

**RULES WITHOUT ANALYSIS:
FEDERAL BANKING PROPOSALS UNDER
THE BIDEN ADMINISTRATION**

HEARING
BEFORE THE
SUBCOMMITTEE ON FINANCIAL
INSTITUTIONS AND MONETARY POLICY
OF THE
COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES
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Wednesday, January 31, 2024

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**RULES WITHOUT ANALYSIS:
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THE BIDEN ADMINISTRATION**

Wednesday, January 31, 2024

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS
AND MONETARY POLICY,
COMMITTEE ON FINANCIAL SERVICES,
Washington, DC.

The subcommittee met, pursuant to notice, at 10 a.m. in room 2128, Rayburn Office Building, Hon. Andy Barr [Chairman of the Subcommittee] presiding.

Present: Representatives Barr, Posey, Luetkemeyer, Williams of Texas, Loudermilk, Rose, Timmons, Norman, Fitzgerald, Kim, Donalds, De La Cruz, Ogles, Foster, Waters, Sherman, Meeks, Scott, Green, Beatty, and Casten.

Chairman BARR. The committee will come to order. Without objection, the Chair is authorized to declare a recess of the committee at any time.

This hearing is titled “Rules Without Analysis: Federal Banking Proposals Under the Biden Administration.” Without objection, all members will have 5 legislative days within which to submit extraneous materials to the Chair for inclusion in the record.

I now recognize myself for 5 minutes to give an opening statement.

**OPENING STATEMENT OF HON. ANDY BARR, CHAIRMAN OF
THE SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND
MONETARY POLICY, A U.S. REPRESENTATIVE FROM KEN-
TUCKY**

An onslaught of significant regulatory proposals has been put forward, driven by Democrat-appointed regulatory officials who have unfortunately injected politics into what used to be an independent rulemaking process. Although Congress has repeatedly asked, we have not seen any analysis of why the existing bank-capital framework needs to be overhauled or how the numerous regulatory proposals over the past year will work together, or not. Rules without analysis lead to bad policy outcomes and invite mistakes that will later be called “unintended consequences.”

The failure to properly analyze proposed rules and follow administrative procedures represents an abdication of responsibility on the part of those who have made numerous significant, but under-analyzed, new regulatory proposals.

The most glaring example of this flawed approach to regulation is the major, significant, unmotivated, and under-analyzed Basel III Endgame. This proposal involves trillions of dollars in resource allocations and will increase regulatory costs for about \$22 trillion in assets, or 80 percent of all U.S. banking assets.

Despite this substantial impact, the needed analysis seems to be an afterthought and far too many elements of the proposal are arbitrary and capricious.

Only recently have Federal bank regulators gathered data that they should have been obtaining before they proposed the rule. Only very recently have Congress and the American people been told that the regulators will do a quantitative impact study, which may be available after the Basel III Endgame proposal's comment period has ended. Whether comments will be accepted and, if so, the timing of the comment period on this quantitative impact study has not been made clear.

Members of Congress from both chambers and both sides of the aisle have expressed significant concerns about effects of the Basel III Endgame proposal, reflecting the lack of analysis that has been performed to this very day.

Comments on the Basel III Endgame submitted by a wide range of interests and from across the ideological spectrum also have expressed far-reaching and widespread concerns. Most comments express the same concerns we have heard in our committee, and in this subcommittee, since the proposal was first put forward.

The banking system is well capitalized and resilient in stress tests, leading to the question of why Democrat-appointed regulators want to massively ramp up capital requirements and go far beyond what Basel recommends, and our competitors are adopting.

The proposal has virtually nothing to do with the March 2023 banking turmoil, even though Democrat-appointed regulators have unsuccessfully tried to use the March turmoil to justify massive changes to the already gold-plated U.S. capital framework.

The Basel III Endgame proposal will reduce credit availability and increase costs for consumers, homebuyers, businesses large and small, manufacturers, municipalities, farmers and ranchers, and more. The proposal will make U.S. institutions less competitive globally and will chase activities outside of the regulatory perimeter for banks, posing threats to financial stability, the functioning of capital markets, and the abilities to hedge risks.

The bottom line is that the Basel III Endgame proposal contains fatal flaws across the board, and we know nothing about how it would "holistically" interact with the numerous other significant recent and prospective regulatory proposals. Those proposals include, but are not limited to, Long-Term Debt requirements, the Community Reinvestment Act, resolution planning requirements, debit card interchange, or Regulation II, and whatever may be forthcoming regarding liquidity requirements and stress testing.

My message to the boards at the Federal Reserve (Fed) and the Federal Deposit Insurance Corporation (FDIC) is that merely "re-calibrating" treatments of mortgages and green-energy tax credits in the proposal and reducing the punitive and unjustified operational risk penalties in the proposal will not resolve our concerns or fix the remaining significant problem areas in the proposal.

There are far too many other fatal flaws that need to be addressed, including treatments of market risk, exposures to companies with public listings versus non-public listing, abandonment of internal models, effective repeal-by-regulation of the tailoring law, and the interplay with stress tests.

The Federal banking regulators should scrap their faulty Basel III Endgame proposal and reevaluate what, if anything, may need to be done. At most, the regulators need to start over, undertake proper analysis, follow proper administrative procedures, and re-propose a significantly different rule.

As things stand for the onslaught of regulatory proposals, the regulators must provide proper quantitative analysis, follow the Administrative Procedure Act, and stop using our regulatory system to push a political agenda. After all, these agencies are meant to be independent, and if they continue to act in a way that threatens this, Congress will act.

Our regulators can and must start over and do better. There is too much at stake.

The Chair now recognizes the Ranking Member of the Subcommittee on Financial Institutions and Monetary Policy, the gentleman from Illinois, Dr. Foster, for 4 minutes for an opening statement.

OPENING STATEMENT OF HON. BILL FOSTER, RANKING MEMBER OF THE SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND MONETARY POLICY, A U.S. REPRESENTATIVE FROM ILLINOIS

Mr. FOSTER. Thank you, Chairman Barr, and thank you to our witnesses for being here today.

Recent proposals from Federal banking regulators on the Basel III Endgame, long-term debt, and the Global Systemically Important Bank (GSIB) surcharge, aim to bolster the safety and soundness of our banking system by ensuring that U.S. banks properly manage and internalize the risks they take on. When I first joined Congress in March 2008, we were on the edge of a financial crisis. Excessive leverage and risk-taking by large U.S. banks and non-banks put the global economy on the brink of collapse, and the result of this crisis was a Federal bailout, a debt the MIT Sloan School estimated ultimately cost U.S. taxpayers nearly half a trillion dollars.

While significant steps have been taken since 2008, including the passage of the Dodd-Frank Act and the implementation of new capital rules, the financial landscape is constantly changing. Rapidly developing financial technologies, growing geopolitical tensions, and climate change present new risks, and we must be vigilant.

Today's conversation will focus on the calibration of new regulations proposed by prudential regulators. Simply put, there are costs and there are benefits associated with raising the capital requirements on large banks. Well-capitalized banks are better able to weather stress and continue lending during an economic downturn without putting taxpayers at risk of funding another bailout.

On the other hand, higher capital requirements can increase the cost of capital for these large banks, which will, to some extent, in-

crease the cost of loans and potentially create economic incentives, whose impacts may be difficult to predict.

In this whole discussion there is a part of it that you can calculate and a part of it that you can probably not calculate. For example, Vice Chair Barr has opined that the cost of capital for the large banks will be increased by about three basis points, 0.03 percent. Others have estimates that may be two times higher, but it is a small fraction of a percent and so, that is the part you can calculate.

The part that is difficult to calculate is how that will trickle through the rest of the economy, what fraction of that increase in the cost of capital will simply result in a transferring of business out away from large banks to smaller banks or to non-banks, and what the implications of the systemic risk to our banking system will be of that sort of transfer. Banks will try to optimize their capital deployment in a different way as we change these rules, and so they will move their business from one area to another. This is the part that is difficult to calculate and was hopefully captured in the data that is being collected by the regulators as they look at the final update of this rule.

I remember during the lead-up to Dodd-Frank, as we were writing it, the banking sector argued that all these new requirements would make the U.S. banks unprofitable and uncompetitive in comparison to other banks, and we have heard that effectively the capital levels have been higher for U.S. large banks than they have for European and other competitors. However, since then, U.S. banks have continued to earn record profits and increase their market share around the world; so, I would be interested in the witnesses' take on why on all of these previous crying wolf on high capital requirements has, from a sort of empirical sense, proven so wrong.

For me the key issue is not the straightforward effect, but it is the knockout effects, and those are difficult to predict. I have become a great believer in unintended consequences of regulation, and so this is the area that I have been mainly focusing on, trying to understand how banks will change their business in response to these changes in capital requirements, and that is what I will continue to be focusing my attention on there.

And I yield back.

Chairman BARR. Thank you. The gentleman yields back.

Today we welcome the testimony of Mr. Greg Baer. Mr. Baer is the President and CEO of the Bank Policy Institute; Mr. Bryan Bashur. Mr. Bashur is the Director of Financial Policy for the Americans for Tax Reform; Mr. Randall Guynn. Mr. Guynn is the Chair of Financial Institutions at Davis Polk; and Professor Jeremy Kress. Mr. Kress is Assistant Professor of Business Law at the Stephen M. Ross School of Business at the University of Michigan. Congratulations on the national championship.

We thank each of you for taking the time to be here. Each of you will be recognized for 5 minutes to give an oral presentation of your testimony. Without objection, each of your written statements will be made part of the record.

Mr. Baer, you are now recognized for 5 minutes for your oral remarks.

**STATEMENT OF GREG BAER, PRESIDENT AND CHIEF
EXECUTIVE OFFICER, BANK POLICY INSTITUTE**

Mr. BAER. Thanks. Chairman Barr, Ranking Member Foster, and members of the subcommittee, thanks for the chance to be here today.

If adopted, the capital rule proposed by the Federal banking agencies would have a profound effect on the cost of credit for nearly every American business and consumer as well as on the resilience of U.S. capital markets. Given those stakes, the proposal is remarkable for its lack of analytical rigor and subversion of the use of relevant data. In almost every case, the proposed risk weight for a given asset is based on no historical experience, even where voluminous data is available. In most cases the proposal simply adopts the risk weights negotiated by agency staff in Basel over 6 years ago and then adds arbitrary surcharges. Finally, the proposal fails completely to acknowledge that in the United States, and the United States alone, a stress capital charge for most of the same risks is already imposed by the Fed.

These failings violate both the procedural and substantive requirements of administrative law.

For credit risk the agency has proposed to eliminate the advanced approach that employs more granular and adaptable bank models, even though retention of those models was the core of the 2017 agreement, and they have, by all accounts, produced accurate results for well over a decade, overseen by these same agencies. Then proposal adds a massive new charge for operational risk, which is estimated would add up to a capital requirement that is 3.5 times larger than the largest losses experienced by U.S. banks in any year since 2003.

