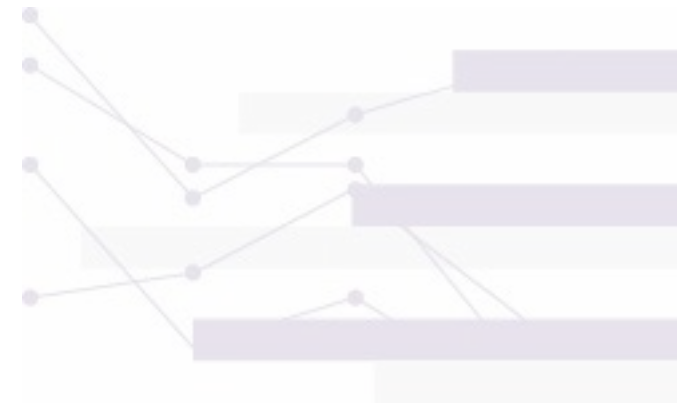


Meeting Between Vice Chair Jefferson and Staff of the Federal Reserve Board, Representatives of the Bank Policy Institute (BPI), and Representatives of Banking Organizations
March 6, 2024

Participants: Vice Chair Philip N. Jefferson and Juan Climent (Federal Reserve Board)

Rene Jones (M&T); Bruce Van Saun (Citizens); Chris Gorman (KeyBank); Bill Demchak (PNC); Ron O'Hanley (State Street); Bill Rogers (Truist); Charlie Scharf (Wells Fargo); Stephen Steinour (Huntington); Daryl White (BMO); Greg Baer, Kate Childress, John Court, Bill Nelson, Chris Feeney, Francisco Covas, Tabitha Edgens, Paige Paridon, and Haelim Anderson (BPI)

Summary: Vice Chair Jefferson and staff of the Federal Reserve Board met with representatives of BPI and representatives of several banking organizations. During the discussion, these representatives expressed concerns regarding the potential impact of the agencies' Basel III endgame notice of proposed rulemaking on banking organizations, their customers, and the economy.



BPI Board of Directors with Vice Chair Jefferson

Prepared February 27, 2024

Agenda

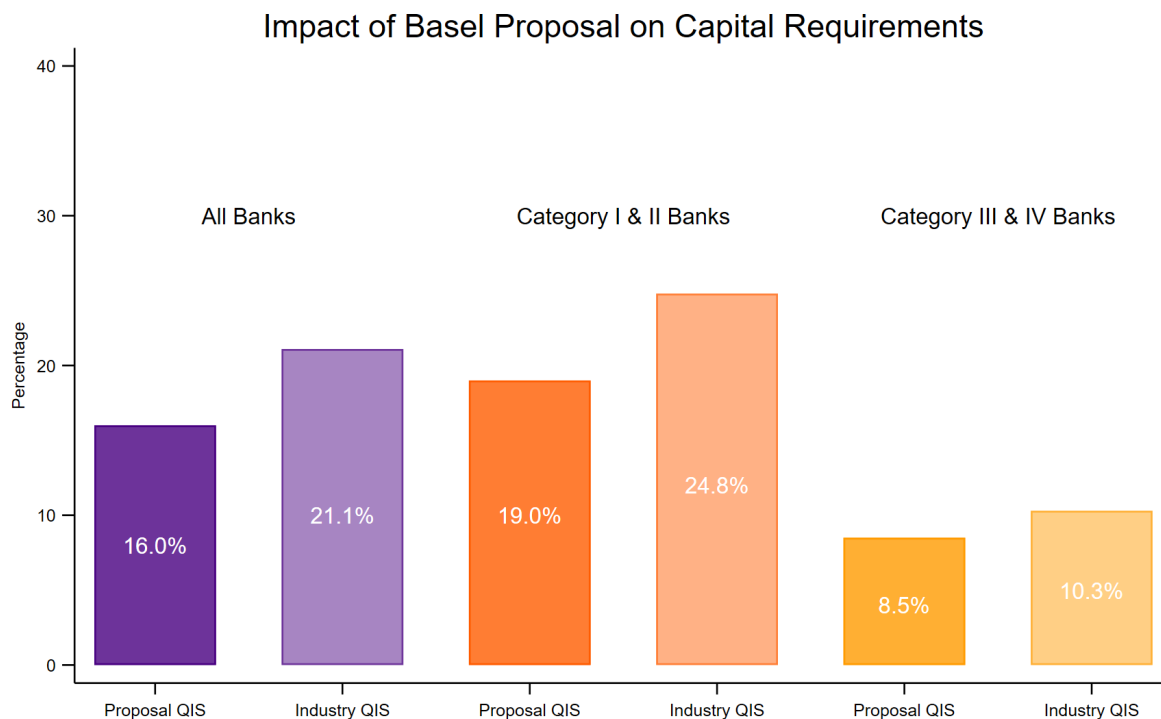
1. Selected Topics on the Basel Proposal
 - a) Why a reproposal is the path forward
 - b) Overcalibration of operational risk
 - c) Removal of the securities listing requirement
 - d) Interplay between the market risk and CVA elements of the proposal and the Global Market Shock in the stress tests
 - e) Lack of tailoring
2. Long-Term Debt Proposal
3. Stress Testing
4. Reg II Proposal
5. Liquidity

The background features a dark blue gradient with faint, glowing financial charts. A line graph with several data points is visible, with values such as 25.05, 49.55, 55.95, and 33.03. A bar chart is also partially visible. The overall aesthetic is professional and data-driven.

Why a reproposal is the path forward

Initial Agency estimates were significantly understated

- The industry QIS shows a material increase in risk-weighted assets and capital requirements relative to the agencies' own estimate included in the July proposal.
 - It would increase Category I-IV banks capital requirements by 21 percent – about 5 percentage points higher than the agencies' initial estimate.
 - The primary cause of the agencies' underestimation is credit risk.
 - The agencies' underestimation of the proposal's impacts means that a significant downward adjustment is necessary to appropriately balance the costs and benefits of any changes to the capital rules.



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

Resolving issues with proposal's empirical support require 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 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.



