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June 23, 2025

By Electronic Mail

Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

Re: **Notice of Proposed Rulemaking, Modifications to the Capital Plan Rule and Stress Capital Buffer Requirement, Federal Reserve Docket No. R-1866 and RIN 7100-AG92**

The Institute of International Bankers ("IIB") appreciates the opportunity to comment on the notice of proposed rulemaking regarding proposed changes to the Federal Reserve Board's capital plan rule and stress capital buffer ("SCB") requirement.[1] The IIB represents internationally headquartered financial institutions from over 35 countries around the world doing business in the United States. The IIB's members consist principally of international banks that operate branches, agencies, bank subsidiaries and broker-dealer subsidiaries in the United States ("international banks").

I. We support the Proposal's general goals of reducing the volatility of capital requirements and thereby better allowing firms to plan their capital actions and financial intermediation activity, while also ensuring that the capital buffer requirements are forward looking and risk sensitive.

We agree with the Proposal's goal of avoiding sudden changes and cliff effects in SCB requirements by averaging a firm's maximum common equity tier 1 ("CET1") capital declines projected in each of the Federal Reserve Board's prior two annual supervisory stress tests to inform a firm's SCB requirement. As stated in the Proposal, such averaging may encourage firms to decrease the amount of capital they hold above their minimum requirements, or their "management buffer," which would allow them "to deploy capital more efficiently across business lines" and "allocate more capital to lending and other financial intermediation activities,

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[1] Board of Governors of the Federal Reserve System ("Federal Reserve Board"), *Modifications to the Capital Plan Rule and Stress Capital Buffer Requirement*, 90 Fed. Reg. 16843 (proposed Apr. 22, 2025) (the "Proposal").

potentially fostering economic growth."[2] We agree with the Federal Reserve Board that the continuous uncertainty caused by the opaque nature of stress test outcomes has led institutions for several years to over-estimate management buffers—many institutions have explored ways over the years to optimize that management buffer with only limited success.

We respectfully request that the Federal Reserve Board adopt Alternative 4 identified in the Proposal, and apply stress capital averaging on an asymmetrical basis (i.e., only basing the SCB requirement on the average if the projected CET1 decline in the current year's stress test is larger than in the prior year's, and otherwise basing the SCB requirement on only the current year's supervisory stress test results). We believe that this alternative strikes a better balance between ensuring safety and soundness and fostering economic growth by helping firms manage SCB requirement volatility and allowing firms to most efficiently deploy capital when stress loss estimates decrease. In particular, a reduction in the SCB does not raise the same issues in relation to uncertainty, planning and sizing of a management buffer as an unexpected increase.

We welcome the additional one quarter prior to effectiveness of a new SCB for intermediate holding companies ("IHCs") to adjust capital plans in light of a new SCB. We expect additional time will further allow firms to optimize management buffers and conduct end-of-year planning. We also look forward to the future public engagement on stress test models and scenarios to increase transparency.

However, we believe it is imperative that any underlying issues of uncertainty, lack of transparency and planning disruption arising from the stress testing framework are not just ameliorated by averaging, but that the individual elements of the stress tests are appropriately calibrated. Therefore, we offer recommendations[3] below about how the stress test should be modified to better address the risk of certain assets or activities and the overall risk profiles of stress test participants. In particular, we recommend that the Federal Reserve Board should:

- Revise the thresholds at which the global market shock ("GMS") and largest counterparty default ("LCD") apply to stress test participants;
- Recalibrate the GMS to avoid its overlap with the already stressed inputs to the market risk capital requirements;
- Revise the structure of the LCD exercise to take into account actual probabilities of default;

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[2] Proposal at 16846.

[3] The Proposal requests comment on "What, if any, other elements of the supervisory stress test framework should the Board consider amending to improve the transparency and effectiveness of its supervisory stress test?" Proposal at 16844. In addition, the Federal Reserve Board stated that their proposed changes to the Forms FR Y-14A/Q/M "would better align the stress capital buffer requirements to firms' risk profiles" and a "firm's stress capital buffer should be aligned with the firm's risk profile" (Proposal at 16847)—goals shared by our recommendations as well.

- Eliminate the dividend add-on component of the SCB, particularly for IHCs;
- Recalibrate, and eliminate certain aspects of, operational risk in the capital rules and operational risk elements of the stress tests due to the overlap between the two, while also avoiding application of standardized operational risk provisions to IHCs;
- Make certain changes to increase the transparency of elements of the FR Y-14 reporting form; and
- Retain a phase-in for material supervisory model changes.