By our estimate, the total capital increase would be significantly more than the 16 percent estimated by the agencies. For the largest, most diversified banks it would be around 30 percent. The increase for market risk would be an astonishing 75 percent.

As a bottom line, the proposal effectively finds that U.S. banks are currently critically undercapitalized, something that no one in the real world believes for a single moment.

Some examples are telling. For business loans, documented historical experience suggests that a risk weight of 41 percent would be sufficient, 30 percent for loans rated investment grades. Instead, the proposal establishes a requirement of 100 percent, and 65 percent only for firms rated investment grade and that have listed securities—so two to three times what the data suggests is necessary, and without explanation.

With regard to market risks, the proposal ignores completely its overlap with the Federal stress test, which covers the same risks for the same reasons. Again, there is nothing about the real-world performance of U.S. banks to suggest that their trading operations are critically undercapitalized, and the proposed rule actually makes no attempt to do so.

Of course, in combination with a variety of other pending rules the Basel proposal would effectively repeal the tailoring law passed by Congress.

Now some who have no desire to engage with the details of the proposal have argued that it is good because it simply means high-

er capital, and higher capital is always good because well-capitalized banks lend more in crisis than undercapitalized banks. Of course, they do, but they also do not reenter businesses that they abandoned years earlier because of high capital requirements. Furthermore, what the research actually shows is that they lend more only if their high capital exceeds regulatory minimums, so that they feel free to draw down on that capital. If the minimums rise, as they sure would here, that will not happen.

By the same token, sport utility vehicles (SUVs) with 50 airbags are safer in a crash than those with 4, so why not mandate 50? Because such cars would be very expensive, fuel-efficient, and no one would build them ex-ante.

The real question is whether large U.S. banks are already sufficiently well capitalized to continue lending under stress. We know they are, as demonstrated by consistent post-crisis experience, including the pandemic and Silicon Valley Bank (SVB), and through performance under the Fed stress test, which has that as its explicit purpose.

To minimize the effect of the proposal, as the ranking member notes, the Fed's vice chair has argued that the proposal would, on average, raise the cost of loans by only three basis points. As our economists, I think, first documented, and it is now not disputed, that estimate omitted over \$1 trillion in operational risk-weighted assets that at least a majority of which are attributable to lending. More importantly, that 3 basis points is only an average. For some assets, for example commercial real estate lending to large, listed companies, the number would actually go down. For others it would go up. We estimate for credit cards the number is 50 basis points, or \$250 per year in interest on a \$5,000 balance. Of course, banks will shift their business away from the assets that receive the higher risk weights.

I should note all of this is occurring in a world where many U.S. banks are trading at or below tangible book value, despite earning profits, but markets do not look at profits. They look at return on equity, where banks are at historical lows in the United States, and where their performance has tailed just about every industry.

In light of all that, we urge the agencies to withdraw the proposal, draft a new one, show their work, and seek public comment.

[Prepared statement of Mr. Baer follows:]

House Financial Services Committee
Subcommittee on Financial Institutions and Monetary Policy
Rules Without Analysis: Federal Banking Proposals Under the Biden Administration
Testimony of Greg Baer, President and CEO, Bank Policy Institute
January 31, 2024

Chairman Barr, Ranking Member Foster, and members of the Subcommittee, thank you for the invitation to testify today. My name is Greg Baer, and I am the CEO of the Bank Policy Institute, which is a research and advocacy group supported by banks with more than \$100 billion in U.S. assets. As our membership comprises the full range of banks covered by the recent capital proposal, I welcome the opportunity to testify today.

Our comment letters to the banking agencies set forth our concerns and suggestions for improvement in considerable detail.¹ Today, I will attempt to summarize them.

Overview

If adopted, the capital rule proposed by the federal banking agencies would have a profound effect on the availability and cost of credit for nearly every American business and consumer, as well as on the resiliency of U.S. capital markets. The U.S. economy would suffer a significant, permanent reduction in GDP and employment; U.S. capital markets would become less liquid and therefore more dependent on non-bank intermediation in normal times and on governmental support when those non-banks step away during times of stress. Given the stakes involved, the proposal is remarkable for its lack of analytical rigor, its hostility to the use of relevant data as opposed to pre-formed opinions, and its failure to consider both its costs and benefits, not just to banks but to all corners of the U.S. economy.

At a macro level, the proposal contains no standard by which to determine what an appropriate risk weight should be for the risks it proposes to capitalize, and therefore makes it impossible to determine whether a proposed risk weight is too high or too low or whether the costs of higher capital outweigh the benefits. This marks a departure from prior practice.

At a micro level, in almost every case the proposed risk weight for a given asset is based on no identified data or historical experience and no economic analysis. In most cases, the proposal simply takes as given the risk weights negotiated by agency staff in Basel in 2017 and 2019, which, in turn, are lacking in data or analysis, or at least any that has been made public. Also, in many cases, the agencies not only take Basel risk weights as a baseline for the proposal, but also add arbitrary surcharges on top of the Basel weights, again with very little explanation. Finally, the proposal fails completely to acknowledge that in the United States, and in the United States alone, a stress capital charge for most of the same risks is already imposed by the Federal Reserve through its stress testing process.

¹ Comment Letter from the Bank Policy Institute and American Bankers Association (Jan. 16, 2024), available at <https://bpi.com/wp-content/uploads/2024/01/ABA-BPI-Basel-III-Endgame-Comment-Letter-Final-2024.01.16.pdf> [hereinafter *BPI/ABA Letter*]

The proposal ignores massive data on the performance of banks operating in the United States, which should have formed the basis for the proposal. The agencies propose to eliminate the Advanced Approaches to credit risk that employs more granular and adaptable bank models even though retention of those models was the core component of the 2017 Basel agreement they purport to be implementing and have by all account produced accurate results for well over a decade of use. Perhaps not coincidentally those results argue for a significantly lower capital charge than the agencies' proposed Standardized Approach.

The proposal then adds to the heightened risk weights for credit a massive charge for operational risk, which is not currently a component of the U.S. Standardized Approach.

In all these cases, respondents are denied any meaningful opportunity to provide comment: we do not know the standard used to calibrate the risk weights; the proposal generally provides no data or analysis to support the risk weights chosen; and the proposal fails to acknowledge any overlap with existing rules, much less seek comment on how that overlap should be reconciled.

If finalized, the principal consequence of the proposal would be a significant increase in the overall capital requirements of large banks in the United States – and only the United States. By the agencies' own initial estimate, the proposal would require 16 percent more capital. Even those numbers are clearly understated. While we await a revised impact analysis from the agencies based on an after-the-fact data collection, a private sector analysis of the effect of the proposal on GSIBs has shown that the Basel proposal when combined with a GSIB proposal would increase their capital requirements by 30 percent² – about 50 percent higher than the agencies' estimate. The agencies have also estimated that the proposal would increase market risk risk-weighted assets by an astonishing 75 percent.³

And as a bottom line, the proposal effectively finds that large U.S. banks are currently critically undercapitalized – something no one in the real world believes for a moment.

The proposed rule fails as a matter of both administrative law and policy. It is based on no articulated standard and provides no evidence to support its requirements, and those requirements are inconsistent with all evidence that we and other commenters can identify on our

² See Comment Letter from the Financial Services Forum, American Bankers Association, Bank Policy Institute and Securities Industry and Financial Markets Association (Dec. 22, 2023), *available at* <https://www.sifma.org/wp-content/uploads/2023/12/Associations-Letter-re-B3E-Impact-on-U.S.-GSIBs.pdf>.

³ Even this estimate may be significantly understated. Whereas the agencies estimated an overall increase in market risk RWAs for Category I and II banks (which includes the 8 U.S. GSIBs and Northern Trust) of 76.7 percent, a quantitative impact study of the GSIBs shows that the impact on GSIBs could be as high as 112%, and would only be as low as 73 percent if banks were able to maintain current model approvals; as described in multiple industry letters, current model approvals would be endangered under the more restrictive qualification and approval requirements of the proposed market risk framework. See Comment Letter from the International Swaps and Derivatives Association, Inc. and the Securities Industry and Financial Markets Association (Jan. 16, 2024), *available at* <https://www.sifma.org/wp-content/uploads/2024/01/ISDA-SIFMA-Comment-Letter-January-16-2024-Basel-III-Endgame.pdf>.

own. The proposal must be withdrawn, reconsidered, and repropose based on identified data and cogent analysis.

The Proposed Rule Is at War with Reality

The costs imposed on the U.S. economy by the proposal are even more unacceptable because incurring them is so unnecessary.

Since major reforms were instituted in the wake of the Global Financial Crisis, the level of common equity tier 1 capital, the highest-quality capital, has increased nearly 3.5 times. Other prudential enhancements since the crisis have further bolstered bank stability: banks hold dramatically more liquid assets, have substantially expanded their risk management functions, and have reduced risk across the board. Banks have weathered very large macroeconomic shocks and market turmoil. Benefiting from diversification across both product and geographic lines, they have proven themselves time and again to be amply capitalized.

Even by 2017, when the Basel agreement was reached, its authors concluded that no further increases in capital were required. As Mario Draghi, Chairman of the Group of Central Bank Governors and Heads of Supervision who oversaw Basel III, stated: “The focus of the exercise was not to increase capital. As a matter of fact, the GHOS almost a year ago endorsed this review by the Basel Committee, provided it wouldn’t create a significant capital increase in the aggregate of the banking system.”⁴ The Basel Committee’s impact study published at that time concluded, “Finalization of Basel III results in no significant increase in overall capital requirements,” and capital in fact was projected to slightly *decrease* for the 96 internationally active banks in the data set in aggregate.⁵

Since 2017, there also has been no evidence that U.S. banks hold insufficient capital against the four risks addressed in the proposal. Much attention has focused, since March 2023, on the case of Silicon Valley Bank, but it did not fail due to credit, operational, market or CVA risk: its borrowers repaid their loans; it suffered no cyber-attack or other operational loss; and it did not trade securities or hedge with derivatives. Its problems were liquidity and interest rate risk. The proposal does not claim otherwise.

Further evidence of the adequacy of current capital levels comes from the Federal Reserve’s own annual stress test, which the Federal Reserve has said provides “the public and firms with credible, independent assessments of each firm’s capital adequacy under stress.”⁶ For 2022, total loss absorbency on the balance sheet of the 33 banks included in the stress tests – equity plus allowances for credit losses and eligible long-term debt of GSIBs – was in excess of \$2.8 trillion, while total net stress losses under that severely adverse scenario were approximately \$300 billion. Thus, absorbency was more than nine times net losses predicted under a stress akin to the Global Financial Crisis and another Great Recession.

⁴ https://www.bis.org/bcbs/b3/ghos_20171207_2.htm

⁵ Basel Committee on Banking Supervision, *Basel III Monitoring Report: Results of the Cumulative Quantitative Impact Study 1* (December 2017) (<https://www.bis.org/bcbs/publ/d426.pdf>)

⁶ *2023 Stress Test Methodology* at 3.