25.05 49.55 55.95 33.03

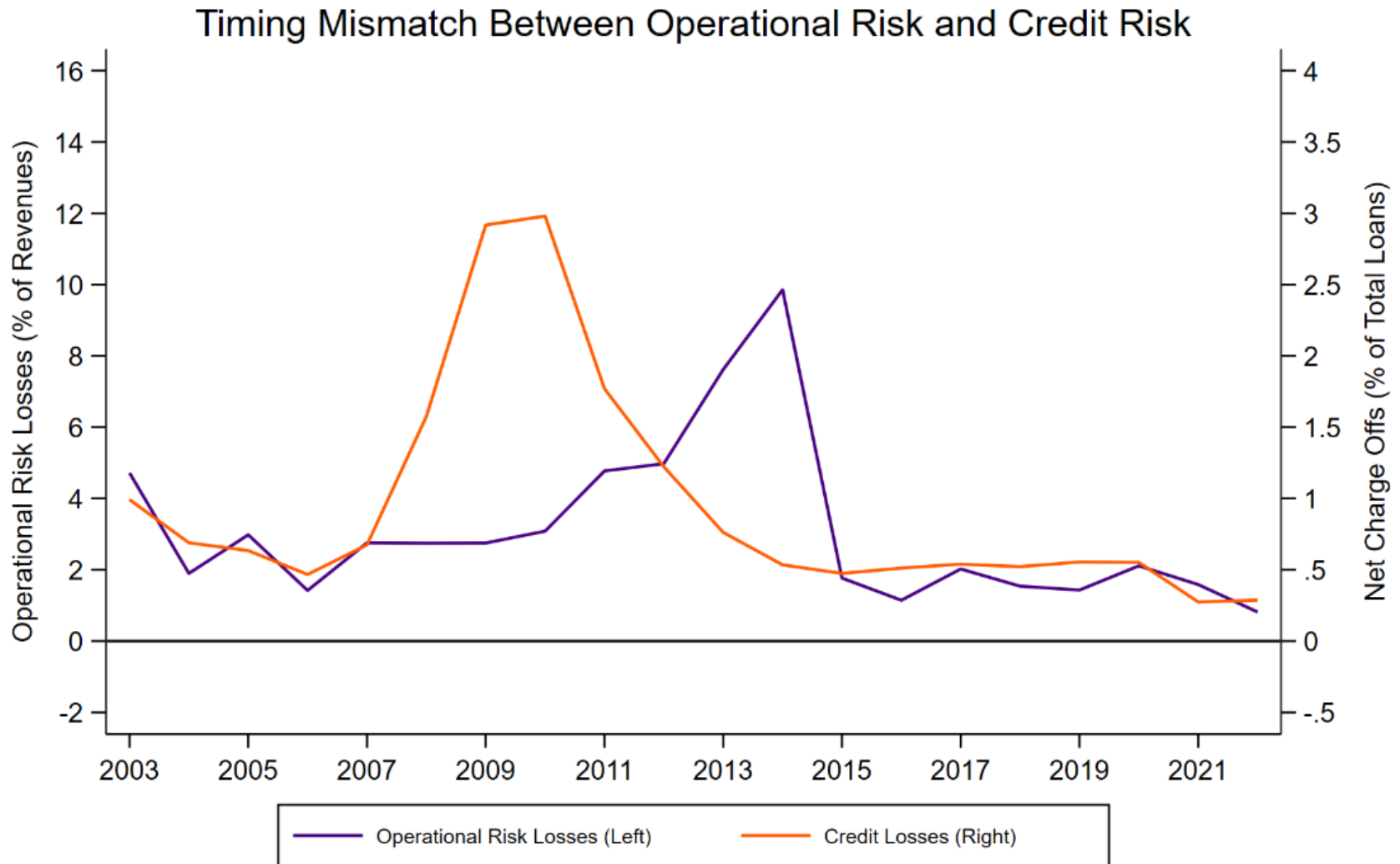
Overcalibration of operational risk capital requirements due to Basel Proposal

Important considerations for operational risk standards

- Governor Waller’s July statement on the proposal raised several important issues that the industry considered in developing its comments; in particular:
 - Whether operational risk RWA estimates corresponded to observed operational risk losses.
 - The absence of an effort in the proposal to rationalize operational risk RWAs with related operational loss projection analysis in the Fed’s stress tests.
 - Timing mismatches between operational losses and credit and market losses, which suggest operational risk losses require a distinct capitalization approach.

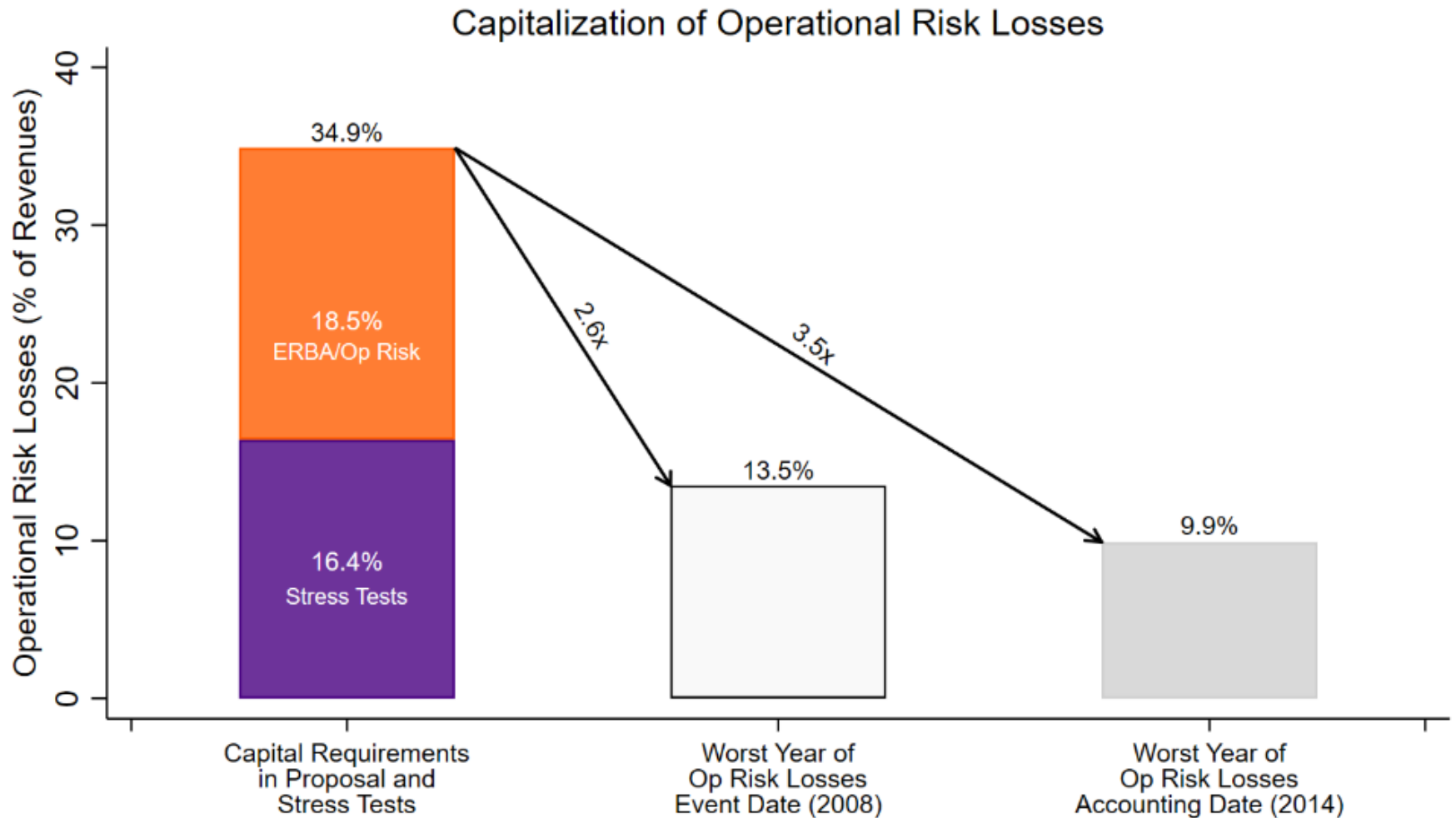
- We agree with these points as key conceptual questions. Our comments submitted in January expanded on these issues and drew attention to several others, specifically:
 - Ways in which the issues noted above, together with the failure to consider the total aggregate operational risk charge — attributed not just to the ERBA but also the SCB, and further exacerbated by the GSIB surcharge — result in an overly excessive capitalization for operational risk.
 - How the “services component” of the operational risk capital charge would impact fee- and commission-based business models.
 - How the design and calibration of the “Internal Loss Multiplier” (ILM) component of the operational risk capital charge would further overstate risk-weighted assets.

