definitions of "defaulted debt exposures" will harm SMEs and consumers. (Cont.)

- In addition, the proposed definition of defaulted exposure conflicts with the definition of defaulted exposure under U.S. GAAP and therefore creates inconsistency across reporting requirements.
  - Under GAAP, impairments or write-downs occur once a creditor determines an exposure is uncollectable; that is, once all commercially reasonable means of collection have been exhausted.
  - If the definition in the proposed rule is left unchanged, the decisions of third-party creditors could require an exposure to be considered defaulted, while GAAP reporting would reflect a bank's own assessment of an obligor's likeliness to repay.
- This could result in the same exposure reported simultaneously as both defaulted and not defaulted across regulatory requirements.
- Finally, definition of defaulted real estate exposure should clarify that an exposure that has undergone a distressed restructuring but has resumed performing its payment obligations no longer qualifies as a defaulted real estate exposure.

Risk weights for subordinated debt are substantially overstated.

- For any corporate debt exposure, a bank exposure, or an exposure to a GSE, that is legally subordinated to any creditor of the obligor, or preferred stock that is not an equity exposure, the proposal would apply a 150 percent risk weight.
  - Applying this risk weight to all subordinated debt instruments, without taking into account other factors that affect credit risk (such as overall creditworthiness of the obligor or collateral) would result in capital requirements that are not risk sensitive nor commensurate with overall risk.
  - The same is true for applying a 150 percent risk weight to all debt, including senior debt, that is issued to satisfy loss-absorbency requirements.
- The agencies should therefore remove the separate risk weight category for subordinated debt and covered debt instruments.

Risk weights for subordinated debt are substantially overstated. (Cont.)

- Inclusion of preferred stock that does not meet the conceptual structure of subordinated debt is also inappropriate.
  - For example, preferred stock issued by certain funds registered under the 1940 Act, particularly those that primarily invest in tax-exempt municipal bonds, would bear a higher risk weight than the funds' common stock (i.e., equity exposures determined under a look-through approach). These preferred are the senior part of the funds' capital structure.
- The agencies should provide that the risk weight for a credit exposure to an investment fund cannot be greater than the risk weight for an equity exposure to that fund determined under the look-through approach and excluding the leverage generated by those credit exposures.

The agencies should address the differences in bank business models and circumstances.

- The proposal would apply essentially the same requirements to highly diverse banking organization cohorts.

- Different organizations are uniquely affected by different parts of the proposal and other aspects of capital regulation.
  - Category III and IV banks would see dramatic capital requirement increases across a wide range of activities and be subject to dual stack requirements.
  - G-SIBs are subject to the G-SIB surcharge, which is likely to increase if finalized as proposed and would further be impacted by the increase in RWA that would result under the Basel proposal.

- In 2018's Economic Growth, Regulatory Relief, and Consumer Protection Act, Congress required tailoring of many prudential regulations. These questions, discussed in prior meetings, must be addressed in revising the proposal.

Selected results from Quantitative Impact Studies

Table 1: Impact of Some of the Proposed Changes to Credit Risk Weighted

	Change in Total RWA (%)
Credit Risk	
Remove the securities listing requirement*	3.3%
Align residential mortgage risk-weights with BCBS Standard	1.9%
Align retail risk-weights with BCBS Standard**	2.2%
Align bank short-term risk-weight with BCBS Standard and treat broker dealers the same counterparties as banks*	0.6%
Total	8.0%

* Estimates are only available for Category II-IV firms that participated in the QIS.

* Includes the effect across all risk stripes: credit, counterparty and SFTs.

Note: BPI, FSF, ISDA/SIFMA conducted quantitative impact studies. These industry-led studies included 28 banks, among which 20 banks from Categories II-IV.

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Equity Risk in the Banking Book

Expand Risk Weight for National Legislated Programs

- Applying a 400 percent risk weight, instead of the current 100 percent risk weight, to investments other than community development or small business investment company exposures would undermine important public policy goals.
- The agencies should expand the 100 percent risk weight category to include all equity investments pursuant to any national legislated program, including those that qualify for tax credits or that participate in programs established under the Internal Revenue Code.
  - Investments for low-income housing, renewable energy and historic preservation/rehabilitation should receive a 100 percent risk weight whether or not they also qualify as community development investments under Section 24(Eleventh) of the National Bank Act.
  - In the proposal, the agencies recognized that community development investments generally receive favorable tax treatment and/or investment subsidies that reduce their risk profile, while also promoting important public welfare goals.
  - These considerations apply equally to other national legislated programs involving tax credits or programs under the Internal Revenue Code.
- Equity exposures that further public policy goals regarding support for local communities, such as investments in community development financial institutions (CDFIs) and minority depository institutions (MDIs), should also receive a 100 percent risk weight.