The agencies' proposal is also at odds with innumerable statements from agency principals themselves, detailed in our comment letter. The proposed rule and its implicit finding that large U.S. banks are significantly capitalized thereby constitutes a radical, unexplained break with these prior statements and all the analysis and experience that supported them.

The Components of the Proposed Rule

Risk-based capital requirements are based on ratios that take a bank's regulatory capital as their numerator and risk-weighted assets as their denominator; the proposal largely focuses on the latter and would fundamentally change how risk-weighted assets are calculated for nearly every type of asset and exposure. The risk weight attached to each asset has a direct and significant effect on whether a bank chooses to hold and how it prices that asset; collectively, those risk weights drive the bank's overall capital requirement and its ability to compete for capital against other companies.

The proposed rule would establish a new standardized, government-devised approach to establishing risk weights, which it names the "Expanded Risk-Based Approach." That approach covers four categories of risk: credit risk, operational risk, market risk and credit valuation adjustment risk (the last basically being the risk of default by a derivatives counterparty).

Despite the clear function of these risk weights – to reflect an asset or exposure's *risk of loss* – the proposed rule includes no standard for determining what the appropriate risk weight should be for credit risk and CVA risk and includes no standard for converting operational risk into risk-weighted assets. There is no legal standard, no quantitative standard, and no qualitative standard for "risk" in these contexts, leaving even the most basic aspects of the calibration of these risk weights and risk weight methodologies unknowable.

The consequences of this omission are significant. If any such standard were identified, a commenter could then assess that standard and provide data and analysis on two fundamental questions: *first*, whether that proposed standard is appropriate for determining risk-based capital requirements; and *second*, whether the proposed risk weights and risk-weighting methodologies are consistent with that standard. But the proposal does no such thing.

The concept of a standard against which to measure risk is not novel or difficult. The current Advanced Approaches to credit risk – the internal-models-based approach that the proposal would eliminate entirely – uses as its standard of risk potential credit losses in a given year at a 99.9 percent confidence interval. Both the current U.S. operational risk capital rule and the Basel II standard on which it was based rely on a clear empirical standard of operational risk: a bank's operational risk exposure is defined as equal to the 99.9th percentile of the distribution of potential aggregate operational losses over a one-year horizon. The proposal replaces these standards with no standard.

Legal and Policy Defects with Respect to Each Component

Even if the proposal contained an articulated standard against which to judge its risk weights, it would remain arbitrary and capricious because it cites no data or information to support the weights it assigns for each of its four risks. The proposal is thus inconsistent with

both the procedural and substantive requirements of the Administrative Procedure Act.

Credit Risk

An overly punitive Standardized Approach

The failure to base capital charges for credit risk on data and analysis is remarkable given the massive historical data available to the agencies, which could inform analysis on probability of default and loss given default for all types of loans. For example, the proposal ignores all of the following data sources:

- Banks report quarterly to the Federal Reserve on loss rates for auto loans, commercial and industrial loans, commercial real estate loans, and a range of other exposure categories.⁷ The data includes delinquency and default rates.
- OCC researchers have previously used a supervisory data set that includes comprehensive, historical account-level data on credit cards, including detailed information on borrower characteristics along with delinquency and default performance.⁸
- The Federal Housing Finance Agency houses the National Mortgage Database, which includes loan-level information on default and loss experience as well as detailed property and borrower characteristics; the Mortgage Bankers Association and private data vendors maintain historical, segment-level databases on performance of commercial real estate loans.
- Credit rating agencies maintain robust databases of corporate credit performance.
- Most notably, large banks have been submitting data to the banking agencies to support the risk weights across all portfolios under the Advanced Approaches since 2014.⁹ This information contains detailed historical data.

Notwithstanding this enormous body of historical loss data – much of it directly used by the agencies for other supervisory and regulatory activities – the proposed rule makes almost no reference to any of these data sources and appears to have ignored them completely in calculating the risk weights it proposes.

A proposal based on data and analysis would have produced very different risk weights. To provide just a few notable examples:

⁷ Board of Governors of the Federal Reserve System, *Capital Assessments and Stress Testing Information Collection* (Reporting Form FR Y-14Q), available at https://www.federalreserve.gov/apps/reportingforms/Report/Index/FR_Y-14Q.

⁸ See Florentin Butaru, Qingqing Chen, Brian Clark, Sanmay Das, Andrew W. Lo and Akhtar Siddique, *Risk and risk management in the credit card industry*, 72 J. of Banking & Fin. 218, 220.

⁹ See Federal Financial Institutions Examination Council, *Regulatory Capital Reporting for Institutions Subject to the Advanced Capital Adequacy Framework—FFIEC 101*, available at https://www.ffiec.gov/pdf/FFIEC_forms/FFIEC101_202309_f.pdf.

- For **credit card loans**, experience taken from regulatory reports supports a risk weight of 73 percent, whereas the proposal would impose an effective risk weight of 111 percent, to which would be added a further operational risk charge – combining for a total risk weight of approximately 140 – 190 percent, or roughly double what the actual risk requires.¹⁰ Furthermore, credit card loans are subject to a further stress capital charge through the Federal Reserve’s stress test, of which the proposal takes no account.
 - For **other consumer loans**, data from the Advanced Approaches supports a risk weight of 50 percent.¹¹ The proposal would introduce a risk weight of 85 percent, which is 10 percentage points higher than what U.S. agency staff agreed to in Basel and materially overstates the actual credit risk, particularly for auto loans. These loans are also subject to a further stress capital charge.
 - The proposal would impose new capital charges on **unused credit card lines** based on no analysis and in conflict with historical data. (As a result, banks would likely reduce lines for credit card holders, with particular harm to lower-income consumers who rely on unused lines as an emergency source of funding and as a way to build a credit history.)
 - Risk weights for **business loans** are similarly overstated. According to FFIEC reports, documented historical experience from 2014 to 2022 suggests that a risk weight of 41 percent would be appropriate. Instead, the proposal establishes a general risk weight of 100 percent, with a 65 percent risk weight available only to businesses that are both (1) rated investment-grade by the bank and (2) have securities listed on a national exchange or have a parent that does. The latter requirement would effectively impose a 100 percent risk weight on loans to tens of thousands of creditworthy small and mid-sized businesses, as well as high credit-quality mutual funds and pension funds that generally do not list securities on an exchange.¹²
- Whether with or without a listed security, historical analysis based on FFIEC data from 2014 to 2022, combined with the Advanced Approaches risk weight formula, shows that a business rated investment-grade by a bank merits a risk weight significantly below 65 percent, and below the 41 percent for all business loans – something on the order of 30 percent.
- Risk weights for **mortgage loans** would range from 40 to 90 percent, even before one considers the impact of the separate operational risk charge and the Federal Reserve’s stress test, which could add as much as 25 percent; for loans intended to be sold to government-

¹⁰ Paul Calem and Francisco Covas, *The Basel Proposal: What It Means for Retail Lending*, Bank Policy Institute (Nov. 8, 2023), available at <https://bpi.com/the-basel-proposal-what-it-means-for-retail-lending/>.

¹¹ *Id.*

¹² The proposal includes no analytical basis for the securities listing requirement. In fact, researchers using a robust data set have demonstrated that the listing requirement does not result in more consistent internal ratings across banks or lower credit risk, demonstrating that the requirement is arbitrary. See Francisco Covas and Barbora Stepankova, *Consistency in Risk Weights for Corporate Exposures Under the Standardized Approach*, Staff Working Paper – Bank Policy Institute (Jan. 2022), available at <https://bpi.com/wp-content/uploads/2022/01/Consistency-in-Risk-Weights-for-Corporate-Exposures-Under-the-Standardized-Approach.pdf>.

sponsored enterprises, the effective risk weight could be as high as 140 percent.¹³ Documented historical experience based on data from FFIEC reports from 2014 to 2022 suggests an average risk weight of 25 percent is more appropriate. For GSE loans, the assumed loss rates – even leaving aside the operational risk and stress test add-ons – are higher than those for the worst losses in history – those originated from 2005 to 2008.¹⁴

Elimination of a more advanced, internal-models-based approach

Compounding the effect of punitive standardized risk weights, the proposal would eliminate the Advanced Approaches for credit risk for the largest banks.

Ending the use of internal models for credit risk would be a repudiation of the core element of the 2017 Basel agreement that the agencies purport to be implementing.¹⁵ That agreement's most negotiated and prominent feature was the continued use of bank models subject to an "output floor," meaning models cannot collectively produce RWAs lower than 72.5 percent of those calculated using a standardized approach.

Ending the use of internal models for credit risk greatly increases the costs of over-calibration of standardized risk weights. In every other major jurisdiction implementing the 2017 Basel agreement, those standardized risk weights are effectively discounted given that in most cases internal models or external credit ratings (the use of which is not permitted in the United States) will produce a significantly lower capital charge. Basically, the standardized charges in that framework were intended to apply at a 72.5 percent discount and will continue to do so in every other major country.

Put another way, having negotiated in Basel an output floor of 72.5 percent, the agencies now propose a de facto output floor of 100 percent but only for U.S. banks, *and* with the Standardized Approach that forms the basis of that output floor set even higher than the Basel agreement in almost every major respect.

Even this formulation understates the impact: the 72.5 percent output floor is an average, and that means some loans in other jurisdictions could receive risk weights significantly lower than 72.5 percent of the risk weight the same loan would receive under the U.S. proposal. Thus,

¹³ See Paul Calem and Francisco Covas, *The Basel Proposal: What It Means for Mortgage Lending*, Bank Policy Institute (Sept. 30, 2023), available at <https://bpi.com/the-basel-proposal-what-it-means-for-mortgage-lending/>.

¹⁴ See Laurie Goodman and Jun Zhu, "Bank Capital Notice of Proposed Rulemaking – A Look at the Provisions Affecting Mortgage Loans in Bank Portfolios," Urban Institute (Sept. 2023), available at https://www.urban.org/sites/default/files/2023-09/Bank_percent20Capital_percent20Notice_percent20of_percent20Proposed_percent20Rulemaking.pdf.

¹⁵ The Basel framework contemplates the continued use of internal models for credit risk. Although the Basel Committee provides that implementing only the Standardized Approaches would not, in and of itself, constitute noncompliance with the Basel framework, see Basel Committee on Banking Supervision, *High-level summary of Basel III reforms*, 12 (Dec. 2017), available at https://www.bis.org/bcbs/publ/d424_hlsummary.pdf, nothing in the Basel framework requires the elimination of internal models for credit risk, and implementing the Basel standards in the United States in no way necessitates the elimination of internal models for credit risk.

for lower-risk activities, U.S. banks would be at a serious competitive disadvantage compared to foreign peers, and U.S. borrowers will be seeing higher prices for business or consumer loans compared to the rest of the world.