There is little correlation between operational risk losses and credit risk losses.



Note: Operational risk losses are measured using the accounting date between 2008 and 2014.

Total required operational risk capital would far exceed historical losses.

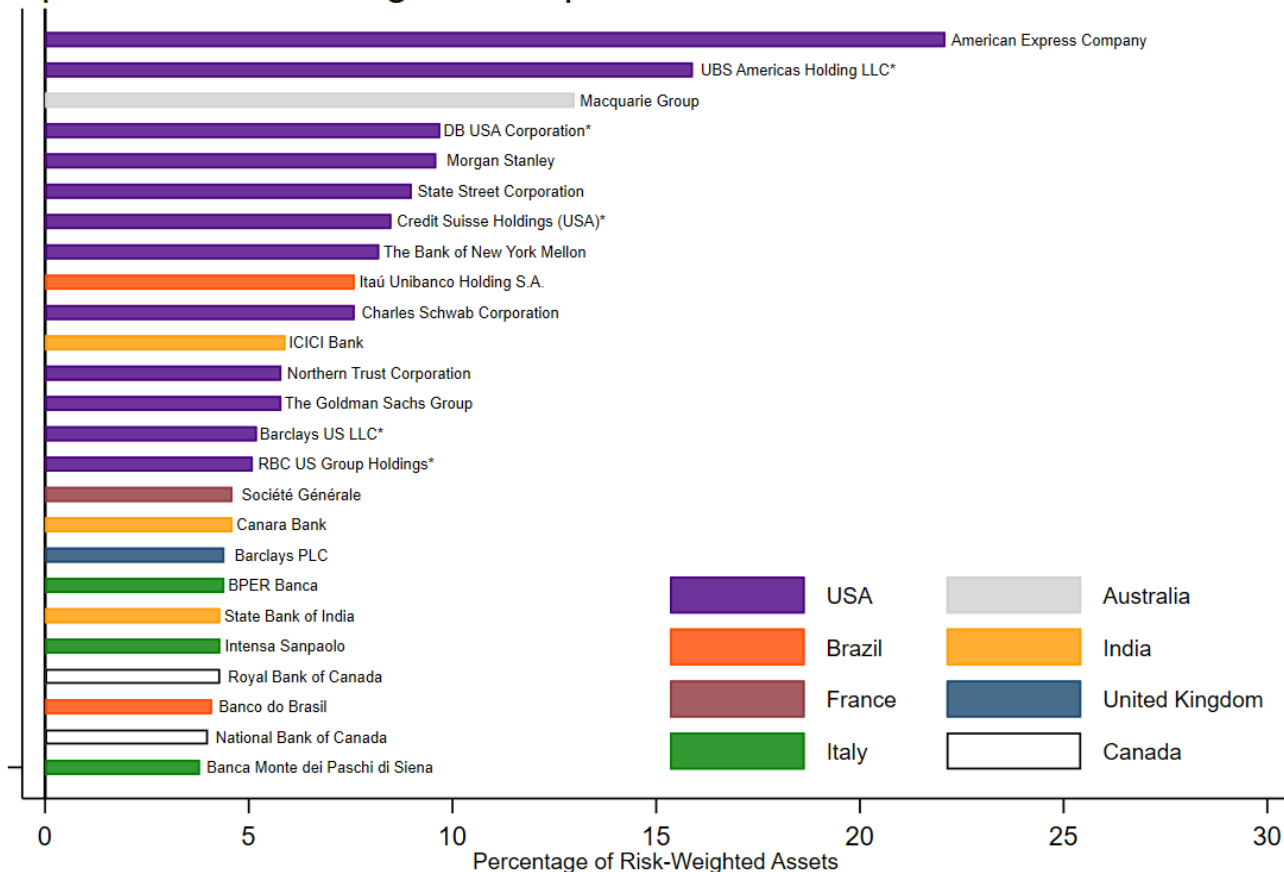


Significant downward adjustment of operational risk charge is necessary and appropriate.

- The agencies should consider the calibration of the overall capital requirements for operational risk across RWA, SCB and the GSIB surcharge, which the NPR does not.
- Operational risk RWA is additive to the binding capital stack, and there is no discussion in the proposal of whether or how ERBA credit risk weights have been appropriately recalibrated to account for this.
- Operational risk capital is particularly punitive for GSIBs, due to higher BIC multiplier for larger banks as well as the higher capital requirements from the surcharge itself.
- It is important to consider both the magnitude and the distribution of the reduction achieved by any adjustments to the operational risk framework.

Operational risk methodology is particularly punitive for banks with high fee income, many of which are in the United States.

Top 25 Banks with Highest Proportion of Noninterest Income Worldwide



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

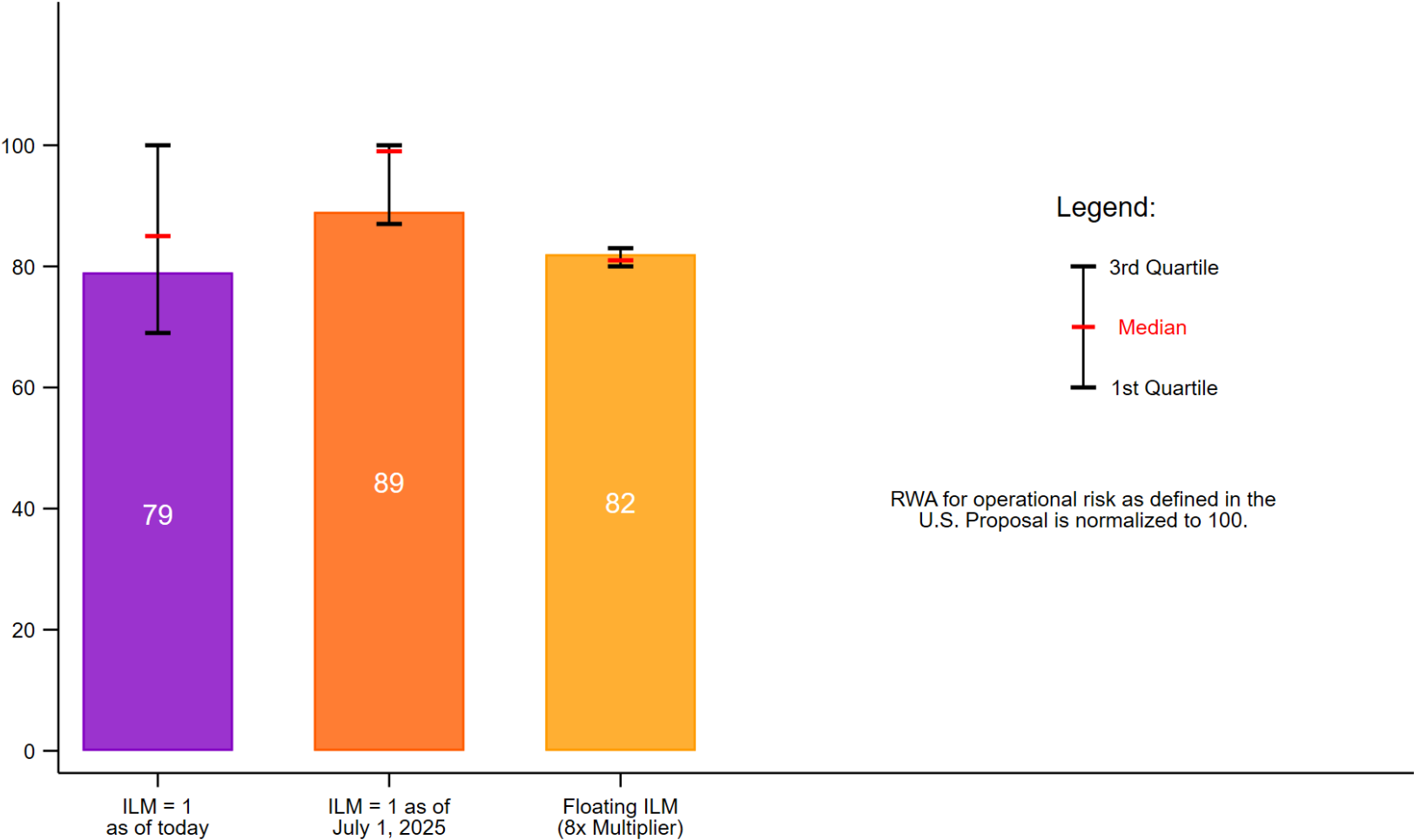
Source: S&P Global Market Intelligence.

