

A Proposed Terrorism-Financing and Sanctions-Risk Capital Buffer in the Banking Industry

as a response to the March 2026 U.S. Banking Agencies' Capital Reform Proposals

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Executive Summary

This paper proposes a targeted amendment to the March 2026 U.S. banking agencies' capital reform package, introducing an explicit Terrorism-Financing, Sanctions-Evasion and Illicit-Finance Risk Capital Buffer.

The proposal is a prudential safety-and-soundness measure, grounded in existing supervisory authority and fully consistent with Basel III principles, the legal authorities of the Federal Reserve, FDIC (Federal Deposit Insurance Corporation), and OCC (the Comptroller of the Currency); and the increasing recognition by international financial institutions that AML/CFT failures can threaten systemic stability.

We leave the specific regulatory design of the proposed buffer to the regulatory authorities' discretion, to be fully integrated with supervisory methodological approaches that are being considered these very days.

However, we do suggest that the Terrorism-Financing, Sanctions-Evasion and Illicit-Finance Risk Capital Buffer be generally designed in a tiered, at least two-layer architecture, that matches the level of analytical complexity to the scale of the institution and the materiality of the risk. The framework should be no more complex than necessary to achieve its deterrence and loss-absorption objectives and should impose no burden on institutions whose financial-integrity risk exposure is genuinely low.

The proposal does not seek to transform prudential capital regulation into a foreign-policy or sanctions-enforcement instrument. Rather, it recognizes that severe financial-integrity failures, including sanctions violations, terrorism-financing exposure, proliferation financing and systemic AML/CFT deficiencies - generate material operational, legal, liquidity, funding, contagion, and systemic risks that may not be adequately captured under current capital methodologies.

Our purpose is to ensure that potential financial-integrity failures in those areas are explicitly reflected in supervisory capital frameworks, proportionate to risk, transparent, and resistant to regulatory arbitrage.

The proposal is constructively engaged with the agencies' reform objectives. We do not contest that recalibrating capital requirements to better align with actual risk, reducing unnecessary compliance burden, and supporting productive financial intermediation are legitimate goals. Our concern is specific and bounded: the March 2026 capital NPRMs and the April 2026 FinCEN AML/CFT NPRM share common structural features that, in the particular domain of terrorism financing and sanctions evasion, may reduce deterrence, raise the practical threshold for supervisory intervention, and may also create arbitrage opportunities whose social costs substantially exceed any efficiency gains from burden reduction. A targeted capital buffer, explicitly calibrated to these risks, would help to bridge this gap without reversing the broader reform direction.

This proposed Terrorism-Financing and Sanctions-Risk Capital Buffer should not remain solely a domestic prudential initiative within the United States. Given the inherently cross-border nature of terrorism financing, sanctions-evasion networks, illicit trade finance, correspondent banking activity, offshore settlement structures, and alternative payment systems, the effectiveness of any enhanced prudential framework will depend

significantly on broader international adoption and supervisory convergence.

The broader strategic objective is therefore not merely a domestic US prudential enhancement, but the gradual development of an internationally harmonized prudential framework recognizing that severe terrorism-financing and sanctions-related failures constitute material operational and systemic risks capable of threatening global financial stability.

With all, we do expect that adopting this proposal will decrease legitimacy of conducting financial activities which might be linked to terror related entities, countries supporting terrorism and sanctioned entities in general. It will also directly cause financial institutions to increase required returns on activities should they be exposed to such risks, possibly to a level that will reduce feasibility of such activities from the beginning.

Defining regulatory capital charges in this context will increase deterrence not only due to possible fines and reputational risks but also due to pure financial considerations of profitability and business worthwhileness due to the mandatory capital charges.

Internal control processes which are taking place to ensure capital adequacy will also have to cover risk mapping and risk assessments in the context of possible integrity risks to fully comply with the regulatory definition of the Terrorism-Financing and Sanctions-Risk Capital Buffer.