There is no evidence whatsoever that internal models for credit risk have led to a systematic understatement (or overstatement) of risk at any bank. Since 2014, banks have used internal models to gauge credit risk for capital purposes, subject to back-testing and model approval from an independent risk function, an independent model validation group, internal auditors and agency examiners.¹⁶ The virtue of internal models is that they are inherently more granular and risk-sensitive than government-imposed, one-size-fits-all standardized methodologies, and they can also be adjusted over time to reflect changing behavior.

Despite the fact that agency representatives spent years developing this component of the 2017 Basel Committee revisions, the proposal fails to consider this carefully crafted alternative. Incredibly, *the proposal does not mention the Basel Committee's revised framework for internal credit models at all*. The proposal also contains no mention of the fact that every major banking center abroad that has implemented the 2017 Basel Committee revisions, including both the European Union and the United Kingdom, has chosen to implement the 2017 framework for internal credit models.

The conclusion here is inescapable: the problem with internal models is not that they are inaccurate, but rather that they produce lower capital charges than the agencies would prefer for reasons other than accuracy. And they deprive the agencies of a monopoly in assessing credit risk for capital purposes. All banks should have the option of using internal models subject to the existing regulatory regime in order to ensure their accuracy.

Operational Risk

If the proposal were adopted without change, large U.S. banks would end up holding over \$300 billion in capital against so-called “operational risk” – basically the risk of non-financial loss, in theory through events like a cyber-attack but in practice through fines from the banking

¹⁶ The agencies nowhere acknowledge a rigorous model risk management regime that they themselves have established. In 2011, the Federal Reserve and OCC issued their *Supervisory Guidance on Model Risk Management*, which lays out the requirements that banks must follow for robust model development, testing, governance, and independent validation. This 2011 supervisory guidance: (i) defines robust standards for model development, documentation, testing, justification, empirical verification and outcomes analysis, review, and governance of models; (ii) requires that a competent independent model validation group validate that all the requirements specified in the guidance have been met for every model a bank uses; and (iii) mandates that banks' internal audit groups assess the effectiveness of both the model development and the independent validation. As a result of these requirements, internal models for credit go through numerous reviews, with each review serving a different purpose. The guidance was expressly designed to mitigate potential issues with model uncertainty, and by all accounts has served fit for that purpose. Since 2011, the agencies have seen no cause to revisit that guidance and have made no public observation that it is flawed, much less failing to such an extent that it must be abandoned entirely in favor of sole reliance on government-set, standardized models. There has never been a public enforcement action against a bank for underreporting its risk weights under the Advanced Approaches; nor have there been material losses reported at banks attributable to credit risk modeling failures.

agencies and civil litigation judgments. This capital charge is produced by creating more than \$3.5 trillion in phantom assets to represent operational risk – which, unlike credit and market risk, is not based on actual assets held by banks, but instead on a bank’s income and operational loss history – and then imposing a capital charge against those phantom assets. For capital purposes, approximately 24 percent of banks’ collective risk-weighted assets would stem from these phantom assets.

This requirement is massively overstated, and the agencies provide no basis for it in the proposal.

- The proposal ignores relevant data in calibrating the operational risk capital requirement. The Federal Reserve collects historical data on operational risk losses for stress testing purposes.¹⁷ Data going back to the first quarter of 2001 is available and is quite detailed, including information on loss amounts, loss classifications, and loss descriptions. There is no evidence that the agencies considered that data.
- Furthermore, ORX – an operational risk management association – has collected a massive data set on operational risk losses, which also extends back to the early 2000s.
- The proposal also fails to acknowledge that U.S. banks are already required to capitalize for operational risk through the Federal Reserve’s stress test. The proposed rule would create \$2 trillion in phantom operational risk assets, and another \$1.5 trillion in phantom assets already results from the SCB that is calculated in the Federal Reserve’s annual stress test, whose latest iteration imposed \$188 billion in aggregate operational risk losses.¹⁸
- The cumulative effect of these two operational risk capital charges leads to overall capital requirements for operational risk that are 3.5 times larger than the largest losses experienced by U.S. banks in the worst year since 2003. Nearly 25 percent of large U.S. banks’ total risk-weighted assets would result from operational risk capital charges, whereas the average for banks in other jurisdictions is nearly half that amount.
- One source of the overstatement of operational risk is a material over-capitalization for the risk arising from fee-related income. Unlike the calculation of the interest component and the financial component of the business indicator for operational risk, the services component does not offset revenues with expenses. There is also no upward limit on the size of the services component; in contrast, for the interest component, there is a cap set at 2.25 percent of interest-earning assets. This method of deriving operational risk RWAs disincentivizes banks from diversifying their income streams away from net interest income and runs counter to sound risk management practices.
- The vastly overstated base operational risk charge in the proposal is, in turn, subject to a

¹⁷ Data submitted confidentially under the FR Y-14Q data collection regime includes operational loss history, so this dataset is not available to the public.

¹⁸ The \$188 billion estimate of losses associated with operational risk events stemmed from the 2022 stress tests, which included all banks subject to the proposal (Categories I-IV). The 2023 stress test yielded an estimate of \$185 billion, reportedly for a subset of those banks (Categories I-III).

bank-specific “internal loss multiplier,” designed to assess whether that bank’s individual operational risk loss history differs from the norm over the past ten years. It is worth noting that by the time the rule is scheduled to take effect, crisis-era litigation settlements and government fines will no longer be included in the ten-year lookback period. Thus, while good policy would require the agencies either to make the multiplier symmetrical (also giving favorable treatment for good operational loss history) or to eliminate it altogether (as the EU and UK have done), it is not a major driver of the overstatement of operational risk capital.

In sum, the current proposal with respect to operational risk capital should be thoroughly reconsidered and re-proposed with a lower calibration, and once it is adopted, the operational risk component of the Federal Reserve’s stress test should be eliminated, as there is no conceptual or analytical basis for it.

Market Risk

The proposed rule would establish a standardized measure of market risk that produces outsized increases in market risk capital despite no indication that firms have undercapitalized those activities. According to the proposal, market risk RWAs are expected to rise 75 percent for affected banks. The proposal requires market risks to be capitalized using either a standardized approach – which, among other problems, does not sufficiently recognize the benefits of diversification – or a models-based approach that determines a substantial part of the capital requirement through a draconian stress test. Additionally, the eligibility requirements for the models-based approach lack empirical support and have the potential to introduce volatility and uncertainty into capital requirements, as banks could be forced to switch between applying models-based and standardized approaches due to the inability to pass arbitrary tests.¹⁹

The proposed rule also ignores completely its overlap with the Global Market Shock in the Federal Reserve’s stress test. Both are intended to ensure a bank can endure a severe market stress; both capture market risk losses; and both estimate those losses based on extreme tail events. Further, both frameworks use market shocks calibrated based on similar historical loss data; both constrain the effects of credit risk mitigation and portfolio diversification; and both use similarly severe liquidity horizon assumptions. And the Global Market Shock already overstates risk: a 2019 study suggests that several factor shocks have less than a 1-in-10,000 chance of occurring based on historical data.²⁰ For several asset classes, the combined shocks from GMS and the Basel standardized charge would far exceed those experienced in the most severe shock that have ever happened over a *six-month* period. For BBB corporate bonds, the GMS alone exceeds the most severe losses experienced over a six-month period for that asset class since 2008. When GMS shocks are combined with the Fundamental Review of the Trading Book, capital requirements for certain exposures can even exceed maximum potential loss.

¹⁹ See Greg Hopper, *The New Profit and Loss Attribution Tests: Not Ready for Prime Time*, Bank Policy Institute (Dec. 14, 2023), available at <https://bpi.com/the-new-profit-and-loss-attribution-tests-not-ready-for-prime-time/#:~:text=In%20light%20of%20these%20fundamental,reporting%20and%20monitoring%20purposes%20only>.

²⁰ See SIFMA (August 2019) *Global Market Shock and Large Counterparty Default Study*, available at <https://www.sifma.org/wp-content/uploads/2019/09/SIFMA-GMS-LCD-Study-FINAL.pdf>.

Given the important role banks and their affiliated broker-dealers play in U.S. capital markets, the proposed rule would do substantial damage. An unjustified increase in market risk capital requirements would raise the cost of debt and equity financing while reducing market liquidity. The increase in the costs of debt financing and hedging activities would translate to increased prices for consumers as they purchase homes, automobiles or other goods and services funded in capital markets.²¹ In addition, the proposal would reduce the liquidity of the U.S. capital markets, which would drive up the cost of funding for American businesses.

Again, there is nothing about the real-world performance of U.S. banks to justify an implicit finding that their trading operations are critically undercapitalized, and the proposed rule makes no attempt to do so. It just makes up the risk weights without any tether to data or analysis.

Derivatives Counterparty Risk

The treatment of default risk with derivatives counterparties is based on no historical data or analysis. The proposal includes two new approaches for calculating this risk, neither of which allows for the use of internal models. The shift away from internal models is expected to result in an approximate 10 percent increase in risk-weighted assets for this risk – again, with no evidence to suggest that current capitalization levels are insufficient.

Tailoring

The proposed rule, in conjunction with other rules proposed over the summer, would have the practical effect of repealing the tailoring provisions of the Economic Growth, Regulatory Relief and Consumer Protection Act of 2018, at least with respect to capital and related requirements. Although the agencies certainly have the right to identify to Congress laws with which they disagree, they lack the authority to override Congress and must implement all statutory mandates. Although the regional banking turmoil of 2023 may merit some change to the law, Congress has not enacted any such changes; rather, through their actions the agencies have assumed the lawmaking process.

The proposed rule would largely apply the same capital requirements to banks in Categories I through IV, namely by (i) requiring banks in Categories I through IV to calculate RWAs in the same manner, including by requiring Category III and IV banks to move to the dual-stack approach previously only required for Category I and II banks; (ii) requiring Category III and IV banks to recognize unrealized gains/losses on available-for-sale debt securities and most other elements of accumulated other comprehensive income (AOCI) in regulatory capital; (iii) requiring Category III and IV banks to apply the capital deductions and minority interest

²¹ With respect to the increased costs of hedging that would result from the proposal, see David Murphy and Sayee Srinivasan, *Capital proposal: Endgame for a robust U.S. derivatives market?*, ABA Banking Journal, available at <https://bankingjournal.aba.com/2023/11/capital-proposal-endgame-for-a-robust-u-s-derivatives-market/> ("It is highly likely that banks will react to these proposals, if finalized, by increasing fees for providing market access, reducing the amount of risk that they allow clients to transfer, and refusing to provide access at all to the least profitable clients.").

treatments that currently apply to only Category I and II banks; (iv) applying the supplementary leverage ratio and countercyclical capital buffer to Category IV banks; and (v) requiring all Category I through IV banks – regardless of the extent of their trading activities – to calculate market RWAs under the revised market risk capital rule. Some of these changes conceivably could be justified as a reaction to events of March 2023; the majority, however, bear no relation. Furthermore, even where change is deemed necessary, the agencies have failed to tailor requirements and instead have opted to treat mid-sized banks the same as GSIBs. In particular, the requirement for Category IV banks to apply a dual-stack approach – meaning those banks must calculate their capital ratios using both the current U.S. Standardized Approach and the Expanded Risk-Based Approach, with the lower of the two being the binding capital requirement – would impose undue costs and burdens without a commensurate supervisory or policy benefit.