BPI Quantitative Impact Study of Possible Operational Risk Adjustments

- BPI members participated in a quantitative impact study to examine the effects of different potential adjustments to the operational risk framework.
- Collectively, these banks represent approximately 70 percent of total RWAs for operational risk under the proposal.
- Sample included universal banks, high fee income banks and banks with business models focused on lending.

Effects of Potential Adjustments to the ILM

Effects on Risk-Weighted Assets When Adjusting the Internal Loss Multiplier



RWA for operational risk as defined in the U.S. Proposal is normalized to 100.

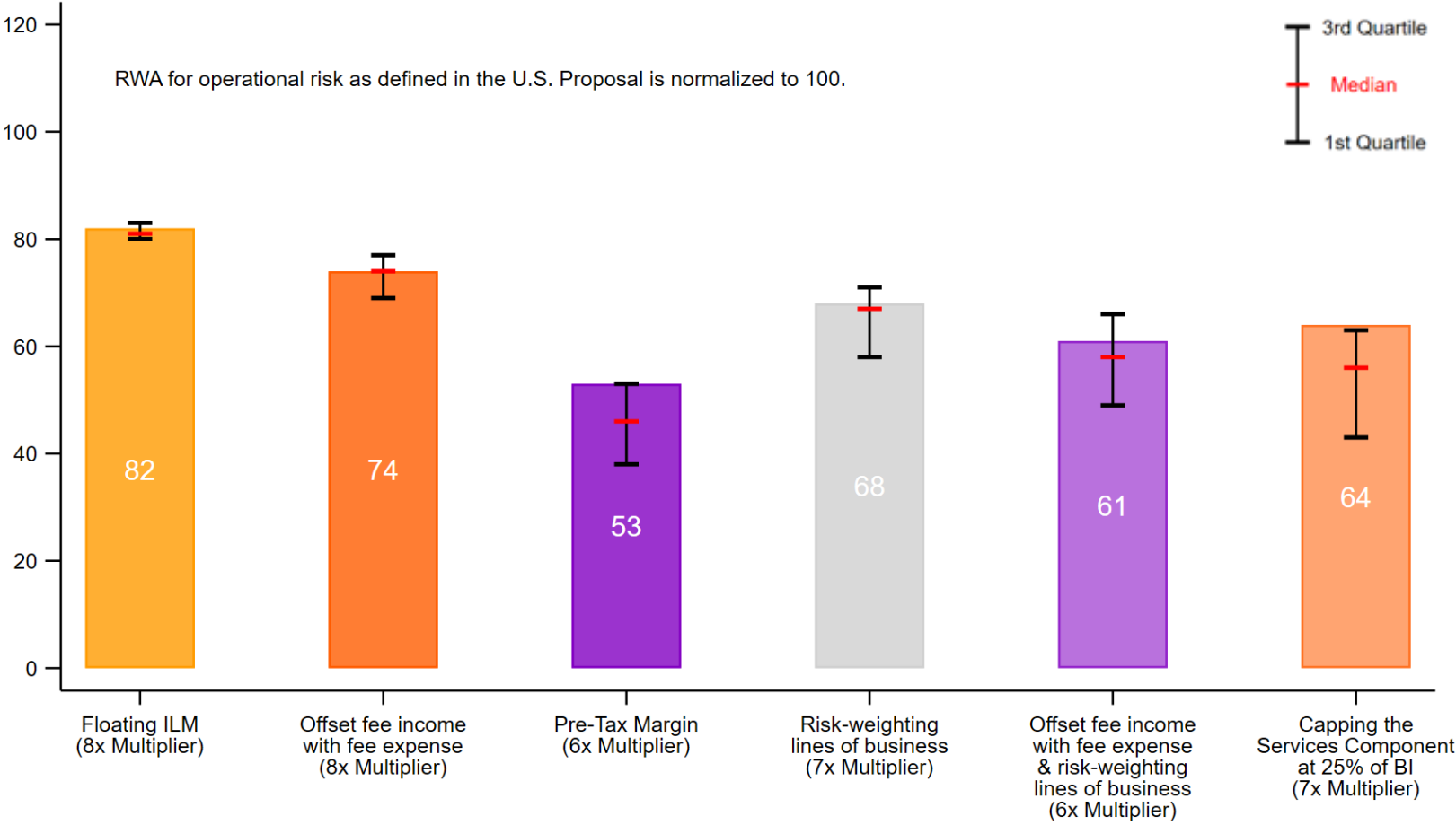
Note: Numbers inside the bars represent the weighted average.
Source: BPI QIS.

Key Findings on Possible ILM Adjustments

- It is important to address the broad-based overcalibration of operational risk capital requirements under the proposal as well as the calibration of the services component of the RWA charge.
- 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.

Effects of Potential Adjustments for High-Fee Banks

Addressing the Overcapitalization of Fee Income in Operational Risk with a Floating Internal Loss Multiplier



Note: Numbers inside the bars represent the weighted average.
Source: BPI QIS.