Retain the Non-Significant Equity Exposures Bucket

- The proposal would eliminate the separate risk-weight category for non-significant equity exposures.
- As a consequence, many investments would become subject to a 400 percent risk weight, including:
  - Asset management-related seeding activities in funds not subject to the market risk framework.
  - Investments in financial market infrastructure.
  - Investments supporting entrepreneurs, such as in qualifying venture capital firms and rural business investment companies.
  - Investments in emerging financial technology providers.
- These investments promote diversification of banks' revenue sources, support the maintenance and operation of financial market infrastructure, and promote other public policy objectives.
  - The higher risk weight under the proposal would be inconsistent with the policy framework established by the Dodd-Frank Act and Volcker Rule, which embody deliberate policy choices about the extent to which banks are permitted to make certain investments in funds.
- Investments in financial market infrastructure, such as designated FMUs, qualifying central counterparties and exchange/trading venues are long-term investments that do not present heightened risks to banks.
- The agencies have not presented any evidence that the current treatment of these investments has resulted in those investments being undercapitalized.

Retain Hedge Pair Treatment

- Although the proposal would expand the scope of "covered positions" subject to the market risk capital rule, banks would continue to have banking book equity exposures that are either publicly traded or have returns that are primarily based on a publicly traded equity exposure.
- Examples include:
  - Visa B shares, which are not publicly traded but are convertible into publicly traded Visa A shares and frequently hedged with Visa A shares.
  - Equity positions arising from employee compensation plans, such as deferred compensation programs, which are often hedged with exposures that are designed to provide returns mirroring the obligations to employees.
- The agencies explained that they proposed to remove hedge pair treatment because they believed it is not necessary in light of the proposed revisions to the trading book/banking book boundary.
  - These examples demonstrate otherwise.
- Removing hedge pair treatment would increase capital requirements for hedged banking book equity exposures in a manner that is not consistent with the actual risk exposure associated with the positions and related hedges.

Improve Risk-Sensitivity of Look-Through Approaches

- The proposal would implement modified versions of the full look-through approach and alternative modified look-through approach and eliminate the simple modified look-through approach.
- If a bank has sufficient data to use the full look-through approach, use of that approach should be permissive, rather than mandatory, consistent with the current Standardized Approach.
- In addition, to improve the risk sensitivity of the proposed look-through approaches, the agencies should make a number of revisions, including:
  - Not adopting the requirement that a fund's financial information be verified by a third party on a quarterly basis in order to use the full look-through approach.
  - Not adopting the upward CVA risk adjustment for derivative exposures of an investment fund.
  - Permitting banks to use actual volumes regarding derivatives and securitizations to calculate RWAs under the alternative modified look-through approach.
  - Including thresholds before banks are required to use look-through approaches to calculate securitization exposures, derivative exposures and fund-of-fund exposures.
  - Recalibrating the proxies for replacement cost and PFE for derivative contracts held by investment funds when there is insufficient information to calculate these values.
- The agencies should also revise the definition of "investment fund" and eliminate the separate risk weight for equity exposures to leveraged investment firms because the revised look-through approaches expressly capture the leverage of investment funds.

Operational Risk

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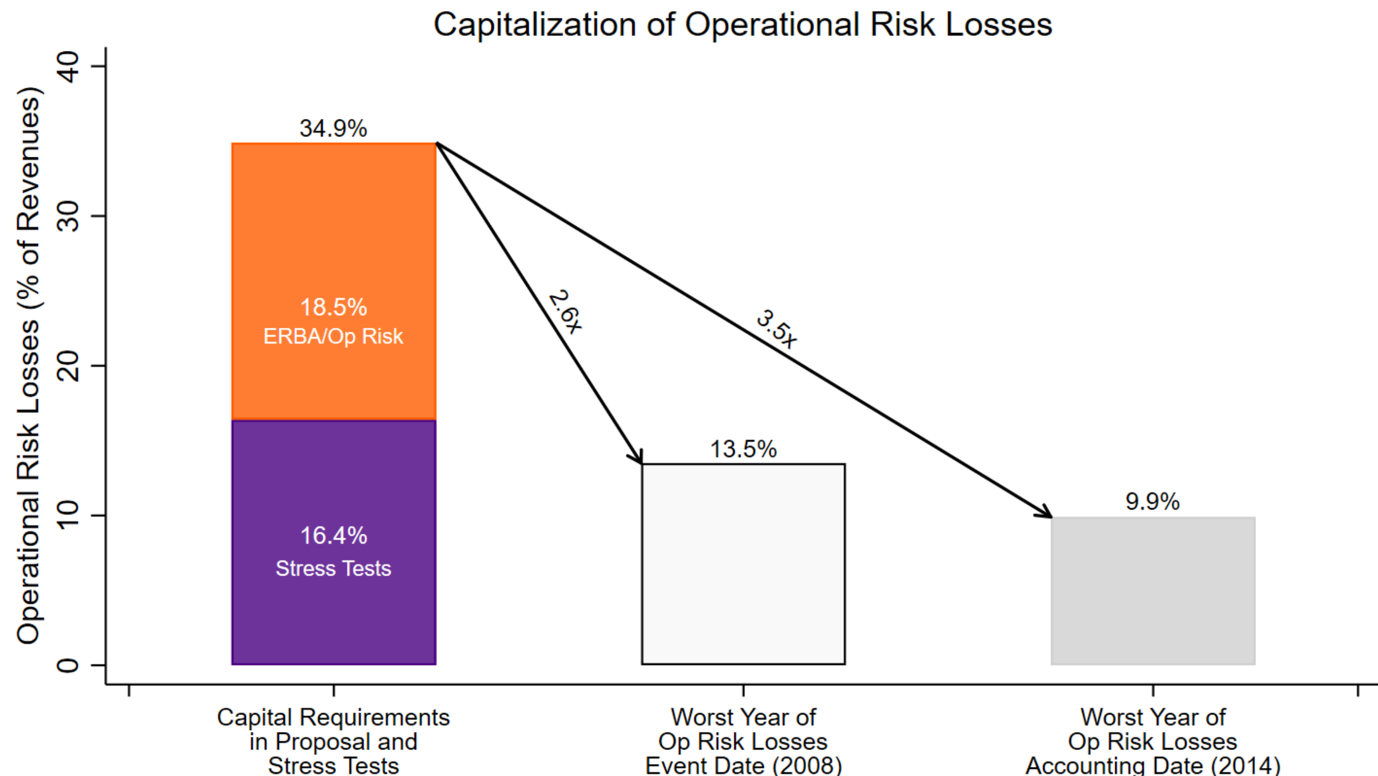
Introduction