Together, those expected implications provide an excellent example to how financial regulatory requirements could also be leveraged to support the general effort to counter terrorism financing and sanctions evasion.

This paper discusses capital adequacy requirements and capital charges in the banking industry as a buffer to absorb terror and sanctions related risks. Future discussions might consider also the applying of similar amendments to regulatory liquidity requirements, limiting the liquidity

quality scores of relevant financial assets which are substantially exposed to these risks, for the regulatory calculation of liquidity coverage ratios.

As stated in my opening remarks, this specific proposal does not seek to transform prudential capital regulation into a foreign policy or sanctions-enforcement instrument. Notwithstanding, it can be taken as an excellent case study for the possible wide leveraging of financial regulatory requirements in general, to support not only the strategic warfare against terror related activities, but also a wide range of other internationally agreed upon policy goals.

1. Background and Context

1.1 The March 2026 Capital Reform Package

In March 2026, the Federal Reserve, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation jointly proposed significant revisions to the U.S. regulatory capital framework. The package includes revised risk-based capital treatment for large banks, recalibrated market-risk and operational-risk requirements, revised G-SIB (Global Systemically Important Bank Surcharge) methodology, and a reduction in the Community Bank Leverage Ratio.

In the specific area of terrorism financing and sanctions evasion, the March 2026 capital NPRMs may weaken deterrence by lowering aggregate capital requirements, replacing institution-specific operational-risk modeling with standardized business-volume proxies and recalibrating systemic surcharges. These changes may improve efficiency and comparability, but they also risk underpricing severe financial-integrity exposures that generate legal, operational, liquidity, reputation, and systemic costs.

The proposals have not yet been finalized and remain subject to notice-and-comment rulemaking. It still requires comment review, interagency finalization, and publication of final rules. Comments were reported due around June 2026.

The agencies' rationale reflects a coherent position that prior regulatory structure and proposals overstated risk in certain categories, constrained productive lending and Treasury-market intermediation, and imposed compliance costs and complexities that were not commensurate with the systemic benefits generated. These are defensible positions. Capital calibration is not a one-directional exercise, and it is legitimate to argue that capital requirements should reflect actual risk rather than serve as a blunt precautionary instrument regardless of underlying exposure.

For this discussion, we accept this framework and do not argue for its reversal. Our argument in this paper is narrower: We argue that within this framework, one category of risk — the operational, legal, reputational, liquidity, and systemic risks arising from severe financial-integrity failures related to terrorism financing, sanctions evasion, and related illicit-finance activity — has not received explicit treatment in the capital reform proposals, and that this omission creates a prudential gap whose consequences may be material and whose correction is fully consistent with the reform's own risk-sensitivity objectives.

1.2 April 2026 FinCEN AML/CFT NPRM and Its Structural Parallel

The proposed amendment addresses two parallel regulatory shifts. The April 2026 FinCEN Notice of Proposed Rulemaking (Docket No. FINCEN-2026-0034) proposes to revise the Bank Secrecy Act's AML/CFT program requirements, explicitly reorienting them toward an 'effectiveness' standard and away from prescriptive rule adherence. FinCEN frames this as directing institutions to focus resources on higher-risk areas rather than low-value technical compliance.

The structural parallel with the capital proposals is direct and consequential. Both reforms share four features: a shift from prescriptive compliance (FinCEN's proposal) or highly complicated modeling (Regulatory Capital) to actual risk-based supervisory judgment; an explicit burden-reduction objective; a raised threshold for supervisory intervention (focused on 'significant or systematic' failures in the FinCEN NPRM; reduced ex ante buffers in the capital proposals); and an increased reliance on institutions' own risk assessment and calculations rather than uniform regulatory expectations.

Each feature is defensible in isolation. Their combination, applied simultaneously across both AML/CFT program requirements and capital adequacy, may create a compounding effect whose implications for financial-integrity risk have not been explicitly addressed in the regulatory capital framework.