Key Findings on Possible Adjustments for High-Fee Banks

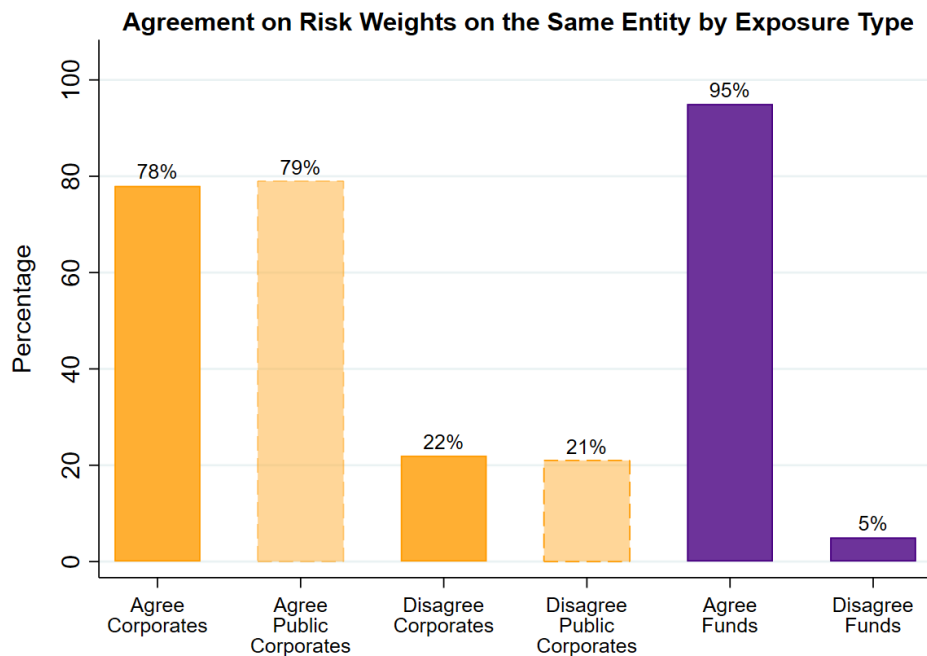
- One straightforward adjustment would be to apply a haircut to gross revenues using the publicly disclosed pre-tax margin percentage (dark purple bar in previous slide). This approach is similar to netting but would also deduct expenses from fee income even when those are not directly linked.
- Moreover, as noted above, adjusting the services component will result in an increased ILM, assuming all other factors remain unchanged. Therefore, making the average bank indifferent between ILM equal to 1 and a floating ILM under the pre-tax margin adjustment, would require setting the ILM loss multiplier to 6x average losses.



The Securities Listing Requirement is Arbitrary

Removal of the Securities Listing Requirement

- The U.S. proposal only allows a bank to categorize a corporate as investment grade if the entity (or its parent company) has securities outstanding on a recognized securities exchange (the “securities-listing requirement”)
- This requirement sharply and unnecessarily reduces the number of corporates that could qualify for the 65-percent risk weight, even though there is no significant empirical evidence to support that these credits would have a more accurate rating or lower credit risk.
- This is a particular important issue for private corporate entities as well as exposures to mutual funds and pension funds that do not have any need to seek a public listing.



The background features a dark blue gradient with faint, semi-transparent financial charts. A line graph with blue markers and a bar chart with yellow bars are visible. Numerical values such as 25.05, 49.55, 55.95, 33.03, 32.00, 43.22, 0.003, and 90% are scattered across the background.

Interplay between market risk and CVA elements of the Basel Proposal and GMS in the stress tests

Without adjustments, market risk and CVA risk capital requirements would be significantly overcalibrated.

- Governor Waller's July statement acknowledged that a large portion of the proposed capital increase would be driven by market risks already captured by the stress tests. Our January letter further explained why this is the case.
- Both the proposed FRTB and GMS assess market risk under extreme conditions and assume prolonged periods of illiquidity during which banks are unable to hedge or close out positions.
- CVA risk is already addressed in the GMS and the large counterparty default components of the supervisory stress tests, and the new standardized CVA capital charge would be completely additive.
- The Federal Reserve and other agencies should consider:
 - Recalibrating the GMS by modifying the assumption of no liquidity over an extended period of time to one of limited liquidity;
 - Recalibrating the GMS by removing private equity from the GMS and instead forecasting private equity losses as part of the macroeconomic scenario in PPNR;
 - Recalibrating the assumptions related to loss given default in the stress test loss projections; and
 - Excluding CVA losses from the SCB; and
 - Not applying the SCB to capital ratios determined under ERBA.

The background features a dark blue gradient with a faint grid and several data visualization elements. A line graph with glowing blue and purple points is visible in the upper right. A bar chart with vertical bars of varying heights is in the lower right. Faint numerical values like '25.05', '49.55', '55.95', and '33.03' are scattered across the top. In the lower right, there's a 'SALES' label with '0.003' and '90%' next to it. The overall aesthetic is professional and data-oriented.

Lack of tailoring of the Basel Proposal

Basel Proposal is not appropriately tailored.

- We agree with Governor Waller’s concern, highlighted in his July statement, that the proposal does not meet the Federal Reserve’s requirement to tailor capital regulation, and discussed this point in further detail in our comment letter.
- The proposal would largely apply the same capital requirements to banks in Categories I through IV and does not comply with statutory tailoring requirements.
- Particular issues due to lack of tailoring include:
 - Proposed changes to the definition in regulatory capital do not account for the fact that existing differences allow for differences in business models between broad commercial banks and other banks.
 - Requiring Category IV banks to apply a dual-stack approach would impose undue costs and burdens without a commensurate supervisory or policy benefit.
 - Applying the new market risk capital rule even to firms with immaterial trading activity would subject many firms to operationally burdensome requirements with minimal—if any—supervisory benefit.