- There are two key issues with the new standardized approach for operational risk:
  - The overall excessive calibration of capital requirements for operational risk.
  - The overcapitalization of operational risk for banks with high fee income.
- On the overcapitalization for operational risk the four main supporting elements are as follows:
  1. Empirical evidence indicates the new standard for operational risk is overcalibrated.
  2. Large banks in the U.S. already capitalize for operational risk losses in the stress tests.
  3. Large operational risk losses do not tend to occur contemporaneously with credit and market losses.
  4. In general, IHCs face a higher impact as reimbursements from transactions between a foreign parent and its US subsidiary are included in noninterest income; such transactions would be eliminated in consolidation for domestic banks.

Excessive Capitalization for Operational Risk

- We estimate that under the banking agencies proposal banks would hold nearly 35 percent of their revenues in operational risk capital.
  - That is approximately **2.6x** the worst year of losses covered in the ORX data set as of the event date.
  - Or **3.5x** based on the accounting date (these estimates can be improved as we have used the booking of "litigation reserves" in the FR Y-9C to approximate for the accounting dates).

- ERBA/Op Risk: $156B.
- Peak to trough op risk losses: $138B.
- Revenues/2022: $842B.



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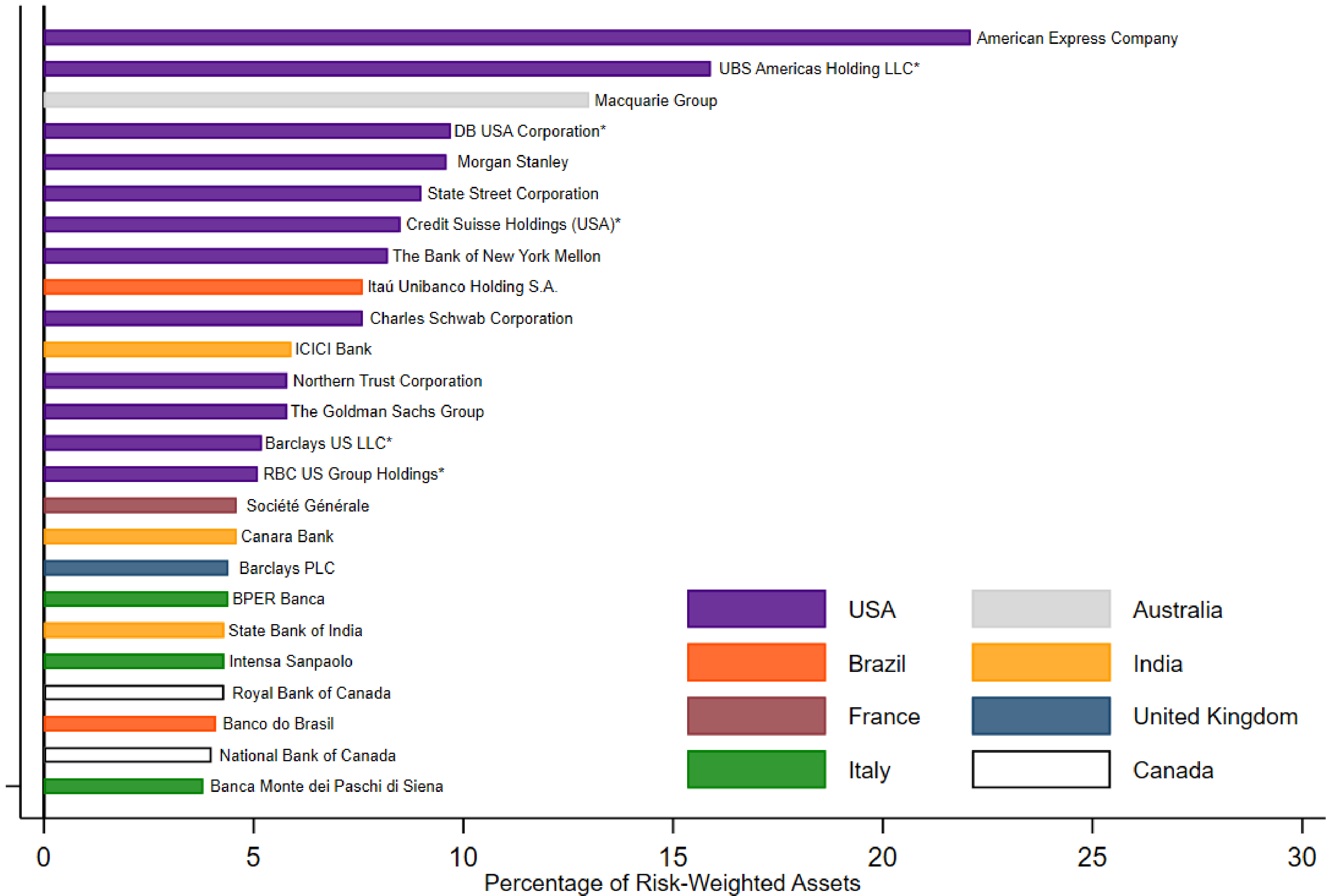
Overcapitalization for High Fee Income Banks

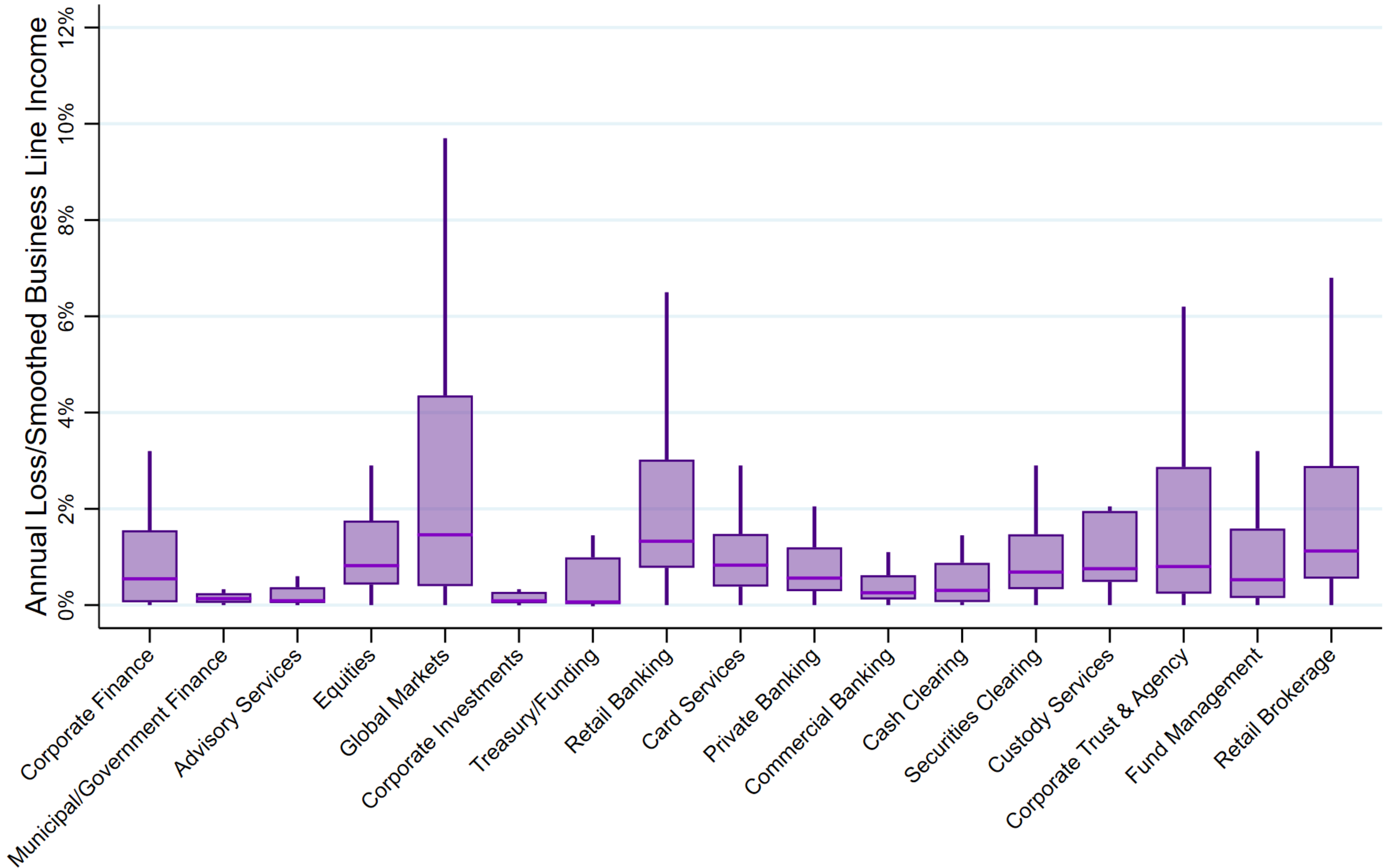
- With respect to the overcalibration of the services component:
  - The U.S. banking system has a higher proportion of fee-oriented banks than other national jurisdictions.
  - As shown in the chart in the next page, **12 of the 15** banking organizations with the highest noninterest income relative to risk-weighted assets are subject to the U.S. capital rules.
    - The 2014 Basel consultation stated that the proposed standard was designed to capture the operational risk profile of a universal bank and it is less accurate in the case of banks engaged predominantly in fee-based activities.
    - The 2016 Basel consultation went further and proposed a cap to mitigate the overcapitalization of operational risk for banks with high fee income and expenses.
    - However, the final Basel operational risk framework did not include an adjustment to the services component, nor did it provide a reason for abandoning the proposed 2016 modification.
  - Furthermore, a recent ORX study found significant differences in risk profiles across business lines (for example, retail banking carries more risk than asset management).