Finally, we note that the Proposal would amend the calculation of a firm's SCB requirement beginning this year,[4] and that industry organizations have urged the Federal Reserve Board in a joint letter to publicly announce that firms will be permitted to operate under the existing SCB framework regardless of whether the Proposal is finalized with an effective date prior to October 1, 2026.[5] We support the recommendations in the joint letter because a firm cannot accurately disclose its SCB requirement and reasonably adjust its capital distributions unless it has certainty that the current SCB requirement framework will continue for another year.

II. In addition to the proposed modifications to the structure of the stress test in the Proposal, the Federal Reserve Board should also address the degree and breadth of applicability of the GMS and LCD and make targeted changes to several of the stress testing components to increase risk sensitivity.

There are several adjustments that should be made to the stress testing requirements to better calibrate the tests to the risk profile of firms, particularly IHCs. In addition to the proposed reductions in volatility and uncertainty, the Federal Reserve Board should better tailor application of the stress test, specifically with respect to the GMS and LCD. As has been highlighted recently by Governor Bowman, further tailoring is necessary to the broader regulatory structure.[6] Furthermore, Federal Reserve Board staff have indicated that the

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[4] Proposal at 16847.

[5] *See* Letter from the Financial Services Forum, American Bankers Association, Bank Policy Institute and Securities Industry and Financial Markets Association to the Federal Reserve Board (May 16, 2025), https://bpi.com/joint-trades-comment-on-stress-capital-buffer-requirement/.

[6] Michelle W. Bowman, Governor, Federal Reserve Board, Statement Before the S. Comm. on Banking, Hous., and Urb. Affs. (Apr. 10, 2025), https://www.federalreserve.gov/newsevents/testimony/bowman20250410a.htm ("Tailoring is fundamental to ensuring we maintain and enhance the diversity of the U.S. banking system, which must include and support banks of all sizes. The U.S. regulatory framework has grown expansively to become overly complicated and redundant, with conflicting and overlapping requirements. This growth has imposed unnecessary and significant costs on banks and their customers."); Michelle W. Bowman, Governor, Federal Reserve Board, Reflections on 2024: Monetary Policy, Economic Performance, and Lessons for Banking Regulation, at the California Bankers Association 2025 Bank Presidents Seminar, Laguna Beach, California (Jan. 9, 2025), https://www.federalreserve.gov/newsevents/speech/bowman20250109a.htm ("However, I see a growing risk that under the veil of supervision, there has been an erosion of a risk-based approach, and effectively a 'push-down' of regulatory requirements designed and calibrated for larger firms

Proposal is the "first of several steps"[7] to improve transparency, and our comments below are in part designed to increase transparency by clarifying, through existing frameworks, and not through opaque determinations, the applicability of various elements of the stress tests, and to decrease redundancy by removing overlapping capital charges that mask true risk in favor of stacking additional capital.

A. *The Federal Reserve Board should revise the thresholds at which the GMS and LCD components of the supervisory stress test apply to firms.*

In general, the applicability of the GMS is not appropriately calibrated to focus on systemic risk issues. Within the institutions subject to the GMS, there are meaningful differences in size and risk profile, calling into question whether inclusion of those institutions with significantly lower size and risk profile is appropriate.

The only firms other than Category I U.S. GSIBs that are subject to the GMS are two IHCs. Neither IHC is even in Category II. The IHCs are materially smaller than any U.S. GSIB, both in terms of total assets and with respect to their trading assets and liabilities ("TAL").[8] In addition, there are important differences in the riskiness and systemic importance of the trading asset portfolios of such firms as compared to the U.S. GSIBs.[9]

Therefore, to better tailor the GMS to those institutions the trading activities of which actually merit application of the GMS within the context of systemic risk to the U.S. financial system, the GMS component of the annual stress test should, at a minimum, not be applied to Category III and below firms. Furthermore, the TAL threshold applied to firms that remain subject to the GMS even after applying a categorization cutoff should be increased. The fixed-dollar TAL threshold at which the GMS applies was introduced in 2017 and has remained at $50 billion in aggregate TAL over the subsequent eight years.[10] To account for inflation between such time and today, and to better capture firms with truly systemic trading portfolios, the Federal

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to apply to smaller firms. I continue to believe that tailoring should be a central tenet of our regulatory and supervisory approach and framework and believe that we must renew our commitment to this philosophy going forward.").

[7] Federal Reserve Board staff, Board Memo on Proposed Rule to Reduce the Volatility of the Stress Capital Buffer Requirement (Apr. 11, 2025), at 1.