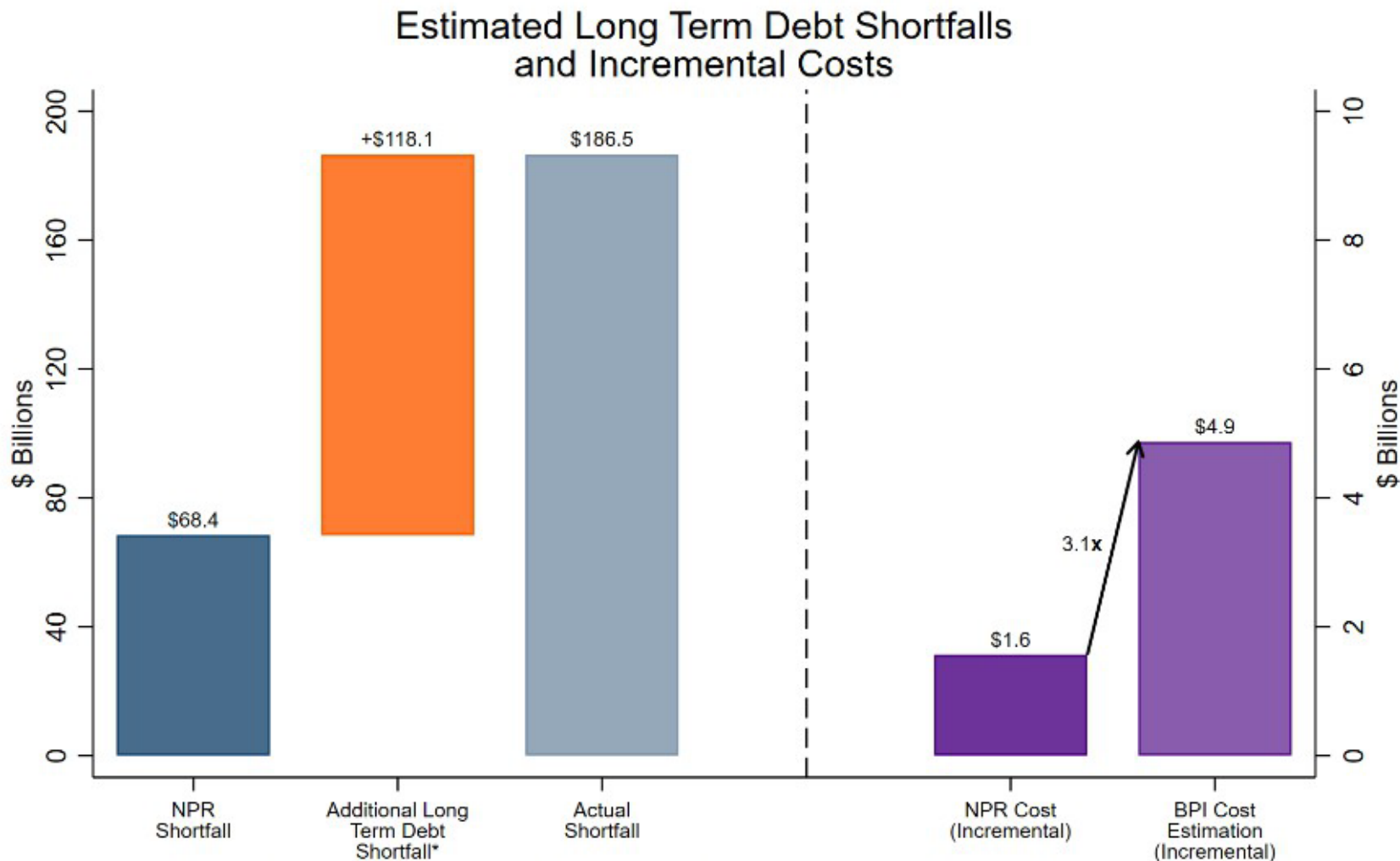


Long-Term Debt Proposal

Proposal severely underestimates the costs to covered banks and is not tailored.

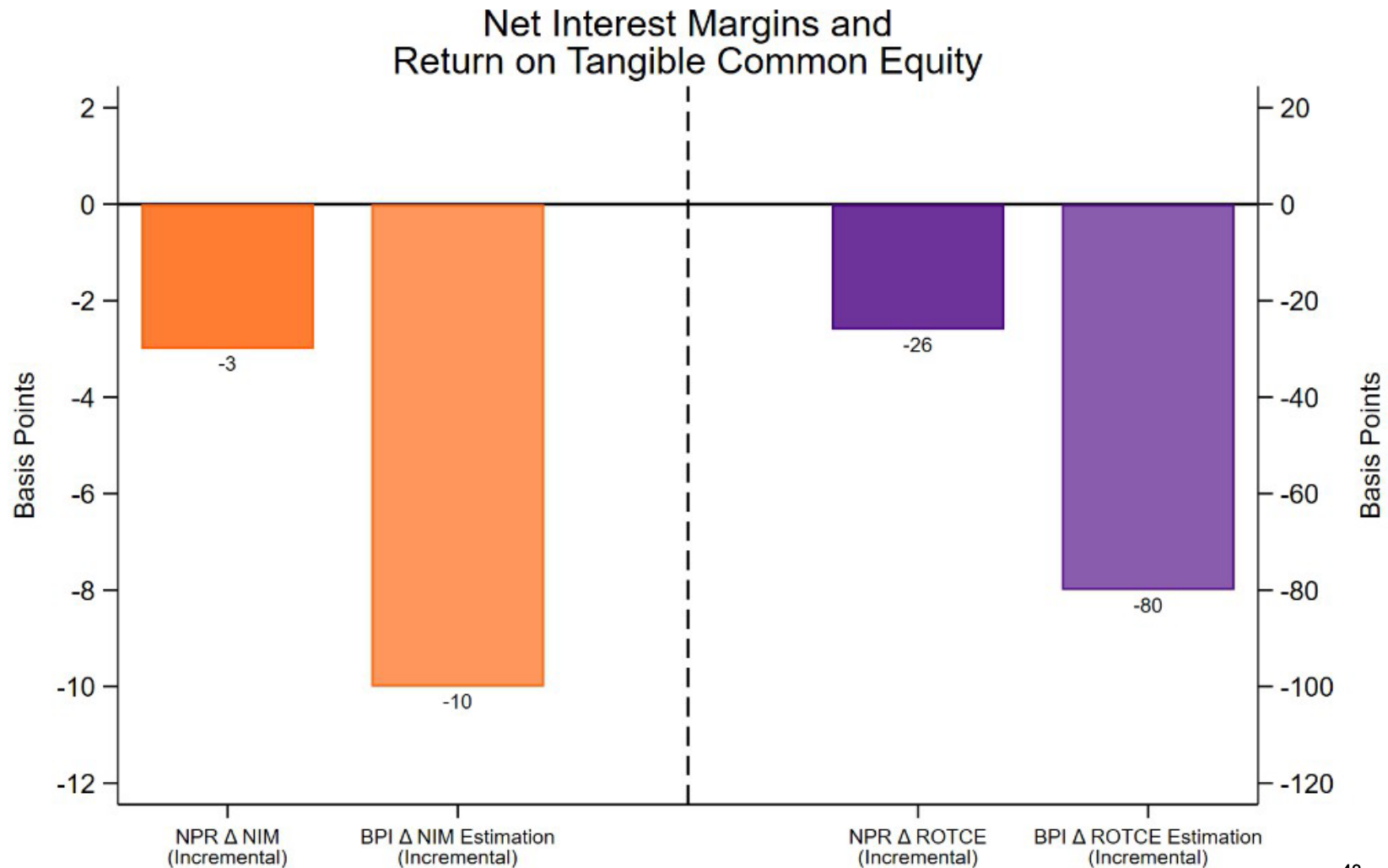
- BPI estimates that the costs of the proposed LTD requirements would be **three times** the estimate in the proposal.
- Based on estimates for LTD requirements, shortfalls and bond spreads (shown in subsequent slides), the total bank funding costs for Category II through IV banks are projected to reach \$4.9 billion, which is three times the proposal's estimated costs of \$1.5 billion under the incremental shortfall approach.
- The proposal has the opposite effect of tailoring, which is required by statute. Category III and IV banks will experience higher costs because there is a less liquid market for their debt and smaller issuers often need to provide higher yields. Rule's calibration and prescriptive requirements exacerbate these higher costs.

Proposal significantly underestimates the LTD shortfalls and incremental costs.



*Additional Long Term Debt Shortfall consists of: IDI, LCR, RWA-Growth, and Management Buffer Shortfalls.
Sources: FR Y-9C, FR Y-9LP, Bloomberg.

Proposal significantly underestimates the covered banks' costs of issuing debt.



Sources: FR Y-9C, FR Y-9LP, Bloomberg.

The proposal is not calibrated appropriately for regional banks.

- The proposed calibration of 6% RWAs is based on a “full capital refill” approach, which was designed for the largest, internationally active holding companies with large broker-dealers and other material operations outside of the bank.
 - Full capital refill concept would fully recapitalize, and allow to continue operating, key holding company subsidiaries by downstreaming funds from their parent holding company.

- 2% of RWAs is a more reasonable calibration. This alternative calibration would recognize regional banks do not need to be fully recapitalized to a level to continue as a going concern to support their resolution strategies.
 - Regional banks typically hold a great majority of assets in their subsidiary banks or retail brokerage subsidiaries that could be sold or wound down in resolution proceedings.
 - In FDIC resolution, bank would need to be recapitalized at a level to give the FDIC time to execute its resolution strategy successfully, minimize losses to the DIF and provide the FDIC, as receiver, with incremental flexibility in resolving the bank – not at a level to operate as going concern.

Internal debt requirement is overly prescriptive and drives higher costs.