Reducing both the AML/CFT program requirements and the capital cushion that would absorb losses from financial-integrity failures, creates a compounding prudential vulnerability. A targeted capital buffer addresses this gap without reversing either reform.

2. Financial-Integrity Failures as a Prudential Concern and Capital-Relevant Events

2.1 The Risk Taxonomy

The case for a capital buffer addressing terrorism-financing and sanctions-related exposure rests on a straightforward prudential proposition: severe financial-integrity failures generate quantifiable, material losses across multiple risk categories recognized in the Basel III framework. These are operational, legal, credit, liquidity, and — in sufficiently severe cases — systemic risk events whose financial consequences can exceed those of

many credit or market shocks that are explicitly reflected in capital requirements.

The risk categories activated by severe financial-integrity failures include: operational losses from regulatory enforcement actions, internal remediation and system overhaul; legal losses from fines, settlements, credit losses from the blocking or impairment of assets associated with designated counterparties; liquidity and funding losses from withdrawal of correspondent banking relationships, investor redemptions, and deposit outflows triggered by reputational damage; and — in the most severe cases — systemic contagion risk from the failure or severe distress of an institution with significant market share in payment intermediation or correspondent banking.

2.2 Current Regulatory Gap

Despite the materiality of these risk categories, the current U.S. capital framework — and the March 2026 proposals — do not include an explicit capital requirement calibrated to a bank's financial-integrity risk exposure. Operational risk capital under the Standardized Measurement Approach captures historical loss experience but is backward-looking and does not capture prospective exposure at institutions whose financial-integrity risk profile has changed materially through new business, new correspondent relationships, or new geographic exposure.

The March 2026 U.S. proposal moves toward a standardized business-volume-based operational-risk measure, rather than a tailored financial-integrity risk measure. The proposal says internal models for credit and operational risk may be more accurate in some cases, but the agencies cite data limitations and subjective modeling assumptions as reasons for moving away from them.

Pillar 2 supervisory add-ons can in principle address any risk not captured in Pillar 1, but we guess that so far, in practice, their application to financial-integrity risk appears to have been rare.

The March 2026 proposals, while recalibrating operational risk capital in several respects, do not introduce any new mechanism for capturing financial-integrity risk prospectively. In the context of the simultaneous FinCEN NPRM — which reduces the prescriptive AML/CFT requirements that have historically provided a first line of deterrence — this gap might be prudentially significant. FinCEN frames this as reform toward “effective, risk-based, and reasonably designed” programs; it also raises the threshold for certain actions based solely on bank implementation deficiencies to “significant or systemic failures.” It means that institutions with elevated financial-integrity risk exposure may, under the combined post-reform framework, face lower capital requirements and lower AML/CFT obligations simultaneously: a combination that reduces both the preventive and the absorptive dimensions of financial-integrity risk management.

The revised 2026 capital proposals replace internal operational-risk modeling approaches with more standardized methodologies, what may also weaken sensitivity to institution-specific illicit-finance exposures.

Large financial integrity events often involve low-frequency; high-severity; and tail-risk scenarios. Such risks may not be adequately reflected through standardized operational-risk metrics.

It should be said that this gap does not reflect a deviation from the Basel regulatory framework. Basel III recognizes operational risk; legal risk; internal process failures; and fraud-related losses. However, Basel III does not explicitly address terrorism-financing exposure; sanctions-evasion exposure; proliferation-financing exposure; or severe financial-integrity concentration risk.

This concern is particularly significant given: increasing geopolitical fragmentation; growth of sanctions-evasion networks; rising use of alternative payment systems; stablecoin-related illicit-finance risks; and the increasing sophistication of transnational illicit-finance structures.

3. International Regulatory Coordination and the Need for Global Prudential Convergence

Financial-integrity risks are uniquely transnational. Modern sanctions-evasion and terrorism-financing structures routinely exploit regulatory fragmentation; differences in supervisory intensity; inconsistent implementation of AML/CFT obligations; and disparities in prudential calibration across jurisdictions.