[8] In Q1 2025, the average total assets of the two IHCs was $155.8 billion, while the average total assets of the U.S. GSIBs was $2.01 trillion. The average TAL of the two IHCs was $44.5 billion, while the average TAL of the U.S. GSIBs was $485.7 billion. Averages based on data from Form FR Y-9C. These are not just mere differences but depict a separation of orders of magnitude.

[9] For example, the average projected trading and counterparty losses through Q1 2026 under the severely adverse scenario in the most recent stress test for the two IHCs was $1.6 billion, while for the U.S. GSIBs, such average projected losses was $11.0 billion. Even when combined, the projected trading and counterparty losses of the two IHCs were dwarfed by the lowest projected losses of a single U.S. GSIB (excluding the two custody banks). *See* Federal Reserve Board, *Dodd-Frank Act Stress Test 2024: Supervisory Stress Test Results June – 2024*, tbl. 8 (Sept. 5, 2024), https://www.federalreserve.gov/publications/2024-june-dodd-frank-act-stress-test-results.htm (the "2024 Stress Test").

[10] 12 C.F.R. § 252.54(b)(2)(i)(A). The cumulative inflation rate between 2017 and 2025 is approximately 30.47%. CPI Inflation Calculator, https://www.in2013dollars.com/us/inflation/2017?amount=1.

Reserve Board should increase the TAL threshold, and should then automatically index the threshold for growth on a yearly basis going forward. If the threshold is not indexed to inflation automatically, the Federal Reserve Board should commit to revisiting and adjusting the threshold as needed so that it does not become inappropriately low over time due to economic growth and inflation. If, however, the Federal Reserve Board is unwilling to either index or commit to adjusting the threshold going forward, it should at least allow for a one-time upward adjustment of the threshold plus a reasonable buffer for future economic growth and inflation.

In addition, the threshold based on the ratio of a firm's aggregate TAL to total consolidated assets should be removed.[11] This threshold is not appropriately calibrated because it could apply to firms with far less significant trading activity if such firms are sufficiently small asset-wise. For example, a Category III firm may have as low as $100 billion in total assets, which would then trigger the GMS at $10 billion of aggregate TAL. An amount of $10 billion in aggregate TAL is less than the trading and counterparty *losses* of each of the individual U.S. GSIBs other than the custody banks under the 2024 stress test results.[12] An amount of $10 billion in aggregate TAL is also but a small fraction of the average U.S. GSIB TAL of over $485 billion, which highlights the significant differences in levels of trading activity among firms that would be subject to the GMS. Therefore, the TAL-to-assets ratio is capturing firms that do not exhibit the type of systemic risk that warrants participation in the highest level of severity of the stress tests (severely adverse, plus GMS and LCD). Firms that do not hit the fixed-dollar aggregate TAL threshold should be excluded from the GMS as not systemically important—there should be no separate TAL ratio to assets test.

Finally, U.S. Treasury securities should be excluded from the calculation of TAL for the fixed-dollar threshold and, if the Federal Reserve Board determines that it should remain, the ratio-based threshold. Such securities do not pose the same risk as other trading assets, which has been recognized by the Federal Reserve Board on numerous occasions.[13] The ownership of U.S. Treasuries, whether or not in trading accounts, does not indicate greater complexity, greater instability of the organization or greater need for testing an organization against a shock.

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[11] 12 C.F.R. § 252.54(b)(2)(i)(A).

[12] *See* 2024 Stress Test.

[13] For example, in the capital rules, U.S. Treasury securities and those obligations issued by U.S. government agencies are assigned a zero percent risk weight. 12 C.F.R. § 217.32(a)(1)(i). In addition, credit transactions between banks and their affiliates, if secured by U.S. Treasury securities, are exempt from the quantitative lending limits under Regulation W. 12 C.F.R. § 223.42(c). Lending limits also provide exemptions for exposures collateralized by U.S. Treasuries. *See, e.g.,* 12 C.F.R. § 32.3(c)(3) (exemption from national bank lending limits); 12 C.F.R. § 252.71(q) (U.S. government is "exempt counterparty" and therefore exposure shift to U.S. Treasury collateral under 12 C.F.R. § 252.74(b) exempts transaction).

From a trading risk perspective (and therefore better correlated with calculations based on TAL), the general prohibition on proprietary trading under the Volcker Rule does not apply to the purchase or sale of U.S. Treasury securities. 12 C.F.R. § 248.6(a)(1). This Volcker Rule exemption also supports the next sentence in the text above, as a significant reason for the exemption was to not hinder Treasury market liquidity. Also in relation to market risk of U.S. Treasuries, these securities are treated as Level 1 high-quality liquid assets ("HQLA") under rules related to the liquidity coverage ratio. 12 C.F.R. § 249.20(a)(3). Level 1 HQLA are not subject to haircut under the liquidity rules, and haircut levels are assigned relative to market price volatility of HQLA, indicating that the bank regulatory agencies have determined that U.S. Treasuries have little to no market volatility in periods of stress.