The proposed rule also has a disproportionate impact on the U.S. operations of foreign banks, which are particularly hard hit by the punitive risk weights imposed on fee income. The proposed GSIB surcharge rule could also subject many of them to heightened regulation even though they are in general shrinking their U.S. footprints at least in part because of the existing level of regulation.

Regulatory Overlap

The proposal would result in significantly higher effective capital requirements for most covered banks with respect to market risk (primarily associated with trading assets and activities) and operational risk. The proposal does not consider the possibility that these significant increases to the capital requirements for both types of risk would lead to redundancy, in whole or in part, with the capital required for these same risks through the Federal Reserve's stress tests.

Market risk

As defined by the Federal Reserve, market risk is “the risk of loss on a position that could result from movements in market prices.”²² Both the existing Global Market Shock (GMS) component of the Federal Reserve's stress testing framework and the proposed rule are designed to measure and capitalize this risk. Their designs bear striking similarities: both assess a bank's ability to withstand a period of extreme market stress over a long duration; both shock trading positions at high confidence levels; and both have bigger shocks for asset classes with longer assumed liquidation periods.²³ Analysis based on publicly available data demonstrates that the proposal's approach to market risk and the GMS are duplicative – that is, they are expressly

²² See 12 C.F.R. § 217.202.

²³ The stated purpose of the stress capital charge is to ensure that banks have sufficient capital to “both absorb losses during times of economic stress and continue to lend to households and businesses and meet their obligations.” Stress Testing Policy Statement, 84 Fed. Reg. 6664, 6666–67 (Feb. 28, 2019), *available at* <https://www.govinfo.gov/content/pkg/FR-2019-02-28/pdf/2019-03503.pdf>. Pursuant to a codified Federal Reserve policy statement, the “severely adverse scenario” is designed to reflect “conditions that characterized post-war U.S. recessions,” and its Global Market Shock component is designed to reflect “large, previously unanticipated moves in asset prices and rates.” 12 C.F.R. 252, Appendix A. The stress test is therefore designed to assess tail risk.

designed to capture the same market risks of a single set of trading positions, with the results that these market risks must effectively be capitalized twice.²⁴

Operational risk

Similar issues arise in the context of the proposal's treatment of operational risk relative to the capitalization of that risk under the Federal Reserve's stress testing framework. Specifically, large banks are already required to hold capital for operational risk through the Federal Reserve's annual stress tests, which the Federal Reserve designs both to reflect aggregate operational-risk losses for the industry over the stress test projection horizon and to account for "large and infrequent operational-risk losses" that may be incurred by a firm.²⁵ Therefore, combining the new Standardized Approach for operational risk with the stress test capital charge would lead to a substantial overstatement of capital requirements for operational risk.²⁶

Systemic risk

For GSIBs, the inflated higher risk-weighted assets from the Basel proposal would feed into the GSIB surcharge score under the approach adopted by the U.S. agencies. Thus, with this multiplier effect, GSIBs will be considered more systemically important and incur a higher capital charge, even as their risk is unchanged. The proposal takes no account of this effect and fails to consider alternatives to offset it – for example, recalibrating the surcharge to reflect economic growth since the framework was finalized in 2015.

Resolution risk

The purposes of the Basel proposal overlap with the agencies' current long-term debt proposal, which would generally apply long-term debt requirements to larger banks (other than U.S. GSIBs currently subject to the TLAC rule). The long-term debt proposal seeks to ensure additional funds are available to banking organizations to aid their resolution and protect uninsured depositors.²⁷ Although the contemplated capital increases under the Basel proposal should reduce the need for long-term debt, given that increased capital can also absorb losses for a distressed bank and protect uninsured depositors, the rules are actually designed to increase concurrently. Indeed, the long-term debt proposal is calibrated based on RWAs that the Basel proposal may increase by \$2.2 trillion.²⁸ Although the long-term debt proposal states that the Basel proposal would, therefore, "lead mechanically to increased requirements for [long-term

²⁴ Greg Hopper, *Why is the FRTB Expected Shortfall Calculation Designed as It Is?*, Bank Policy Institute (May 23, 2023), available at <https://bpi.com/why-is-the-frtb-expected-shortfall-calculation-designed-as-it-is/>; Greg Hopper, *How Can The Global Market Shock More Effectively Complement The Fundamental Review of the Trading Book?*, Bank Policy Institute (May 30, 2023), available at <https://bpi.com/how-can-the-global-market-shock-more-effectively-complement-the-fundamental-review-of-the-trading-book/>.

²⁵ See 2023 Stress Test Methodology, at 23.

²⁶ Francisco Covas, *About Excessive Calibration of Capital Requirements for Operational Risk*, Bank Policy Institute (Oct. 30, 2023), <https://bpi.com/about-excessive-calibration-of-capital-requirements-for-operational-risk/>.

²⁷ *Long-Term Debt Requirements for Large Bank Holding Companies, Certain Intermediate Holding Companies of Foreign Banking Organizations, and Large Insured Depository Institutions*, 88 Fed. Reg. 64,524 (Sep. 19, 2023).

²⁸ See *Regulatory Capital Rule: Large Banking Organizations and Banking Organizations With Significant Trading Activity*, 88 Fed. Reg. 64,028, 64,168 (Sept. 18, 2023).

debt] under the [long-term debt] proposal,” the agencies cannot provide a robust cost-benefit analysis accounting for the ultimate impacts of the Basel proposal. Until the Basel proposal is finalized, neither the agencies nor the public have the information to fully assess the benefits and costs of the two proposals.²⁹

Correlation of Risks

The proposal would impose capital charges for credit risk, operational risk, market risk, and CVA risk on a purely aggregate basis. That is, it assumes that all such risks would arise and impose losses on covered banks at the same time, effectively assuming that all such risks are perfectly correlated. Under a 99.9-percent confidence-interval assumption, it would mean that, if credit risk losses are in the 0.1-percent tail of the distribution of credit losses, the same is true for market risk losses, operational risk losses, and losses associated with credit quality of banks’ derivatives counterparties. This assumption is flatly inconsistent with all available evidence, which implies a fatal problem with the proposal that it does not acknowledge, let alone thoughtfully consider and resolve.

In particular, the proposal presents no historical evidence of operational risk losses being correlated with financial risks. Fines or judgments against banks for anti-money laundering and sanctions compliance, antitrust violations and consumer credit practices – which now make up the largest operational risk loss events – would appear entirely uncorrelated with credit and market loss events. The only case where there appeared to be some correlation involved penalties for mortgage practices in connection with the credit losses of the Global Financial Crisis. However, in reality, there was low correlation because the actual litigation losses were generally recognized several years later.

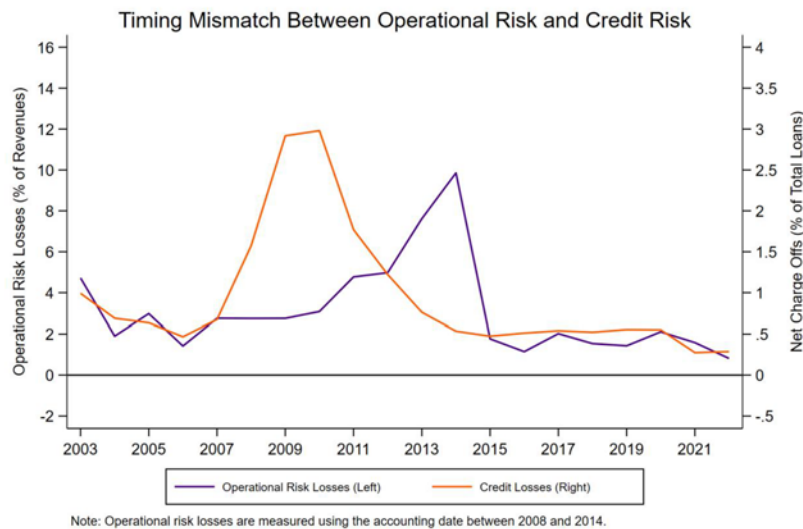
As Governor Waller explained in his dissent from the proposed rule:

[T]here is no discussion on why operational risk capital needs to be an additional charge as opposed to just using the existing capital stack to absorb operational losses. Having an additional layer of operational risk capital would make sense if large operational risk losses tend to occur contemporaneously with credit and market losses. But there is little evidence of that. For example, some of the largest operational risk expenses U.S. banks have incurred were those owing to fines and lawsuits associated with mortgage underwriting and securitization leading up to the 2008–09 financial crisis. But banks didn’t incur those losses until

²⁹ Additionally, the long-term debt proposal would likely be *three* times more costly than the agencies estimate, after factoring in the interactions of the debt proposal with current regulation, market practice, and banking organizations’ current debt shortfalls. See Haelim Anderson, Francisco Covas and Felipe Rosa, *The Long-Term Debt Proposal and Bank Profitability*, Bank Policy Institute (Dec. 7, 2023), <https://bpi.com/the-long-term-debt-proposal-and-bank-profitability/>. The agencies estimate a total funding cost of \$1.5 billion; a more accurate estimate is \$4.9 billion. The agencies estimate a 3-basis-point decline in net interest margin (NIM); a more accurate estimate is a 10-basis-point decline in NIM. The agencies’ assumptions would lead to a 26-basis-point decline in return on average tangible common shareholders’ equity (ROTCE); a more accurate estimate is an 80-basis-point decline in ROTCE. These significant costs would burden banks at the same time that they must grapple with the costs of the Basel proposal.

years after the financial crisis because it takes time to recognize fiduciary failings, bring forward legal claims, and adjudicate those claims. That is typical for these sorts of losses, which often stem from litigation. An important question, therefore, is why do banks need to sideline separate buckets of operational risk, credit risk, and market risk capital when those risks are unlikely to manifest at the same time? It is similar to asking individuals to establish separate emergency funds for shocks to their income, such as losing their job, and shocks to their expenses, like a fire in their house or their car breaking down. Households understand it is exceedingly unlikely that they will experience a month where all these shocks hit simultaneously, so their emergency funds are less than the sum of those individual expected expenses.³⁰

Below is a graphical illustration of this point from our comment letter, showing the history of actual operational and credit losses since 2003; the correlation is weak to non-existent.



The proposal's counterfactual assumption of perfect correlation also represents a marked and unexplained change in policy. In prior rulemakings, the agencies have expressly declined to add incremental operational risk capital charges to risk-weighted assets calculated using

³⁰ Statement by Christopher J. Waller, Governor, Board of Governors of the Federal Reserve System, on the Proposed Amendments to the Capital Framework (July 27, 2023), available at <https://www.federalreserve.gov/newsevents/pressreleases/waller-statement-20230727.htm>.

standardized risk weights on the following grounds: “Because the general risk-based capital rules include a buffer for risks not easily quantified (for example, operational risk and concentration risk), [banks subject to the Standardized Approach] would not be subject to an additional direct capital charge for operational risk.”³¹ The proposal would continue that approach for the existing Standardized Approach that would apply to all smaller banks and act as a “floor” for larger banks subject to the proposal.