Accordingly, a purely domestic capital response may create incentives for regulatory arbitrage; migration of high-risk activity toward less restrictive jurisdictions; relocation of high-risk correspondent relationships; and concentration of illicit-finance exposure within institutions operating under weaker prudential standards.

For this reason, the United States should not only incorporate the proposed *Terrorism-Financing and Sanctions-Risk Capital Buffer* into its domestic capital framework, but should also actively seek the internationalization of the underlying prudential principles through:

- the Basel Committee on Banking Supervision;
- the Financial Stability Board;
- FATF-related supervisory processes;
- and bilateral and multilateral supervisory engagement with European and Asian regulators.

Those principles should explicitly encourage the recognition of terrorism-financing and sanctions-evasion exposure as prudentially material operational-risk factors that require an adequate capital buffer allocation to address this unique risk, also under the capital adequacy rules.

4. U.S Regulatory and Market Leverage for Supervisory Convergence

The United States possesses substantial regulatory and market leverage capable of influencing international supervisory convergence:

4.1. Correspondent Banking Dependence

Many non-U.S. financial institutions remain structurally dependent on access to U.S. dollar clearing; correspondent banking relationships with U.S. institutions; and participation in U.S.-linked financial infrastructure.

U.S. regulators therefore possess substantial indirect influence over foreign prudential practices through supervisory expectations imposed on U.S. banking organizations and their correspondent relationships.

4.2. Supervisory Expectations for Cross-Border Banking Groups

To create strong incentives for internationally active banks to adopt harmonized internal standards globally, U.S. regulators may incorporate financial-integrity capital expectations into supervisory examinations; stress-testing methodologies; and expectations regarding foreign banking organizations operating within the United States.

4.3 Basel Committee Influence

The United States remains one of the most influential jurisdictions within the Basel Committee framework and U.S. regulators may significantly shape future Basel standards and supervisory expectations in this field.

Specifically, U.S regulators have the power to formally propose and advance recognition of severe financial-integrity exposure within operational-risk and Pillar 2 methodologies; and promote supervisory guidance through Basel working groups; and integrating such principles into supervisory dialogue.

4.4 FATF Mutual Evaluation and Financial Integrity Frameworks

The United States may further advocate integration of prudential-capital considerations into FATF-related supervisory assessments and financial-stability discussions.

Such integration would reinforce the growing recognition that severe AML/CFT failures are not merely compliance events, but potential threats to safety and soundness; market confidence; correspondent banking stability; and systemic resilience.

4.5 Market Discipline

International banking organizations operating in global capital markets may increasingly face investor expectations; counterparty risk assessments; and other market discipline mechanisms that favor institutions demonstrating stronger prudential treatment of sanctions, terrorism-financing, and illicit-finance risks.

5. Legal and Prudential Justification

5.1 Existing Supervisory Authority

The proposed *Terrorism-Financing and Sanctions-Risk Capital Buffer* does not require new legislative authority. The three agencies possess existing legal authority to impose institution-specific and system-wide capital requirements that address risks not fully captured in Pillar 1 requirements. Section 165 of the Dodd-Frank Act, the federal banking agencies' safety-and-soundness authority under the Federal Deposit Insurance Act, and the Basel III Pillar 2 supervisory framework provide substantial prudential foundations for supervisory capital add-ons addressing material financial-integrity risks. Section 908 of the International Financial Institutions Act further reflects longstanding U.S. policy support for strengthening AML/CFT and financial-integrity standards in international financial governance.

5.2 Consistency with Basel III

The *Terrorism-Financing and Sanctions-Risk Capital Buffer* is fully consistent with the Basel III framework. Basel III's Pillar 2 explicitly contemplates supervisory add-ons for risks not fully captured in Pillar 1, including reputational risk, strategic risk, and other risks specific to an institution's business model. The Basel Committee's guidance on operational risk explicitly recognizes legal risk - which encompasses regulatory enforcement risk - as a component of operational risk, and its stress-testing guidance explicitly supports the use of institution-specific scenarios to capture tail risks not modelled in standardized scenarios.