Therefore, including such securities in the context of the trigger for a market risk shock is inappropriate. In addition, with respect to U.S. Treasuries, the Federal Reserve Board and other regulators have been focused on enhancing Treasury market liquidity, which would be served better by not penalizing firms with more stringent stress testing requirements for actively engaging in the U.S. Treasury market.[14]

Furthermore, with regard to the LCD, we do not believe it is sufficiently clear how the participating firms are chosen. While 12 C.F.R. § 252.54(b)(2)(i) mentions the possibility of a "counterparty component" in addition to a trading shock when setting out the TAL thresholds for triggering the GMS, (i) the Federal Reserve Board itself indicates that the LCD component arises from the more discretionary Regulation YY provision wherein the Federal Reserve Board "may require a covered company to include one or more additional components in its severely adverse scenario in the stress test required by this section based on the company's financial condition, size, complexity, risk profile, scope of operations, or activities, or risks to the U.S. economy",[15] and (ii) the cohort of LCD component participants includes two global custody banks (but only two, and not other banks known to be large global custody banks) that presumably do not meet the TAL thresholds for the GMS as they do not participate in the GMS. The criteria for choosing those subject to the LCD is unknown.[16] Therefore, in the continued interest of objectivity and transparency, the Federal Reserve Board should also use pre-defined objective criteria for determining those institutions it would subject to the LCD.

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[14] Since 2021, the Inter-Agency Working Group ("IAWG"), composed of staff from the U.S. Treasury, Federal Reserve Board, Federal Reserve Bank of New York, Securities and Exchange Commission and Commodity Futures Trading Commission, has been spearheading initiatives to enhance Treasury market resilience. Treasury Borrowing Advisory Committee, *Inter-Agency Working Group's efforts on Treasury Market Resilience* (Oct. 29, 2024) at 2, 6, https://home.treasury.gov/system/files/221/TBACCharge1Q42024.pdf. Notable efforts include requiring the central clearing of certain repurchase and cash transactions in Treasury securities, increasing public disclosure on Treasury securities transactions and on hedge funds, collecting new data on the bilateral uncleared repo market, launching a Treasury buyback program and establishing a standing facility to finance Treasury repo with pre-authorized dealers and banks. *Id.* at 8; Brookings, *What's going on in the US Treasury market, and why does it matter?* (Apr. 14, 2025), https://www.brookings.edu/articles/whats-going-on-in-the-us-treasury-market-and-why-does-it-matter/#:~:text=The%20work%20of%20the%20Inter,in%20times%20of%20market%20stress.

[15] *See* Federal Reserve Board, 2025 Stress Test Scenarios (Feb. 2025), at 11, n. 16 (the "2025 Stress Test Scenarios").

[16] We are not aware of any published criteria for triggering the LCD. Currently, we understand that the Federal Reserve Board notifies firms via a confidential letter that it has determined the LCD is appropriate for the firm based on its size, complexity, risk profile, scope of operations, activities, and risks presented to the U.S. economy. Those letters include no further details. No firm knows precisely why it is being required to hold an additional "add-on" to capital under the LCD.

B. The Federal Reserve Board should remove double-counting based on both GMS losses and regular stressed market risk losses under the market risk capital rules and stress test.

The GMS component of the stress test, as currently calibrated, has reduced banks' holdings of debt securities and ability to act as market-makers, and should be revisited.[17]

All of the GMS participants also apply the market risk capital rules. Under the standardized measure for market risk, a firm must sum its VaR-based capital requirement for trading positions[18] and its stressed VaR-based capital requirement,[19] in addition to other add-ons.[20] First, the VaR-based measure already includes any stress or volatility that have occurred over at least the last year, and perhaps longer.[21] In addition, for VaR, the "institution must update data sets at least monthly or more frequently as changes in market conditions or portfolio composition warrant."[22] Second, the stressed VaR-based measure also already includes "model inputs calibrated to historical data from a continuous 12-month period that reflects a period of significant financial stress appropriate to the Board-regulated institution's current portfolio."[23] The firm must have a "process for selecting, reviewing, and updating the period of significant financial stress used to calculate the stressed VaR-based measure and for monitoring the appropriateness of the period." While we understand that there is some variability in the market shock applied by the Federal Reserve Board under the GMS, in our experience the scenarios generally overlap significantly with other stressed measures (i.e., the scenarios that firms pick for a 12-month stressed VaR period of significant financial stress). For example, in the experience of our members, firms generally choose a range of months within the 2007-09 crisis for stressed VaR, while the severely adverse scenario for the Federal Reserve Board's stress test often includes parameters that produce 2007-09 crisis-like results.