Any operational risk capital charge needs to be discounted very substantially, and there is a strong case for eliminating it altogether. And there is no case for retaining a second charge in the stress test if one is adopted for Basel purposes.

The Role of Basel

Nearly the entirety of the proposal relies in whole or in part upon decisions made by the Basel Committee in 2017 and 2019. Yet almost none of the various requirements and associated methodologies and other details based on the Basel Committee’s standards is accompanied by *any* associated analysis, reasoning, or evidentiary support required of the agencies themselves as part of the U.S. rulemaking process under the APA. The Basel Committee’s deliberations and decision making occurred wholly outside the U.S. administrative law framework. Furthermore, to the extent that the Basel Committee agreement was based on analysis, that analysis was conducted almost a decade ago, averaged results among quite different banks around the world, and included no analysis of the impact on smaller U.S. banks to which the proposal would apply. While promoting international consistency in capital regulation may benefit U.S. public policy in certain respects, it does not excuse the agencies from the basic obligation under U.S. law to independently explain and justify the proposal in its own right.

As Director McKernan of the FDIC noted in dissenting from the proposed rule:

As the complexity of the capital framework mounts, we are asked to defer more and more to the technical work of, and the backroom deals made at, the Basel Committee. In the case of the Basel III standards, the Basel Committee has made some key decisions with little or no explanation. That then leaves the U.S. bank regulators unable to defend or perhaps even understand important aspects of the Basel III standards that we are now proposing to implement.

In sum, an agreement reached by agency staff in 2017 is no policy or legal excuse for failing to produce data and analysis to justify a U.S. rule.

Summary

We urge the agencies to withdraw this proposal, draft a new one, show their work, and seek public comment.

³¹ Risk-Based Capital Guidelines; Implementation of New Basel Capital Accord, 68 Fed. Reg. 45900, 45902 (Aug. 4, 2003).

Chairman BARR. Thank you. Mr. Bashur, you are now recognized for 5 minutes.

STATEMENT OF BRYAN BASHUR, DIRECTOR OF FINANCIAL POLICY, AMERICANS FOR TAX REFORM

Mr. BASHUR. Chairman Barr, Ranking Member Foster, and members of the subcommittee, thank you for the invitation to testify today. My name is Bryan Bashur, and I am the Director of Financial Policy at Americans for Tax Reform (ATR). ATR is a nonprofit, 501(c)(4) taxpayer advocacy organization that opposes all tax increases and supports limited government, free market policies. In support of these goals, ATR opposes heavy regulation and taxation of financial services. ATR was founded in 1985, at the request of President Ronald Reagan.

I am here today to talk about the proposed bank capital rule, which is based off the Basel Committee on Banking Supervision's Basel III Endgame framework.

In November, this subcommittee discussed how the Basel Committee, among other international organizations, has directly influenced U.S. banking regulation. Now, the discussion will specifically revolve around a proposal that circumvents congressional intent, abuses regulators' discretion, and is arbitrary and capricious.

The Federal Reserve, Federal Deposit Insurance Corporation, Office of Comptroller of the Currency are proposing to heighten regulations on banks with at least \$100 billion in consolidated assets. The proposal would force large banks to build up more capital through retained earnings and additional stock issuances without any input from Congress.

These new rules will make borrowing more expensive, hamper dividends and share repurchases, and reduce the availability of credit cards and mortgage loans, activities and services the government should not be micromanaging. Banks should remain private and not regulated to such an extent that they resemble heavily regulated utilities or other quasi-governmental entities.

The Basel Committee's influence on banking regulation across the globe has created a regulatory structure that circumvents Congress. This is evidenced by the proposal's direct repudiation of the bipartisan Economic Growth, Regulatory Relief, and Consumer Protection Act. Congress passed this legislation with the intent to tailor regulation for bank holding companies. The proposal eliminates and replaces the tailored regulation from S. 2155 by applying uniform regulations to all banks with more than \$100 billion in assets.

For example, the proposal expands the inclusion of accumulated other comprehensive income for available-for-sale securities to capital calculations for Category III and IV banks. Category III and IV banks would also be required to calculate their capital based on both the new expanded risk-based approach and the existing standardized approach, and then measure compliance based on the more stringent of the two ratios. The supplementary leverage ratio and the countercyclical capital buffer would also be expanded to apply to Category IV banks.

The proposal also largely eliminates the use of banks' internal models without any empirical analysis justifying this prohibition.

The blanket application of these requirements defeats the purpose of S. 2155.

This proposal is arbitrary and capricious, an abuse of discretion, and exceeds the statutory bounds with which the regulators are supposed to operate.

Regulators may not expand their authority merely because they believe their preferred approach would be better policy. The regulators claim to have broad statutory authority to amend capital requirements at will. However, Congress does not alter the fundamental details of a regulatory scheme in vague terms or ancillary provisions. It does not, one might say, hide elephants in mouseholes. Congress made it clear in S. 2155 that there needs to be a regulatory structure that is best tailored to banks with different services and operations. The proposal dismisses Congress' intent and moves ahead anyway.

Regulators are justifying the uniform application of capital regulations to banks in categories I, II, III, and IV by referring to "recent events" or the collapses of Silicon Valley Bank, Signature Bank, and First Republic Bank. However, these banks' failures cannot and should not be attributed to all U.S. banks with more than \$100 billion in assets.

The capital requirements dictated by the regulators have not been condoned by Congress and are arbitrary and capricious under the Administrative Procedure Act.

The proposal is a classic example of the government intervening in the operations of private companies by mandating how they must organize their balance sheets. If finalized, the proposal has the potential to reduce the availability, or increase the cost of credit for auto loans, credit cards, small business loans, and mortgages. One paper describes how the regulators' unbridled quest for more stringent capital requirements can make capital allocation more expensive. According to the paper, "All else equal, making regulated banks less risky may actually raise their cost of capital, with consequent implications for investment and growth."

At the end of the day, major questions and policy decisions need to be left to Congress. Unelected bureaucrats should not be in the business of creating the law.

Thank you again for inviting me to this hearing. I look forward to answering your questions.

[Prepared statement of Mr. Bashur follows:]



**Testimony of Bryan Bashur
Director of Financial Policy
Americans for Tax Reform**

**Before the
U.S. House Committee on Financial Services
Subcommittee on Financial Institutions and Monetary Policy**

“Rules Without Analysis: Federal Banking Proposals Under the Biden Administration”

January 31, 2024

Chairman Barr (R-Ky.), Ranking Member Foster (D-Ill.), and members of the subcommittee, thank you for the invitation to testify today. My name is Bryan Bashur, and I am the Director of Financial Policy at Americans for Tax Reform (ATR). ATR is a nonprofit, 501(c)(4) taxpayer advocacy organization that opposes all tax increases and supports limited government, free market policies. In support of these goals, ATR opposes heavy regulation and taxation of financial services. ATR was founded in 1985 at the request of President Ronald Reagan.

I am here today to talk about the proposed bank capital rule, which is based off the Basel Committee on Banking Supervision’s (Basel Committee) Basel III Endgame framework.

In November, this subcommittee discussed how the Basel Committee, among other international organizations, has directly influenced U.S. banking regulation. Now, the discussion will specifically revolve around a Proposal that circumvents congressional intent, abuses regulators’ discretion, and is arbitrary and capricious.

The Federal Reserve (Fed), Federal Deposit Insurance Corporation (FDIC), and Office of the Comptroller of the Currency (OCC) are proposing to heighten regulation on banks with at least \$100 billion in consolidated assets. The Proposal would force large banks to build up more capital through retained earnings and additional stock issuances without any input from Congress.

These new rules will make borrowing more expensive, hamper dividends and share repurchases,¹ and reduce the availability of credit cards and mortgage loans—activities and services the government should not be micromanaging. Banks should remain private and not regulated to such an extent that they resemble heavily regulated utilities, or other quasi-governmental entities.

¹ <https://www.wsj.com/articles/banks-stock-buybacks-basel-endgame-50fb9e7c>.

The Basel Committee's influence on banking regulation across the globe has created a regulatory structure that circumvents Congress. This is evidenced by the Proposal's direct repudiation of the bipartisan *Economic Growth, Regulatory Relief, and Consumer Protection Act* (P.L. 115-174).² Congress passed this legislation with the intent to tailor regulation for bank holding companies. The Proposal eliminates and replaces the tailored regulation from P.L. 115-174 by applying uniform regulations to all banks with more than \$100 billion in assets. For example, the Proposal expands the inclusion of accumulated other comprehensive income (AOCI) for available-for-sale (AFS) securities to capital calculations for Category III and IV banks. Category III and IV banks would also be required to calculate their capital based on both the new expanded risk-based approach and the existing standardized approach, "and then measure compliance based on the more stringent of the two ratios."³ The supplementary leverage ratio (SLR) and the countercyclical capital buffer (CCyB) would also be expanded to apply to Category IV banks. The Proposal also largely eliminates the use of banks' internal models without any empirical analysis justifying this prohibition. The blanket application of these requirements defeats the purpose of P.L. 115-174. Congress did not intend for all banks with more than \$100 billion in assets to be subjected to the same rules uniformly. The application of these new rules is a direct rejection of congressional intent. According to the FDIC Vice Chairman, the proposal is a "repudiation of the intent and spirit of" P.L. 115-174.⁴

This Proposal is arbitrary and capricious, an abuse of discretion, and exceeds the statutory bounds with which the regulators are supposed to operate.⁵ Regulators may not expand their authority merely because they believe their "preferred approach would be better policy."⁶ The regulators claim to have broad statutory authority to amend capital requirements at will. However, Congress "does not alter the fundamental details of a regulatory scheme in vague terms or ancillary provisions—it does not, one might say, hide elephants in mouseholes."⁷ Congress made it clear in P.L. 115-174 that there needs to be a regulatory structure that is best tailored to banks with different services and operations. The Proposal dismisses Congress's intent and moves ahead anyway.

The Proposal's insistence on applying uniform rules to all banks with more than \$100 billion in assets contravenes P.L. 115-174 and is inconsistent with previous rules. Other rules have been vacated because the agency "failed adequately to justify departing from its own prior interpretation."⁸

Regulators are justifying the uniform application of capital regulations to banks in categories I, II, III, and IV by referring to "recent events" or the collapses of Silicon Valley Bank (SVB),

² <https://www.congress.gov/bills/115/congress/senate/bills/2155>.

³ <https://clsbluesky.law.columbia.edu/2023/08/01/clearly-gottlieb-discusses-proposed-capital-requirement-increases-for-banks/>.

⁴ <https://www.fdic.gov/news/speeches/2023/spiul2723b.html>.

⁵ <https://www.justice.gov/sites/default/files/jmd/legacy/2014/05/01/act-pl79-404.pdf>.