Top 25 Banks with Highest Proportion of Noninterest Income Worldwide



Note: * Indicates the entity is a U.S. subsidiary of a global bank.

Source: S&P Global Market Intelligence.


Loss Over Annual Smoothed Income at Business Line Level 2
Annual Loss/Smoothed Business Line Income
0%
2%
4%
6%
8%
10%
12%
Corporate Finance
Municipal/Government Finance
Advisory Services
Equities
Global Markets
Corporate Investments
Treasury/Funding
Retail Banking
Card Services
Private Banking
Commercial Banking
Cash Clearing
Securities Clearing
Custody Services
Corporate Trust & Agency
Fund Management
Retail Brokerage
Source: ORX, https:orx.org/resource/basel-iii-and-standardised-approaches-to-capital-2023.

Adjustments to Operational Risk

- The remainder of the presentation will discuss the QIS results covering various options to address the overcapitalization of operational risk and the disproportionate treatment of the services component for high-fee income banks.

- The BPI/ABA letter commenting on the proposal recommended other adjustments to eliminate the general overcalibration of operational risk, including:
    1. Elimination of operational risk losses in the stress tests.
    2. Adjustments to the institution specific factor and BIC coefficients.

Although important in the overall calibration of the framework for operational risk, these adjustments are not the focus of today’s presentation.

Quantitative Impact Study

- We have conducted a QIS with 16 banks (including universal banks, high fee income banks and lending banks), which together account for approximately 70 percent of the aggregate RWA for operational risk generated by the standardized approach across all banks subject to the Basel Proposal.

- The QIS analyzed changes to the internal loss multiplier.

- The QIS also considered the hypothetical impact on the services component and risk-weighted assets for operational risk of various alternatives for calculating operational risk capital requirements.
  - The QIS collected data on revenues and expenses by lines of business for each bank. The definition of lines of business followed the Basel definition as in OPE25.16.

Possible ILM Adjustments

- Simply setting ILM to 1 would not adequately address the excessive calibration of the operational risk charge for many banks, due to large GFC-related operational risk losses rolling out of the 10-year ILM window by the proposed implementation date.
  - About half of the banks would experience no change in RWA for op risk, as their ILM is expected to be at or below 1 by the time the rule is proposed to be implemented.

- Allowing the ILM to float with a 8x multiplier and without the floor of 1 would reduce RWA by about 20 percent and more uniformly across banks.
  - Moreover, reducing the services component would lower the BIC, consequently leading to a higher ILM. Thus, a more material decrease in the services component necessitates a larger reduction in the multiplier for average annual operational risk losses used to calibrate the floating ILM.

$$ILM = \ln\left(\exp(1) - 1 + \left(\frac{y \times Average\ Annual\ Operational\ Losses}{\boldsymbol{Business\ Indicator\ Component}}\right)^{0.8}\right)$$

  - We calibrate the multiplier y so that the average bank is indifferent between setting ILM equal to 1 and floating.