Furthermore, there is additional overlap in the stress test itself. Those participants subject to the GMS are to recognize the GMS in the first quarter of the stress test and carry the shocked losses through the remainder of the stress test horizon. The GMS is characterized, at least in 2025, as a fall in equity prices, Treasury yields and commodity prices, with widening credit spreads, and dollar and yen appreciation, apparently brought on by "a severe slowdown in the economy leading to increased unemployment and lower inflationary pressures."[24] Yet, the

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17 *See* SIFMA, *US Stress Test Capital Requirements Are Excessively Volatile and Overestimate Losses* (Oct. 6, 2022), https://www.sifma.org/resources/news/blog/u-s-stress-test-capital-requirements-are-excessively-volatile-and-over-estimate-losses-identifying-the-problem-and-how-to-solve-it/; Adam Freedman and Francisco Covas, *The Global Market Shock and Bond Market Liquidity*, Bank Policy Institute (May 23, 2019), https://bpi.com/the-global-market-shock-and-bond-market-liquidity/.

18 *See* 12 C.F.R. § 217.205.

19 *See* 12 C.F.R. § 217.206.

20 *See* 12 C.F.R. § 217.204(a).

21 *See* 12 C.F.R. § 217.205(b)(2).

22 *Id.*

23 12 C.F.R. § 217.206(b)(1).

24 2025 Stress Test Scenarios at 10.

macroeconomic severely adverse scenario in 2025 is also characterized by unemployment increase, a decline in demand, increased credit spreads, falling asset prices (including equities, real estate) and declining inflation, with dollar and yen appreciation.[25] By carrying the lower shocked value through the stressed period, it compounds the losses on the trading assets, based on the same macroeconomic effects applied twice. Furthermore, the LCD component of the supervisory stress test utilizes the stressed market prices under the GMS (and not just the severely adverse scenarios) for collateral and transaction pricing which may, directionally, yield greater in-the-money and uncollateralized values at the time of the counterparty default, thus compounding the overlap.

Even if there are some differences (i.e., we understand that a shock and a 9-quarter recession horizon may paint different pictures), in our experience and based on our review of data, the overlap is significant (worsening the troughs of CET1 losses in an unrealistic way) and therefore requires considered and significant recalibration. The compounded effect of the following overlaps should be rethought and corrected:

- VaR-based measurement requirement to iterate models for market conditions, including stress and volatility;
- Stressed VaR-based measurement requirements for choosing a period of significant financial stress;
- The GMS hypothetical shock that includes many of the same factors as both the period chosen by firms for a period of VaR significant financial stress *and* the 9-quarter severely adverse scenario;
- The severely adverse scenario which continues the overlapping of stress on already stressed elements; and
- The LCD which first increases losses through applying the stress scenario and the GMS to asset, liability and collateral amounts, and then assumes that a large counterparty defaults when those stressed values are in play.

We note that this issue will be exacerbated if the Fundamental Review of the Trading Book ("FRTB") is finalized by the banking agencies. The FRTB is designed to include additional market stress elements as compared to the current market risk requirement, effectively rendering the GMS, which we understand was in part introduced to address what were viewed as weaknesses in the market risk framework, redundant. Therefore, the Federal Reserve Board should not both finalize the FRTB and maintain the GMS, particularly not as currently calibrated.

C. The LCD should take into account probability of default.

The LCD assumes a 100% probability of default of the stress test participant's largest counterparty. However, through risk management and monitoring, as well as customer and transactional onboarding and approval advances over the last two decades, the likelihood

[25] *Id.* at 5–7.

that a participant's largest counterparty is also the counterparty that is most likely to fail is completely unrealistic. It is, in fact, the inverse of expected risk management practices. Firms provide additional credit lines and permit increased exposure to those counterparties that they believe run a much lower risk of default. Therefore, the Federal Reserve Board should modify its approach to more accurately reflect the true risk posed by a firm's largest counterparties. As examples of possible alternatives, the European Banking Authority and the Bank of England have developed methods of scoping large counterparties that are more risk-sensitive and realistic.[26] The LCD framework should be more sophisticated, nuanced and risk-sensitive, leveraging criteria regarding size, concentration of exposures and probabilities of default rather than a simplistic choice of the largest counterparty.