⁶ *Virginia Dep't of Med. Assistance Servs. v. United States Dep't of Health & Human Servs.*, 678 F.3d 918, 400 U.S. App. D.C. 319 (D.C. Cir. 2012).

⁷ *Whitman v. American Trucking Associations, Inc.*, 531 U.S. 457 (2001).

⁸ *Goldstein v. S.E.C.*, 451 F.3d 873 (D.C. Cir. 2006).

Signature Bank (Signature), and First Republic Bank (FRB).⁹ However, these bank failures cannot and should not be attributed to all U.S. banks with more than \$100 billion in assets. The capital requirements dictated by the regulators have not been condoned by Congress and are arbitrary and capricious under the *Administrative Procedure Act* (APA).

The U.S. government has issued regulations for U.S. banks that are based on a framework designed by a coalition of global regulators. It is concerning that U.S. regulators are taking international guidelines and imposing them on banks and ultimately the American public. Consumers will have to pay higher costs that are passed down through more expensive borrowing or banking services more generally. The executive branch hijacked the rulemaking process by circumventing Congress. The executive branch enforces the law, it does not create it. In this case, the Biden administration is ignoring checks and balances to notch a win.

The Proposal is a classic example of the government intervening in the operations of private companies by mandating how they must organize their balance sheets. If finalized, the Proposal has the potential to reduce the availability, or increase the cost of credit for auto loans, credit cards, and mortgages. One paper describes how the regulators' unbridled quest for more stringent capital requirements can make capital allocation more expensive. According to the paper, "[a]ll else equal, making regulated banks less risky may actually raise their cost of capital—with consequent implications for investment, growth, and the development of a shadow banking sector."¹⁰

At the end of the day, "major questions"¹¹ and policy decisions need to be left to Congress. Unelected bureaucrats should not be in the business of creating the law.

Burdens of the Proposal

The Proposal, in some cases, is stricter than the final Basel III framework. For example, the Proposal uses more punitive calculations for residential mortgages held by banks. The calculations are 20 percent higher than Basel III even though the proposal contains no "evidence to support the sizing of the surcharge."¹² These burdensome requirements could weaken U.S. bank competitiveness with foreign-owned banks, or force banks to look for merger opportunities to offset cost increases.

The Urban Institute published a paper highlighting how the new rules harm minority homeowners trying to acquire a mortgage from a bank.¹³ According to the report, the capital requirements are too high across the board for single-family residential mortgages. The enhanced regulations are especially burdensome for low-and moderate-income (LMI) borrowers with loans exhibiting high loan-to-value (LTV) ratios. The report estimates that "[o]n a \$200,000 mortgage with an LTV ratio from 90 to 100 percent," borrowers would pay "an extra \$33 a month."¹⁴

⁹ 88 FR 64032

¹⁰ https://www.hbs.edu/ris/Publication%20Files/Wurgler_Paper_78db6340-ae41-4630-8e25-d990b547171b.pdf.

¹¹ *West Virginia v. Environmental Protection Agency*, 597 U.S. ____ (2022).

¹² <https://www.fdic.gov/news/speeches/2023/spjul2723c.html>.

¹³ <https://www.urban.org/sites/default/files/2023-09/Bank%20Capital%20Notice%20of%20Proposed%20Rulemaking.pdf>.

¹⁴ *Id.*

The competitive nature of the U.S. banking sector is what makes lending costs so sensitive to increased capital requirements. One study found that if a bank is “forced to adopt a capital structure that raises its cost of funding relative to other intermediaries” by as little as 0.2% then it may “become much less profitable” or “lose most of its business.”¹⁵

The Proposal also imposes stringent leverage evaluations for banks that previously did not have to comply. The new mandate will force banks to limit funding for credit cards or reduce exposure to securitizations that fund auto loans and mortgages. One paper from Columbia Business School found that relaxing, instead of expanding, the supplementary leverage ratio (SLR) would allow banks to expand credit “during economic downturns.”¹⁶

Bill Dudley stated in an opinion piece that “[e]quity costs more than deposits or subordinated debt, so banks and their securities units will pass that on in the form of higher lending rates, higher trading costs and reduced market liquidity.”¹⁷ Dudley went on to say there are other ways to enhance stability. For example, “[b]etter and more timely supervision could have prevented the failure of Silicon Valley Bank: Supervisors identified the risks well ahead of time, but simply failed to act quickly or forcibly enough.”¹⁸

Regulators are unilaterally harnessing more power to control how banks construct their capital structure. The new rules could force banks out of some activities and into other activities—such as when mortgage lending largely shifted to nonbanks. This is a prime example of the federal government distorting the allocation of capital.

Regulators are embedding short-term securities’ valuations in capital requirements even though almost all of SVB’s bond portfolio consisted of long-term securities.¹⁹ Simple accounting tweaks, such as marking-to-market all of a bank’s securities can offer transparency to bank shareholders, bondholders, and depositors without the need to account for unrealized gains and losses on short-term securities in bank capital.²⁰ SVB’s depositor base combined with the Fed’s lackluster monetary policy put the bank in a unique position to fail.

According to Allan Meltzer, in the past, increasing reserve requirements would result in a “steep monetary contraction.”²¹ Reserve requirements require banks to hold onto a certain amount of “liquid assets.”²² Similarly, capital requirements require banks to hold onto a certain amount of retained earnings, or issue new stock to absorb potential losses. The Proposal amends the parameters for assets banks can hold, which will constrain the amount of investments or

¹⁵ https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1708173.

¹⁶ https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3798714.

¹⁷ <https://www.bloomberg.com/opinion/articles/2023-09-11/the-fed-s-bank-capital-proposal-isn-t-the-right-answer?smd=undefined&embedded-checkout=true>.

¹⁸ *Id.*

¹⁹ <https://news.bloomberglaw.com/financial-accounting/bank-capital-revamp-avoids-long-term-asset-issue-that-felled-svb>.

²⁰ <https://www.wsj.com/articles/in-todays-banking-crisis-echoes-of-the-80s-thrift-delayed-recognition-risk-taking-deposit-insurance-svb-signature-cfdd2b37>.

²¹ <https://press.uchicago.edu/ucp/books/book/chicago/H/bo3634061.html>.

²² <https://www.clevelandfed.org/en/publications/economic-commentary/2020/ec-202005-evolution-bank-capital-requirements>.

financing banks can make, whether it is in bonds, mortgages, or credit cards. This directly affects American households and consumers. The government should be limited in its ability to mandate how banks should structure their balance sheets. Enhancing regulatory authority, as proffered in the Proposal, would only further entrench the federal government's foothold in banks—forcing them to operate as quasi-governmental entities.

Internal Models

The Proposal arbitrarily, and without direction from Congress, removes the usage of internal models for calculating credit and operational risk for Category I and II banks. The Proposal “would remove the use of internal models to set credit risk and operational risk capital requirements (the so-called advanced approaches) for banking organizations subject to Category I or II capital standards.”²³

The Proposal would also “revise the calculation of single-counterparty credit limits by removing the option of using a banking organization's internal models to calculate derivatives exposure amounts and requiring the use of the standardized approach for counterparty credit risk for this purpose.”²⁴

Banks may use internal models for calculating market risk, but the models may only be used by “trading desks for which a banking organization has received approval from its primary Federal supervisor.”²⁵ Additionally, banks must show that their models are “acceptable” otherwise they would have to use a standardized approach.²⁶ This provides the regulators with seemingly unlimited discretion to critique internal models. Regulators, however, do not have “unbridled” discretionary authority.²⁷ In fact, regulators “must be able to articulate a correlation between the action taken and the reason given for the action. Reasons which are in substance mere rhetoric are not sufficient and indicate arbitrary action.”²⁸

Regulators would still control the internal models that banks may continue to use for market risk calculations. In footnote 232, the regulators explain that the separate capital calculations between trading desks using internal models and others using the standardized approach “could unnecessarily increase capital requirement[s].”²⁹ This begs the question of why introducing a standardized approach is necessary in the first place. The introduction of the complicated requirements for using internal models to calculate market risk is unnecessarily convoluted and fails to prove what benefits come from this new methodology. The Proposal offers no substantive justification for the limits on internal models.

If a trading desk's internal models are approved, regulators could still unilaterally disqualify them from being used to calculate the necessary capital ratios. The Proposal states that:

²³ 88 FR 64031

²⁴ *Id.*

²⁵ 88 FR 64032

²⁶ *Id.*

²⁷ *First Nat. Bank, Bellaire v. Comp. of Currency*, 697 F.2d 674 (5th Cir. 1983).

²⁸ *Id.*

²⁹ 88 FR 64093, n. 232

a banking organization's primary Federal supervisor could determine that the desk no longer complies with any of the proposed applicable requirements for use of the models-based measure for market risk or that the banking organization's internal model for the trading desk fails to either comply with any of the applicable requirements or to accurately reflect the risks of the desk's market risk covered positions.³⁰

This is arbitrary and a gross abuse of the regulators' discretion.

The Proposal would also "eliminate references to model-based approaches" for credit risk mitigation for securitization exposures.³¹ Regulators will also "not include an internal models approach" for equity exposures.³² Instead, the Proposal expects banks to calculate most of the equity exposure under the market risk calculations, which offer strictly regulated internal models. Regulators are provided so much authority to limit the usage of internal models for market risk calculations that they could prove to be no less burdensome than the standardized approach.

Standardized models, instead of internal bank models, hand more power to regulators to determine the quantity and breadth of capital banks must hold. The Proposal has not determined through quantitative analysis that the benefits of standardizing these models would outweigh the cost to banks and the broader economy as a result of higher capital requirements.

Based on some academic literature, the variability in internal models appears to be mixed.³³ The uncertainty in variability does not justify the elimination of internal models to calculate risk charges. When discussing the variability of internal models, the Proposal admits that "severe credit risk and operational risk losses can occur infrequently."³⁴ It also cites a Basel Committee report discussing internal model variability without any other justification to bolster its argument.³⁵ Blind consideration of the Basel Committee's recommendations and beliefs ignores congressional intent as statutorily mandated in P.L. 115-174.

Output Floor

The Proposal restricts the benefits of using internal models for calculating risk. According to the Proposal, the output floor is 72.5 percent.³⁶ This number is the summation of a bank's risk-weighted assets (RWAs) under the expanded approach plus RWAs calculated using the standardized measure for market risk.³⁷ The calculation subtracts out "adjusted allowance for credit losses that is not included in tier 2 capital and any amount of allocated transfer risk reserves."³⁸ The output floor is designed to restrict banks' usage of internal models for market

³⁰ 88 FR 64108

³¹ 88 FR 64073, n. 146

³² 88 FR 64074

³³ https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3879379#.

³⁴ 88 FR 64031

³⁵ 88 FR 64031, n. 13

³⁶ 88 FR 64034

³⁷ Id.

³⁸ Id.

risk calculations, even though the banks would better understand their own market exposure.³⁹ The Proposal offers no substantive justification for the limits on internal models.