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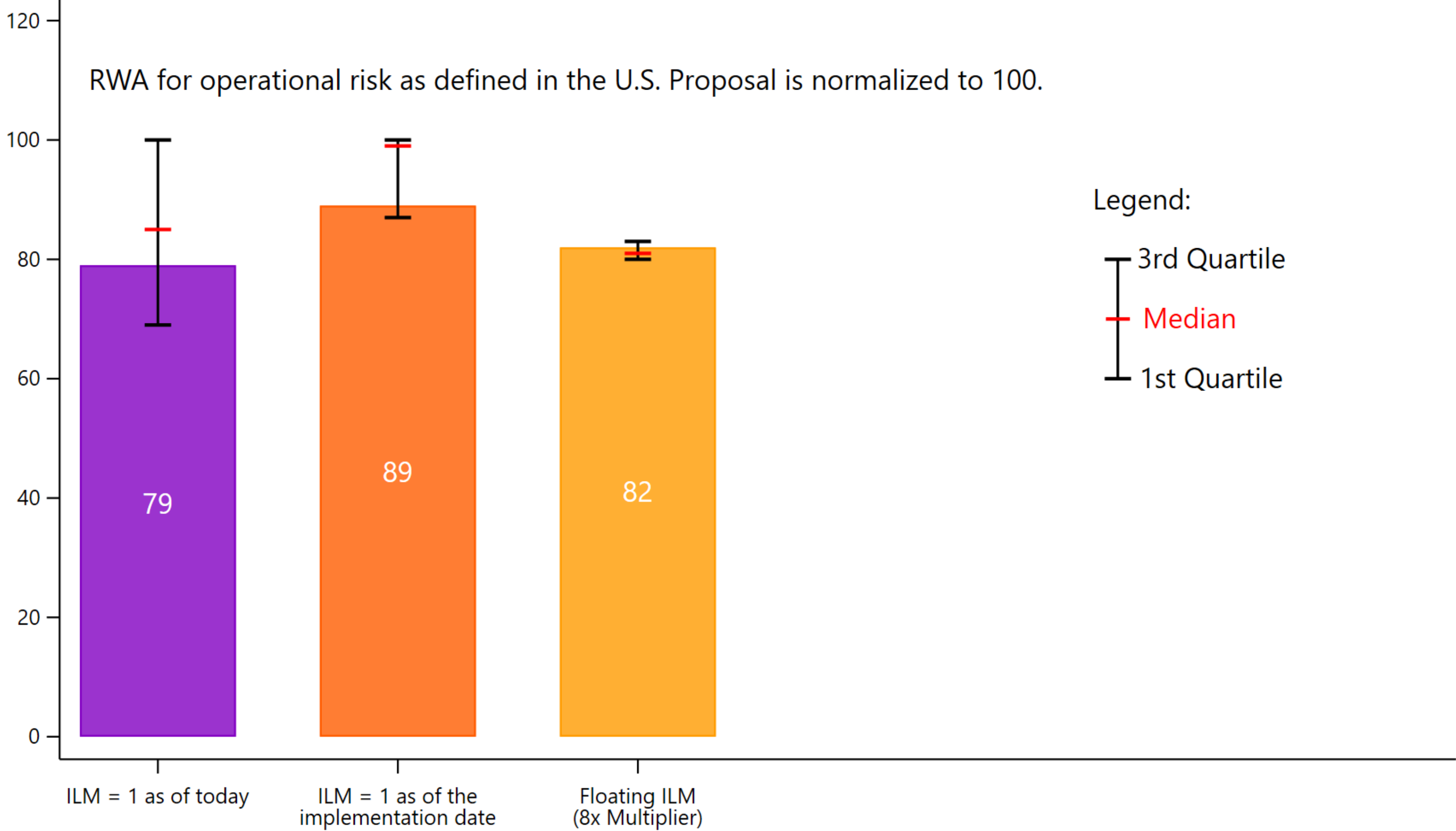