In addition, whether or not the Federal Reserve Board adopts the approach to LCD scoping we suggest above, the excluded counterparties from the LCD should be expanded. Currently, certain sovereign entities, multilateral development banks, supranational entities and qualifying central counterparties are excluded from consideration in identifying a firm's largest counterparty.[27] The Federal Reserve Board should also exclude other counterparties that have low risks of default from consideration as a defaulting counterparty. We propose the following additional exclusions:

- Pension plans;

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[26] Under the E.U. approach, banks must identify their 10 largest counterparties and of those counterparties, banks must identify the 3 most vulnerable ones based on the highest external probability of default. *See generally* European Banking Authority, *2025 EU-Wide Stress Test* (July 5, 2024), https://www.eba.europa.eu/sites/default/files/2024-07/3bd993e0-8678-40ac-9fba-9b8a6bf03f44/2025%20EU-wide%20stress%20test%20-%20Methodological%20Note.pdf. Under the U.K. approach, banks are required to identify counterparties that are particularly vulnerable to the stress scenario and model their defaults accordingly. They are expected to exercise judgment in identifying vulnerable counterparties under the stress scenario. The number of counterparties to be defaulted is determined based on the bank's top exposures with minimum numbers specified for different categories. If the stress scenario indicates that more counterparties would be at risk of default, banks are expected to default additional counterparties beyond the minimum requirement.

[27] A complete list of excluded counterparties is available in the 2025 Stress Test Scenarios: "In identifying its largest counterparty, a firm subject to the counterparty default component will not consider certain sovereign entities (Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States), certain multilateral development banks and supranational entities (International Bank for Reconstruction and Development, International Monetary Fund, Bank for International Settlements, European Commission, and European Central Bank), or qualifying central counterparties (QCCPs). See the definition of a QCCP at 12 C.F.R. § 217.2. Please note that although the International Bank for Reconstruction and Development is excluded, the other subsidiaries of World Bank Group (including the International Development Association, International Finance Corporation, Multilateral Investment Guarantee Agency, and International Centre for Settlement of Investment Disputes) must be considered when selecting the firm's largest counterparty. U.S. IHCs are not required to include any affiliate as a counterparty. An affiliate of a company includes a parent of the company, as well as any other firm that is consolidated with the company under applicable accounting standards, including U.S. generally accepted accounting principles or International Financial Reporting Standards. See 12 C.F.R. § 252.171(b) & (f)." *Id.* at 11 n. 17.

- Counterparties with a 0% risk weight under the capital rules;[28] and
- Counterparties with firm-modeled probabilities of default that are sufficiently low or below a materially low threshold, even if exposures are large.

These entities pose sufficiently small probabilities of default that their inclusion in the LCD scoping is unnecessary, even if they are a large counterparty, and distorts the true risk of a large counterparty default.

D. The dividend add-on component of the SCB should be eliminated for IHCs.[29]

Under the SCB a planned dividend in any or all of the fourth through seventh quarters of the nine-quarter capital planning horizon must be added (the "dividend add-on") to an IHC's SCB, while other forms of distributions to shareholders, such as a planned share repurchase, are not.[30] While the Proposal suggests a slight revision to the timing of the dividends subject to the dividend add-on, in our view, the Federal Reserve Board should instead eliminate this requirement altogether for IHCs. IHCs do not fit the character and types of systemic issues that the dividend add-on was designed to address. The dividend add-on is biased against IHCs in several ways, given their materially different profile as subsidiaries of a larger organization. IHCs effectively do not, and often cannot, distribute capital through share repurchases, and therefore the exclusion for share repurchases, rather than dividends on shares, is a benefit in the SCB framework that is unusable and irrelevant to IHCs. Also, as wholly owned subsidiaries IHCs would typically issue a dividend to provide funds to its parent foreign banking organization to deploy elsewhere through additional financial services, the dividend is not leaving the banking system (at least initially) unlike dividends from stress test participants that have publicly traded common and preferred stock. More importantly, the principal rationale for the dividend add-on was based solely on U.S. publicly traded institutions and the reputational risks they face in the market with regard to decreasing or eliminating their dividends.[31] Pre-funding should not be required given the fully discretionary nature of IHC dividends and lack of market expectations.

Further, the dividend add-on miscalibrates capital requirements because it essentially serves as a floor to the amount of any distribution that can be paid regardless of over-

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[28] *See* 12 C.F.R. § 217.32.

[29] Question 21 of the Proposal asks, "What would be the advantages and disadvantages of removing the dividend add-on component from the calculation of a firm's stress capital buffer requirement?", and Question 22 of the Proposal asks, "The Board seeks comment on all aspects of the dividend add-on component of the stress capital buffer requirement. Please provide any rationale or data that may be helpful for the Board to consider." Proposal at 16850.

[30] 12 C.F.R. § 225.8(f)(2)(C).