5.3 Proportionality and the Deregulatory Context

We address directly the possible concern that the *Terrorism-Financing and Sanctions-Risk Capital Buffer* will contradict the agencies stated goal of reducing regulatory burden. It will not — for two reasons:

5.3.1 First, it is genuinely proportionate: for institutions with no significant financial-integrity risk exposure, the Layer 1 floor will produce zero or negligible additional capital requirements, and the Layer 2 add-on will not be triggered. Most community banks and regional banks with limited high-risk-jurisdiction exposure will be entirely unaffected.

The burden falls on precisely those institutions where the risk is genuinely elevated.

5.3.2 Second, the cost-benefit balance is strongly favorable. The compliance and capital cost of the buffer - concentrated at large, complex institutions with significant financial-integrity risk exposure - is modest relative to the social cost of the financial-integrity failures it is designed to deter and absorb. The documented costs of major AML/CFT and sanctions enforcement actions - fines, remediation, reputational damage, and systemic disruption - might run to billions of dollars per institution.

A capital buffer that carries a fraction of this expected cost and creates a standing incentive to reduce financial-integrity risk exposure, produces benefits that substantially exceed its costs. This is the efficient regulatory design that the agencies' risk-sensitivity objectives call for.

6. The specific design and amendments

This paper leaves the specific regulatory design of the proposed buffer to the regulatory authorities' discretion, to be fully integrated with supervisory methodological approaches that are being considered these very days.

Still, we do suggest that the *Terrorism-Financing, Sanctions-Evasion and Illicit-Finance Risk Capital Buffer* be generally designed in a tiered, at least two-layer architecture, that matches the level of analytical complexity to the scale of the institution and the materiality of the risk.

The framework should be no more complex than necessary to achieve its deterrence and loss-absorption objectives and should impose no capital burden on institutions whose financial-integrity risk exposure is genuinely low.

Layer 1 — The Standardized Exposure-Based Floor

The standardized floor will be applied to all categories of banking organizations and calculated from specific, pre-defined exposure metrics, each assigned a defined weight in the capital calculation.

For most institutions with limited financial-integrity risk exposure, Layer 1 calculation will produce zero or a negligible add-on, imposing no material burden. The structure will be intentionally designed so that institutions can reduce their Layer 1 requirement through genuine risk reduction and avoiding enforcement actions — divesting high-risk correspondent relationships, improving compliance systems etc.

For example, the exposure Metrics for conducting Layer 1 calculation may include, inter alia, factors of the following kind:

Exposure metric	Measurement
High-risk-jurisdiction correspondent exposure	Aggregate net due-to and due-from balances with correspondent banks in FATF-identified high-risk or monitored jurisdictions
Repeat enforcement history	Number of formal AML/CFT, OFAC, or financial-integrity enforcement actions within preceding x years
OFAC-adjacent counterparty exposure	Aggregate credit exposure (loans, securities, derivatives) to counterparties subsequently designated by OFAC within y years
Trade-finance opaque-shipping volume	Aggregate trade finance exposure involving maritime transportation, possible direct or indirect finance links to vessels with documented AIS manipulation, flag-of-convenience anomalies, or ship-to-ship (STS) transfers in high-risk zones (utilizing Maritime intelligence sources; OFAC maritime advisories; internal trade finance screening records etc.).
The capital add-on formula for each factor, to be determined by regulators	

Layer 2 — The Pillar 2 Supervisory Add-On

The Layer 2 add-on will be imposed through the supervisory review process, using a structured factor scoring framework that will be designed to ensure consistency across examination teams while preserving the flexibility that is the primary advantage of the Pillar 2 approach.