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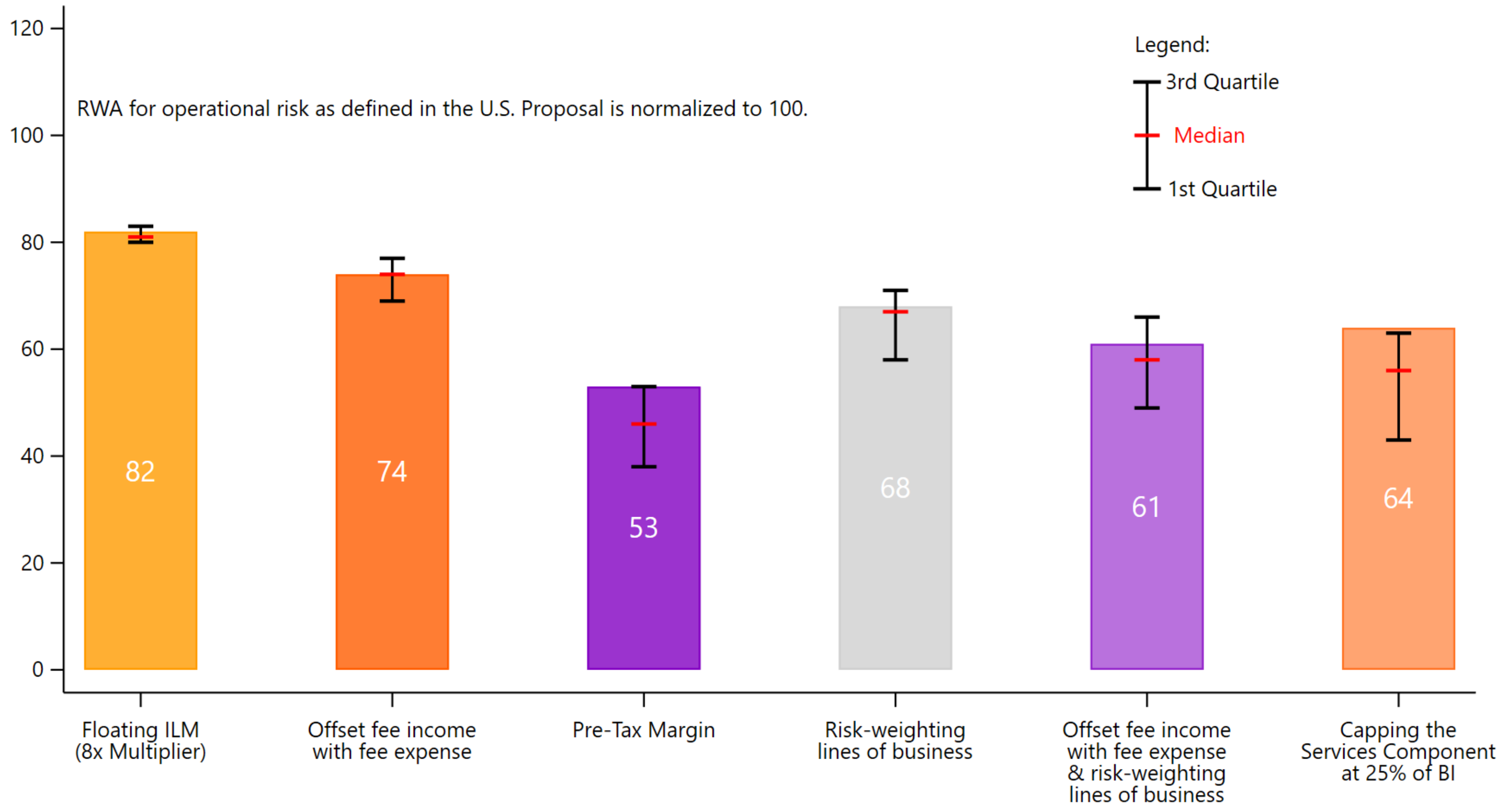
Possible Adjustments to the Services Component

1. Netting or offsetting fee-related income with fee-related expenses.
2. Similar to netting, but instead of using expenses as the netting mechanism, apply a publicly disclosed pre-tax margin percentage to fee income.
3. "Risk-weight" fee income differently depending on historical losses associated with the business line.
4. "Risk-weight" the fee income associated with different business lines, as in option 3, but also offset fee-related income with fee-related expenses for each business line for purposes of calculating the services component.
5. Include a cap on the amount of fees included in the services component calculation, either for all banks or for banks with a relatively large share of fee income (25% cap of the unadjusted business indicator)

The appendix provides additional details on all the options



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Appendix

QIS Template to Propose Adjustments to the Services Component

Bank Name:

Business Lines: Level 1	Business Lines: Level 2	Fee Income ($ thousands)	Fee Expense ($ thousands)	memo: names of ORX Business Lines
Corporate Finance	Corporate Finance			Corporate finance
	Municipal / Government Finance			Municipal / Government Finance
	Merchant Banking			
	Advisory Services			Advisory Services
Trading and Sales	Sales			Equities
	Market-Making			Global Markets
	Proprietary Positions			Corporate Investments
	Treasury			Treasury
Retail Banking	Retail Banking			Retail Banking
	Private Banking			Private Banking
	Card Services			Card Services
Commercial Banking	Commercial Banking			Commercial Banking
Payment and settlement	External Clients			Cash Clearing
				Securities Clearing
Agency services	Custody			Custody Services
	Corporate Agency			Corporate Trust & Agency
	Corporate Trust			
Asset management	Discretionary Fund Management			Fund Management
	Non-discretionary Fund Management			
Retail Brokerage	Retail Brokerage			Retail Brokerage
Insurance	Insurance			Insurance is not included in the SA for Op Risk in 2006

other operating income ($ thousands)	
other operating expense ($ thousands)	