- Requirement that a bank must internally issue debt to its holding company would create operational complexity and would drive a significant portion of the underestimated costs, such as by interfering with liquidity coverage ratio compliance.
- Banks need flexibility to manage their funding structures.
 - Rule could provide greater flexibility by allowing banks to satisfy external LTD requirement at holding company or bank level.
 - Rule should also give credit for additional types of funding pledged by the holding company to secure its obligation to recapitalize the bank. “Secured support agreements” are a common and accepted feature of Title 1 resolution plans.

Minimum denomination requirement would weaken bank debt market.

- Proposed \$400,000 denomination requirement should be eliminated.
 - This is a solution in search of a problem; direct retail investment in long-term debt the United States has been historically very limited. Federal Reserve data used for the agencies' own estimates show that only ~1% of households buy corporate bonds of any kind directly.

- Proposed minimum denomination is too high even for institutional investors.
 - Industry standard denomination is \$2,000, and where the GSIBs currently have the LTD requirement, more than 90% of GSIB long-term debt trades under \$400,000.
 - Minimum denomination of \$400,000 would exclude many institutional investors. By some estimates, less than half of key institutional investors (e.g., mutual funds and ETFs with a fixed income portfolio tracking the U.S. Aggregated Bond Index) are large enough to make such a large allocation to a single bank. Additionally, institutional investors often distribute across separately managed accounts, which requires lower denominations.

- A minimum denomination requirement would be inconsistent with the disclosure-based framework of the federal securities laws.

Stress Testing

Stress Testing

- As a general matter, the lack of transparency around the model design and plans for the longer-term path for supervisory stress testing to incorporate the effects of CECL, changes to the capital rules, etc. continues to be a concern and makes it difficult to engage in effective long-term capital planning.
- In connection with reconsidering the Basel proposal, the Board should put out for comment the stress testing policy statements and more generally solicit views on how to reconcile stress testing/SCB with any changes to the capital rules.
- Even apart from Basel finalization, the Board must act on our outstanding petition for rulemaking requesting that all models, formulas, scenarios and other decisional methodologies that the Board uses to calculate the SCB, including models used to project credit losses, go through a formal APA notice-and-comment rulemaking on an annual basis.
- With respect to the multiple scenarios being used in this year's cycle, the Board should not publicly disclose the results of the exploratory scenarios, at least not on an individual firm level.

Reg II Proposal

Costs the Board May Consider: 2014 Litigation

- In assessing costs, the Board is directed to consider the “incremental cost incurred by an issuer for the role of the issuer in the authorization, clearance or settlement of a particular electronic debit transaction” and prohibited from considering “other costs incurred by an issuer which are not specific to a particular electronic debit transaction.”
- **In interpreting the statute, the Board:**
 - Explicitly rejected the notion that only variable/marginal costs could be considered.
 - Instead, allowed any cost that was necessary to transactions occurring, which included fixed costs such as hardware and software.
 - Disallowed only those costs that would be incurred whether or not debit transactions were occurring – e.g., card production and delivery costs.
- **D.C. Circuit:**
 - “In our view, the Board reasonably distinguished between costs issuers could recover and those they could not recover on the basis of whether those costs are “incurred in the course of effecting” transactions. For instance, the Board's rule allows issuers to recover equipment, hardware, software, and labor costs since “[e]ach transaction uses the equipment, hardware, software and associated labor, and no particular transaction can occur without incurring these costs.” By contrast, the rule precludes issuers from recovering the costs of producing and distributing debit cards because “an issuer's card production and delivery costs are *incurred without regard to whether, how often, or in what way an electronic debit transaction will occur.*” (emphasis added)

Costs the Board May Consider: 2014 Litigation (Contd.)

- **D.C. Circuit (Contd.):**
 - “[T]he Board interpreted section 920(a)(4)(B) as allowing issuers to recover costs they must incur in order to effectuate particular electronic debit card transactions but precluding them from recovering other costs too remote from the processing of actual transactions.”
- As described in the following slides, the broad reading of allowable costs by the Board and the D.C. Circuit is not reflected in the data gathering undertaken by Board staff. Multiple costs necessary to the processing of transactions are excluded.

Banks Are Entitled to Recover Their Costs and a Reasonable Return

- The statute requires interchange fees to be “*reasonable and proportional*” to a covered issuer’s costs—not “equal to” those costs.
- The Board did not consider the meaning of this phrase in its rule, and Board staff did not raise it as a defense in the litigation.
- Courts have routinely held that price-control regulations that fail to allow a reasonable return are unconstitutional. *See, e.g., Michigan Bell Tel. Co. v. Engler*, 257 F.3d 587, 595-596 (6th Cir. 2001). This is likely why Congress used the language “reasonable and proportional” which is akin to the phrase “fair, just and reasonable,” which is frequently used in utility rate-setting statutes.
- In short, if Congress had meant for the cap to be “equal” to costs, it would have said “equal.” And that would have been unconstitutional.
- The Board should ask counsel to revisit the meaning of “reasonable and proportional.”

The Board's Survey Excludes Relevant Costs

See below a list of all costs incurred by a debit card issuer. Those in **bold** were not included in the Board's calculation of the cap, despite repeated public comments requesting that they be included.

Included Issuer Costs:

- Authorization, clearance, and settlement costs: costs incurred by debit card issuers for authorization (including authorization transaction monitoring), clearance and settlement of U.S. debit card transactions (excluding ATM transactions).
- Issuer fraud losses – fraud losses incurred by debit card issuers in connection with U.S. debit card transactions.
- Fraud-prevention costs – costs incurred by debit card issuers related to fraud prevention in connection with U.S. debit card transactions.

Excluded Costs:

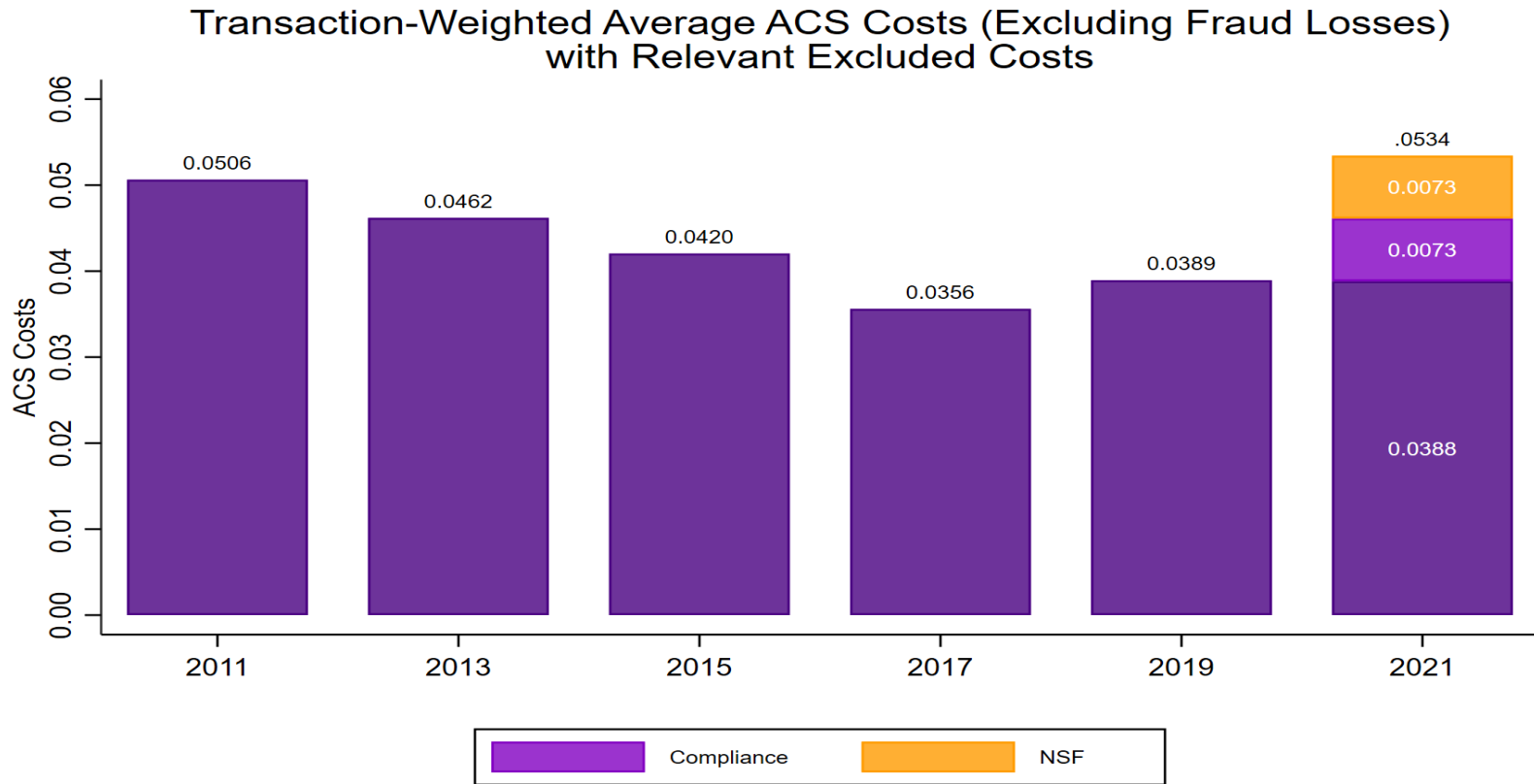
These excluded costs appear to be within the definition of allowable costs adopted by the Board and affirmed by the D.C. Circuit.

- **Non-sufficient funds handling costs**
- **Non-sufficient funds losses**
- **International transaction fraud costs/losses**
- **Dispute handling and management costs**
- **Debit program compliance costs (e.g., laws and network rules)**
- **Other transaction-monitoring and evaluation costs**
- **Other network fees not currently included by the Board**
- **Costs of establishing and maintaining a debit card relationship with the cardholder**
- **Cardholder rewards costs**
- **Cardholder inquiry costs**
- **Research and development costs**

The Excluded Costs Are Material

- For example, the Board reports that based on 2021 survey data, the transaction weighted average cost of non-fraud-related, transaction-specific cardholder inquiries was 3 cents. (The Board collects, but does not include this information in the cap.)
- Simply adding that component would increase the pre-multiplier base component from 3.9 cents to 6.9 cents per transaction (resulting in base component cost recovery of 25.5 cents per transaction after applying the Board's chosen multiplier of 3.7).
- In addition, BPI conducted a survey asking BPI/TCH/ABA member banks to quantify several of the excluded cost items.
- The next slide demonstrates the transaction weighted average costs that would be included in the cap if just these two additional categories were included:
 - Compliance
 - NSF losses and handling costs

The Board's Survey Excludes Relevant Costs



Sources: Federal Reserve Board, BPI & Trade Groups Survey.

Issuer Costs Do Not Justify Lowering the Fee Cap

- The previous slide also demonstrates that issuer costs as measured by transaction weighted average do not support a 30% reduction in the interchange fee cap.
- The transaction weighted average of per-transaction base component costs across covered issuers has fallen only 1.2 cents since 2011.
- That metric was 3.9 cents in 2021, and 5.1 cents in 2011.
- This is well within the range of uncertainty for this type of data collection exercise and the lack of consensus around what costs are appropriate to include.
- Yet, the Board proposes to reduce the base component from 21 cents to 14.4 cents, a 30% reduction, which is disproportionate to the reduction in transaction weighted average base component costs.

The Proposal's Shift in Methodology is Unexplained and Unwise

80% of
all issuers

58% (2011)

77% (2021)

- The largest change in the cap comes from a change in methodology, not from changing costs. The proposal changes from issuer-weighted cost to transaction-weighted cost.
 - If the proposal had retained the original methodology for setting the ACS component of the cap – even based on the limited set of costs the Board considers – the cap would have increased from its current 21 cents.
- Transaction weighting skews the allowable base component toward high-volume issuers.
- Because of scale, the very largest issuers have the lowest costs, so the move to transaction weighting significantly lowers the cap.
- Bottom line: the proposal would not allow **34% of covered issuers** – **approximately 55 of 163 total issuers** – to recover even the limited universe of costs considered by the Board, up from 23% in 2021 using the existing methodology.
- The proposal provides no justification for this change.

The Board Is Required to Consider the Effect of the Proposal on Consumers

- Section 904 of EFTA requires the Board to: (a) consider the “costs and benefits to financial institutions, consumers, and other users of electronic fund transfers” of the regulation prior to issuing the regulation; (b) consider the ways that the proposed regulation affects “competition in the provision of electronic banking services among non-exempt and exempt financial institutions and the availability of such services to different classes of consumers, particularly low-income consumers”; and (c) to the extent practicable, “demonstrate that the consumer protections of the proposed regulations outweigh the compliance costs imposed upon consumers and financial institutions.”
- *This requirement is fully consistent with the statute, as properly read, given that (as noted above) allowing a rate of return as part of a “reasonable and proportional” price would allow for consumer interests to be factored into the cap, whereas the proposal’s focus solely on cost has not.*
- The stakes are significant. Prior to the Board’s imposition of the Interchange Fee Cap in 2011, nearly 60 percent of large financial institutions offered free checking account options to consumers.
 - In first few years after the cap was imposed, that number fell to below 20 percent.
 - Consumers also experienced substantial increases in the amounts of fees on fee-based checking accounts. Within the first few years after 2011, average checking account fees for consumers nearly doubled, from roughly \$4 per month to more than \$7 per month.
 - Reduced interchange fee revenue also likely reduces innovation and investment in the payments system by covered issuers.

The Board Is Not Required to Amend Reg. II

- There is no statutory or regulatory requirement that the Board revise the interchange fee cap either periodically or with reference to any particular data point (and certainly not by reference to a transaction-weighted average cost).
- In releasing the Regulation II final rule in 2011, the Board stated in the preamble to the rule that it would “periodically conduct surveys of covered issuers in order to reexamine and *potentially reset* the fee standard.”
- Thus, the Board has all the time it needs to gather the relevant data, factor in a required rate of return, more fully consider the effect of the proposal on consumers, financial institutions and consumers, and reissue the proposal, if it determines that a proposal is appropriate.

Liquidity

Changes to liquidity regulation, if any, should only be proposed after comprehensive review and public engagement.

- While many ideas for regulatory revisions have theoretical merits, it is imperative to think about them in a comprehensive way that considers the impacts across all business models, relevant regulations and markets.
- Given the wide range of liquidity changes under consideration, the high stakes involved, and the complexity of the task, we would strongly recommend that the agencies invite public input through an advance notice of proposed rulemaking or a request for information before proposing any changes.

An aerial photograph of a city skyline, featuring several tall skyscrapers. A large, semi-transparent purple rectangle is overlaid on the top half of the image, containing white text. The sky is blue with scattered white clouds.

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