[31] Federal Reserve Board, Amendments to the Regulatory Capital, Capital Plan, and Stress Test Rules, 80 Fed. Reg. 18,160, 18,166 (proposed April 25, 2018) ("A reduction in dividends by a publicly-traded firm could be interpreted by market participants as a signal of long-run deterioration in firm profitability, which could lead to a negative stock price reaction. Hence, even if the outlook for a publicly traded firm has significantly worsened, public pressure and competition may deter the firm from reducing dividend payments. Requiring a firm to pre-fund one year of dividends reflects the assumption that the firm will strive to maintain its current level of dividends even during times of stress."). This policy goal is wholly inapposite to IHCs.

capitalization of the entity. If the dividend add-on were a true "pre-funding," an organization should be permitted to "dip into" and reduce its SCB by the amount of a dividend in order to use those "pre-funded" resources to distribute to shareholders. However, the amount of any "pre-funding" is binding through the entire year (which equates to the four-quarter period that is pre-funded under the SCB rules) during which a particular SCB is effective. A firm should have enough capital in any quarter not to fall below minima and stress losses *after* it pays its dividend. However, currently, a firm must maintain its capital above its minima, its stress losses *and* its dividend add-on, even after it pays its dividend.[32]

E. The operational risk elements of the stress test and capital requirements should be rationalized and recalibrated to address overlap.

There are a number of ways in which the operational risk elements of the overall capital framework could, and should, be tailored for IHCs. In any revised version of a Basel III endgame proposal, IHCs should continue to be subject to the current exclusion (as Category III or IV institutions) from the operational risk elements of risk-weighted asset determinations. It is important, as we have indicated in other comments above, that the tailoring framework be leveraged to make decisions regarding how to apply elements of the risk-based capital framework.

It is also the case that many, if not all, IHCs will have operational risk elements of the international capital regime applied to them through their parent home country rules. In this context, we believe that the operational risk capital allocated through the stress tests (subject to our comments below) sufficiently allocates global capital to the U.S. for operational risk, and IHCs should not be subject to *any* standardized operational risk capital requirements in any final version of Basel III.

However, to the extent that operational risk is included in both the stress test and in a revised Basel III endgame proposal applicable to IHCs, recalibration is essential, and the Federal Reserve Board must consider any operational risk elements holistically. In such case, we suggest that, in addition to general recalibration downward to account for the overlap between the stress test and standardized operational risk elements, the operational risk elements in the stress test should be substantially amended in terms of how they are stressed. Operational risk in the stress tests constituted, over the last two stress tests, over one-quarter to over one-third of a firm's SCB based on the ratio of aggregate operational risk losses to total losses over the stress

[32] Former Vice Chair Quarles recognized this redundant penalty. *See* Randal K. Quarles, Vice Chair for Supervision, Federal Reserve Board, "Refining the Stress Capital Buffer" (Sept. 5, 2019) ("The second element of the SCB proposal that I believe should be removed is the requirement for banks to pre-fund the next four quarters of their planned dividend payments. The stress tests currently require banks to set aside sufficient capital today to 'pre-fund' expected capital distributions, both dividends and repurchases, for all nine quarters of the capital planning horizon. Removing the pre-funding of dividend requirement would simplify the SCB proposal. Additionally, the SCB already has a mechanism for curbing dividends and other distributions when a bank's capital ratio falls into the buffer. Requiring pre-funding of dividends is a needless redundancy. Even worse, the pre-funding of dividends could lead to a conflict with the mechanics of the SCB—the SCB could call for a restriction of dividend payments even when those payments had been pre-funded.").

horizon.[33] In a test that is focused on sensitivity to credit, market and counterparty risk, the operational risk element appears unbalanced and outsized, and will need to be modified materially to avoid compounding operational risk stresses across the stress test and any elements of the risk-weighted asset rules.

F. The Federal Reserve Board should amend Schedule A.7.a. of the FR Y-14 to include a footnote that allows firms to provide a detailed breakdown of specific revenues included in Line Item 24, similar to the footnote that exists for Line Item 37.[34]

We note that the Proposal would revise the FR Y-14A/Q/M reports to "refine the collection of information" to assess a firm's net income under stress.[35] We suggest one additional revision to the FR Y-14A in this vein. Firms report "Corporate/Other" income and "Other non-interest expense" on Line Items 24 and 37 on Schedule A.7.a., respectively. These reporting fields are aggregate amounts, but the "Other non-interest expense" line item also includes a footnote which allows firms to provide the Federal Reserve Board with a detailed breakdown of specific expenses included in Line Item 37. However, a comparable footnote does not exist in Schedule A.7.a. for "Corporate/Other" income on Line Item 24.