Adjustments to the Services Component

1. Baseline (services component as proposed):

$$SC = \max(Avg_{3y}(fee\ income), Avg_{3y}(fee\ expense)) + \max\left(Avg_{3y}(oth\ oper\ inc), Avg_{3y}(oth\ oper\ exp)\right)$$

2. “Netting” or offsetting fee-related income with fee-related expenses (two possibilities regarding the treatment of other operating income/expenses:

$$SC = \left|Avg_{3y}(\text{fee income}) - Avg_{3y}(\text{fee expense})\right| + \left|Avg_{3y}(oth\ oper\ inc) - Avg_{3y}(oth\ oper\ exp)\right|$$

Rationale for Option 2: The interest, lease and dividend component, as well as the financial component, are both accounted for on a net basis.

- We also examine how the removal of netting from other operating income and expense items affects our results.

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Risk Weights Used in Option #4

Business Line	US Median loss ratio (%)	"Risk-weight"	US 90th percentile loss ratio (%)	"Risk-weight"
Corporate Finance	0.55	37%	4.76	38%
Municipal / Government Finance	0.13	9%	1.40	11%
Advisory Services	0.09	6%	0.79	6%
Equities	0.82	56%	3.19	25%
Global Markets	1.46	100%	11.84	94%
Corporate Investments	0.09	6%	0.86	7%
Treasury / Funding	0.06	4%	7.95	63%
Retail Banking	1.33	91%	6.23	49%
Card Services	0.83	57%	7.69	61%
Private Banking	0.56	39%	2.27	18%
Commercial Banking	0.26	18%	1.57	12%
Cash Clearing	0.30	21%	2.29	18%
Securities Clearing	0.69	47%	4.82	38%
Custody Services	0.76	52%	7.36	58%
Corporate Trust & Agency	0.80	55%	12.60	100%
Fund Management	0.53	36%	5.46	43%
Retail Brokerage	1.12	77%	8.30	66%

US risk-weights are derived from a subset ORX members who are U.S. banks.

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Adjustments to the Services Component (Cont.)

3. Similar to netting, but instead of using expenses as the netting mechanism, apply a publicly disclosed pre-tax margin percentage:

$$SC = \theta \times \left[Avg_{3y}(fee\ income) + Avg_{3y}(oth\ oper\ inc)\right]$$

$$Pre - tax\ margin = \theta = \frac{Income\ before\ taxes}{total\ revenues}$$

Rationale for Option 3: There are substantial expenses that firms incur to generate fee income, but these costs are often not directly tied to revenues in a way that would allow for easy identification in a netting formula. Applying a scalar calibrated using a bank's (or industry's average) pre-tax margin would address this issue.

- Pre-tax margin is also calculated using a 3-year average of income before taxes and total revenues.

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Adjustments to the Services Component (Cont.)

4. Based on the ORX analysis demonstrating different operational loss history across business lines, “risk-weight” fee income differently depending on historical losses associated with the business line:

$$SC = \sum_{i=1}^{N} \pi_i \times \max\left\{Avg_{3y}(fee\ income_i), Avg_{3y}(fee\ expense_i)\right\} + \max\left(Avg_{3y}(oth\ oper\ income), Avg_{3y}(oth\ oper\ expense)\right)$$

Rationale for Option 4: Increase the risk sensitivity of the proposal by more accurately relating operational risk capital charges to industry loss history

- Insurance fees and other operating income/expenses are RW at 100%.

Adjustments to the Services Component (Cont.)

5. "Risk-weight" the fee income associated with different business lines, as in option 4, but also offset fee-related income with fee-related expenses for each business line for purposes of calculating the services component.

$$SC = \sum_{i=1}^{N} \pi_i \times \left[\left| Avg_{3y}(fee\ income_i) - Avg_{3y}(\text{fee expense}_i) \right| \right] + \left| Avg_{3y}(oth\ oper\ inc) - Avg_{3y}(oth\ oper\ exp) \right|$$

Rationale for Option 5: Increase the risk sensitivity of the proposal by more accurately relating operational risk capital charges to industry loss history and enhance consistency with the other components of the operational risk framework.

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Adjustments to the Services Component (Cont.)

6. Include a cap on the amount of fees included in the services component calculation, either for all banks or for banks with a relatively large share of fee income:

$$SC = \min\begin{bmatrix} 0.25 \times unadj.BI, \\ max(Avg_{3y}(fee\ inc), Avg_{3y}(fee\ exp)) + \\ max\left(Avg_{3y}(oth\ oper\ inc), Avg_{3y}(oth\ oper\ exp)\right) \end{bmatrix}$$

Rationale for Option 6: Similar to the BCBS's proposed solution in 2016. For purposes of the QIS, we selected 25 percent of the unadjusted business indicator to target a similar reduction in risk-weighted assets relative to the other options.

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