Each factor will be assessed, for example on a four-point scale (0 = no concern; 1 = minor concern; 2 = material concern; 3 = severe concern), and the weighted total score will be mapped to a capital add-on range, **determined by regulators.**

For example, the structured factor scoring framework will include the following factors, which will be assessed by examiners, scored and weighted in the final supervisory score and then, mapped to a capital add-on range (as demonstrated below).

Assessment factor	What examiners assess
AML/CFT program effectiveness	Quality and effectiveness of the institution's AML/CFT program: transaction monitoring, customer due diligence, beneficial ownership verification, SAR quality
OFAC sanctions compliance program	Adequacy of sanctions screening, designated country exposure management, nested correspondent controls, watchlist screening frequency and coverage
Correspondent banking risk management	Due diligence on correspondent relationships in high-risk jurisdictions; implementation of correspondent guidances; de-risking vs. managed engagement approach
Enforcement and regulatory history	Pattern of prior enforcement actions; quality of remediation following prior actions; recidivism indicators; deferred prosecution agreement compliance
Trade finance and shipping exposure	Exposure to opaque shipping practices, multi-jurisdictional commodity trade, documentation fraud indicators, and sanctioned-jurisdiction trade routes
Digital assets and alternative payment systems	Exposure to cryptocurrency, stablecoin, or alternative payment flows with inadequate sanctions and AML screening
Governance and management quality	Board and senior management engagement with financial-integrity risk; adequacy of resources

Example: Score-to-Add-On Mapping and possible supervisory position — Layer 2
(assuming max. add-on 150 bps)

Weighted total score	Supervisory assessment	Layer 2 add-on range	Possible Supervisory disposition
0.0 – 0.4	Low financial-integrity risk	0 bps	No Layer 2 add-on. Standard monitoring. Layer 1 floor applies if exposure metrics triggered.
0.5 – 0.9	Moderate financial-integrity risk	0 – 25 bps	Supervisory notification of findings. Institution expected to address identified gaps within 12 months. Capital add-on at examiner discretion within range.
1.0 – 1.4	Elevated financial-integrity risk	25 – 75 bps	Formal supervisory process. Remediation plan required within 90 days. Capital add-on imposed within range. Annual reassessment.
1.5 – 1.9	High financial-integrity risk	75 – 125 bps	Supervisory letter or memorandum of understanding. Quarterly reporting. Capital add-on imposed within range. Enhanced examination frequency.
2.0 – 3.0	Severe financial-integrity risk	125 – 150 bps	Formal enforcement action considered. Maximum Layer 2 add-on. Board-level engagement required. Potential business activity restrictions in high-risk areas.

Layer 3 — The Stress Scenario Overlay – For Future Consideration Only

For Category I and II institutions subject to DFAST (Dodd Frank Act Stress Test) and CCAR (Comprehensive Capital Analysis and Review), an additional stress scenario — *the Financial Integrity Severe Stress Scenario*— could be run to model financial-integrity failure events that, while individually manageable, create compounding capital pressure when

they occur simultaneously or in rapid sequence.

Applying this layer might be considered as not consistent with the current effort to simplify capital calculations and charges and we would recommend considering it only after a test period when the adequacy of this new capital buffer could be judged.

If applied, the capital shortfall generated by running the institution's balance sheet through the stress scenario — the additional capital needed to absorb the scenario losses without falling below minimum requirements — would be compared to the combined Layer 1 and Layer 2 buffer. If the generated shortfall exceeds the combined buffer, the excess will be added as a Layer 3 supplement. For most institutions with well-managed financial-integrity risk, the *Financial Integrity Severe Stress Scenario* shortfall will be less than the combined buffer and no Layer 3 supplement will be required anyway.

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Joint Press Release

March 19, 2026

Agencies request comments on proposals to modernize the regulatory capital framework and maintain the strength of the banking system

https://www.federalreserve.gov/newsevents/pressreleases/bcreg20260319a.htm?utm_source=chatgpt.com

News Release 2026-17|March 19, 2026

Comptroller Gould Statement on Notice of Proposed Rulemakings to Modernize Regulatory Capital Framework

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