This is an issue for international banks' IHCs in particular because, unlike a U.S. standalone bank holding company, a large amount of the other non-interest income and other non-interest expenses reported by international banks in Line Items 24 and 37 comes from transfer pricing—i.e., reimbursed revenues and reimbursed expenses in affiliate relationships. For Line Item 37, the footnote allows firms to, for example, show the amount of other non-interest expenses that are reimbursed expenses to affiliates. The addition of a footnote to Line Item 24 comparable to the one that already exists for Line Item 37 would provide the Federal Reserve Board a more accurate picture of a bank's risk profile by providing additional information on certain low-risk revenue streams (e.g., reimbursement revenues flowing in from the foreign parent or revenues from risk mitigating activities such as mark to market of hedge instruments, interest rate swaps, etc.) that cannot be provided elsewhere in the Schedule A.7.a. The Federal Reserve Board can use this information to more accurately model PPNR and its various components, which will yield a more accurate and less volatile SCB and a more tailored approach to a firm's risk profile under the stress tests.

This one example also raises a broader consideration for the stress tests—one that we look forward to being addressed in both the finalization of the Proposal and future proposals to increase transparency in the stress test process. That consideration is a question about how the

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[33] In the 2024 stress test, aggregate operational risk losses were $193 billion, comprising 28.2% of total losses, which were $684 billion. *See* 2024 Stress Test. In the 2023 stress test, aggregate operational risk losses were $185 billion, comprising 34.2% of total losses, which were $541 billion. *See* Federal Reserve Board, *Dodd-Frank Act Stress Test 2023: Supervisory Stress Test Results June – 2023* (July 31, 2023), https://www.federalreserve.gov/publications/2023-june-dodd-frank-act-stress-test-results.htm.

[34] The Proposal notes that the proposed changes to the Forms FR Y-14A/Q/M "would better align the stress capital buffer requirements to firms' risk profiles" and a "firm's stress capital buffer should be aligned with the firm's risk profile." Proposal at 16847. Our recommendation in this section is consistent with better aligning the SCB elements with a firm's risk profile.

[35] Proposal at 16857.

Federal Reserve Board uses the granular data available to it to appropriately determine PPNR, CET1 and SCB under the stress test. We have repeatedly requested, in a variety of scenarios, that the Federal Reserve Board take into account the unique nature of IHCs as subsidiaries of a larger organization that is also comprehensively regulated and capitalized. We stress again that we believe that information of the sort we describe above should be leveraged to capture the unique qualities of foreign banking organizations and their IHCs, resulting in more tailored treatment of stresses based on the unique qualities of IHCs.

G. The Federal Reserve Board should maintain a phase-in for material supervisory model changes.

The Federal Reserve Board has proposed to remove the phase-in (over a two-year period) of material supervisory model changes, based on the theory that the proposed averaging of the SCB would have a similar result.[36]

We view model changes as an aspect of stress testing that should be subject to significantly more transparency, and we look forward to future proposals regarding how the Federal Reserve Board may disclose and effect model changes. In the meantime, some version of the current Stress Testing Policy Statement's phase-in should remain. In our view, material changes to an institution's SCB from a model tweak is not evidence of an asset portfolio that requires additional capital. Inputs of stress scenario data into the model should be the primary (and almost sole) driver of additional requirements, as that data reflects the actual economic effects on an institution. A model does not.

Regardless of any averaging finalized under the Proposal, there is still a need "to mitigate sudden and unexpected changes to the supervisory stress test results"[37] *caused by model changes* that are in the sole control of the Federal Reserve Board. These changes have little relevance to the actual riskiness of an institution's assets and exposures, and are imposed by the Federal Reserve Board by fiat. According to the Federal Reserve Board, a model change is "considered a highly material change if its use results in a change in the CET1 ratio of 50 basis points or more for one or more firms, relative to the model used in prior years' supervisory exercises."[38] We propose that a similar measure of "sudden and unexpected changes" continue to result in a phase-in—for example, the Federal Reserve Board could increase both the basis point change and the number of firms affected to include as a new material change phase-in trigger (such as a 100 basis point change for 3 or more firms).

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[36] Proposal at 16847-48.

[37] 12 C.F.R. Part 252, Appendix B, § 2.3(b).

[38] 12 C.F.R. Part 252, Appendix B, § 2.3(d).

We appreciate your consideration of our comments on the Proposal. If we can answer any questions or provide any further information, please contact me at 646-213-1147, bzorc@iib.org or Stephanie Webster, General Counsel at 646-213-1149, swebster@iib.org.

Very truly yours,

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