The Proposal states that removing the usage of banks' internal models for certain calculations "would increase capital requirements in the aggregate."⁴⁰ According to the Proposal, the regulators' economic analysis finds that the benefits of higher capital requirements outweigh the costs. However, the economic analysis conducted in the Proposal is incomplete and fails to adequately prove that the benefits outweigh the costs. This is underscored by the fact that in October 2023 the regulators began accepting new data on the potential impact of higher capital requirements.⁴¹ Without inputting this new data into its analysis, the Proposal's determination that benefits outweigh the costs is presumptuous and erroneous.

Credit Risk

The proposal wrongly eliminates the use of internal credit risk models and creates a new expanded approach without any empirical evidence to justify the changes.

Reinsurance Credit Risk Transfers

Credit insurance is a private-sector option that allows banks to alleviate capital burdens. Allowing banks to participate in credit risk transfers (CRTs) to ameliorate the burdensome effects of higher capital requirements is a step in the right direction.

Under the Proposal banks should be explicitly authorized to use insurance and reinsurance CRTs to offload asset risk and alleviate the burden of the new capital requirements. The Proposal should allow insurance and reinsurance contracts to be considered as "eligible guarantees" while reinsurers should be considered "eligible guarantors."

The Proposal should not erect regulatory barriers that would prevent banks from using insurance or reinsurance as an option. For example, lowering the risk weight for corporate exposures or even exempting reinsurance from the 100 percent risk weight could be an alternative option.⁴² One paper discusses the potential benefits of expanding government-sponsored enterprise (GSE) CRT exposure to reinsurance.⁴³ The same benefits could be afforded to the banking sector, if the regulatory framework adequately authorizes it.

Other countries already allow their banks to use insurance and reinsurance CRTs, putting banks in the U.S. at a competitive disadvantage.

Consumers, taxpayers, and banks do not need another financial crisis that results in another era of taxpayer-funded bank bailouts. They need tailored regulation that reduces risk and volatility, and gives consumers access to affordable capital—all of which the private sector can offer.

³⁹ <https://www.mayerbrown.com/en/perspectives-events/publications/2023/07/overhaul-of-regulatory-capital-requirements-proposed-by-us-banking-regulators#TwentyFour>.

⁴⁰ 88 FR 64030

⁴¹ <https://www.federalreserve.gov/newsevents/pressreleases/bcreg20231020b.htm>.

⁴² 88 FR 64053, 64054

⁴³ <https://us.milliman.com/en/insight/In-it-for-the-long-haul-A-case-for-the-expanded-use-of-the-GSEs-reinsurance-CRT-executions>.

The Proposal should abide by the statutory mandates in P.L. 115-174 by tailoring regulations and ensuring that banks have the option to use private-sector alternatives to mitigate capital burdens while also enhancing capital allocation to all reaches of the U.S. economy.

Corporate Exposures

In general, the Proposal wrongly favors public company exposure over private business exposure. The Proposal bases this on the fact that public securities are subject to more “enhanced transparency and market discipline.”⁴⁴ This would unnecessarily discourage exposure to small businesses and divert capital to larger publicly traded companies. The Proposal’s economic analysis lacks any discussion of the diversion of capital that would occur due to government intervention. Regulators should remove any provisions that would make it more difficult for banks to provide capital to small businesses and privately-owned businesses.

The 65 percent risk weight is limited to publicly traded businesses with investment grade debt. This unnecessarily excludes private businesses. Exchange-traded fund (ETF) shares that are publicly listed would qualify for the 65 percent risk weight, while mutual funds would be treated more harshly with the 100 percent risk weight because their shares are not publicly traded. UK⁴⁵ and EU⁴⁶ proposals do not contain the same requirement that shares be publicly listed for special treatment. In this case, the U.S. government is picking winners and losers.

Market Risk

The Proposal will allow banks to use internal models to set market risk capital requirements, but “[t]he proposal would limit the use of models to only those trading desks for which a banking organization has received approval from its primary Federal supervisor.”⁴⁷ Moreover, regulators designed the Proposal to hand themselves unbridled discretion to alter a bank’s market risk capital requirements:

*Specifically, as part of the proposal's reservation of authority provisions, the primary Federal supervisor may require a banking organization to maintain an overall amount of capital that differs from the amount otherwise required under the proposal, if the primary Federal supervisor determines that the banking organization's market risk capital requirements under the proposal are not commensurate with the risk of the banking organization's market risk covered positions, a specific market risk covered position, or categories of positions, as applicable.*⁴⁸

The regulators have unilaterally decided to authorize themselves to adjust market risk capital requirements at will. This abuse of discretion would likely violate the APA, especially since this regulation is uniform and would not be tailored to certain banks. In fact, this could apply to

⁴⁴ 88 FR 64054

⁴⁵ <https://www.bankofengland.co.uk/prudential-regulation/publication/2023/december/implementation-of-the-basel-3-1-standards-near-final-policy-statement-part-1>.

⁴⁶ <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A52021PC0664>.

⁴⁷ 88 FR 64032

⁴⁸ 88 FR 64093

banks with less than \$100 billion in assets if the bank's trading assets and trading liabilities are at least \$5 billion or at least 10 percent of its total assets.⁴⁹ The claim that only banks with more than \$100 billion in assets would be affected by the Proposal is erroneous.⁵⁰

The Proposal offers no substantive empirical evidence on how it will affect trading activity. However, the Proposal admits that "higher capital requirements on trading activity may also reduce banking organizations' incentives to engage in certain market making activities and may impair market liquidity."⁵¹ At the same time the Proposal states that empirical studies relating capital requirements to trading activity are "limited" and "mixed."⁵² The Proposal concludes that higher capital requirements on trading and market liquidity "remains a research question needing further study."⁵³ It remains to be seen how the regulators can justify increasing capital ratios for trading activity when they clearly admit they are unsure of the effect it may have on capital markets. Regulators are putting the cart before the horse.

The capital requirements in the Proposal could significantly reduce liquidity in markets and harm retirement plan returns. A prime example of this is the negative effects on collective investment trusts (CITs). National and state-chartered CITs hold approximately \$7 trillion in assets⁵⁴ and "nearly 30 percent of all assets in defined contribution plans."⁵⁵ Instead of making it more difficult to subscribe to CITs, regulators should further enable employees with retirement plans to access CITs. Congress indicated its support for expanding the availability of CITs when the House Committee on Financial Services passed the bipartisan *Retirement Fairness for Charities and Educational Institutions Act of 2023* (H.R. 3063).⁵⁶

Pension funds, mutual funds, and CITs will be negatively affected by the new capital calculations for market risk because banks will be less likely to add exposure to assets that will compel them to raise significantly more equity. Ultimately, these costs get passed down to college savings plans, pension plans, and defined contribution plans.

Operational Risk

The Proposal adds a standardized calculation for determining operational losses.⁵⁷ This differs from the status quo, which allows banks to use internal models to determine operational risk. Calculating operational risk will include factors in the services component of the business indicator such as income and expenses from fees and commission business (e.g., interchange fees, fiduciary fees, fees and commission from securities brokerage, underwriting fees, wire transfer fees, charges on deposit accounts, annuity sales, and underwriting income from insurance and reinsurance activities).⁵⁸ Insurance income is counted here even though it is not

⁴⁹ 88 FR 64032

⁵⁰ 88 FR 64095

⁵¹ 88 FR 64170

⁵² *Id.*

⁵³ 88 FR 64171

⁵⁴ https://www.sec.gov/news/speech/gensler-remarks-investment-company-institute-05252023#_ftn27.

⁵⁵ <https://clsbluesky.law.columbia.edu/2023/11/09/overtaking-mutual-funds-the-hidden-rise-and-risk-of-collective-investment-trusts/>.

⁵⁶ <https://www.congress.gov/bills/118th-congress/house-bill/3063/all-actions>.

⁵⁷ 88 FR 64082

⁵⁸ 88 FR 64084, n. 184

counted in the Basel framework.⁵⁹ All of these services are arbitrarily categorized into the same “services component” regardless of the risk each service exhibits.

Operational risk charges do not differentiate between the different types of bank services offered, including fee-related services. Banks with lots of fee-related activity will face higher capital charges than banks without fee-related activity. However, the Proposal does not provide any empirical evidence substantiating a need for these changes. Moreover, this failure to differentiate between banks that provide fee-based services versus those that do not stands in contrast to 12 USC §5365, which states that the Fed is required to “differentiate among companies on an individual basis or by category” when setting “more stringent prudential standards.”⁶⁰ The broad and uniform application of operational risk fails to take into consideration the variety of services offered by banks and how they differ functionally. This is a gross abuse of regulatory overreach.

The Proposal also arbitrarily expands the “enhanced public disclosure and reporting requirements” to apply to Category III and IV banks.⁶¹ There is no explanation for expanding these requirements other than to provide “consistency” and “promote transparency” for all banks with more than \$100 billion in assets.⁶² This appears to be an abuse of the regulators’ authority and contravenes other parts of statute that clearly intends to impose differentiating regulations on banks with more than \$100 billion in assets.

The stress capital buffer (SCB) also includes operational risk, which is duplicating risk charges applied in the Proposal. The duplicative nature of the operational risk charges and the fact that it deviates from the Basel framework exposes the arbitrary and capricious nature of operational risk charges. In fact, regulators have previously “indicated that the standardized approach implicitly considers operational risk in the calibration of risk weights for credit risk.”⁶³

New capital charges for credit cards will likely restrict lines of credit, which may negatively affect consumers’ credit scores⁶⁴ and potentially increase borrowing costs. Higher capital charges may result in a reduction in credit allocation, which in turn would reduce consumption, and consequently diminish interchange fee revenue that is used to fund rewards programs and consumer privacy protections, such as tokenization. Notably, applying the SLR to Category IV banks would disincentivize these banks from offering additional lines of credit because “the undrawn portion of lines of credit” is considered an off-balance sheet activity that would be included in the denominator of the SLR.⁶⁵

The Proposal put the cart before the horse by expanding the application of operational risk charges. After the Proposal’s comment period closed, the Fed’s Vice Chair for Supervision admitted that there is “a lack of good data” to be able to “quantify cyber risk.”⁶⁶ Regulators

⁵⁹ <https://www.mayerbrown.com/en/perspectives-events/publications/2023/07/overhaul-of-regulatory-capital-requirements-proposed-by-us-banking-regulators#ThirtyFour>.

⁶⁰ 12 USC §5365(a)(2)(A)

⁶¹ 88 FR 64090

⁶² *Id.*

⁶³ <https://www.mayerbrown.com/en/perspectives-events/publications/2023/07/overhaul-of-regulatory-capital-requirements-proposed-by-us-banking-regulators>, n. 33.

⁶⁴ <https://www.wsj.com/buyside/personal-finance/credit-utilization-ratio-91caf804>.

⁶⁵ 88 FR 64038

⁶⁶ <https://www.federalreserve.gov/newsevents/speech/barr20240117a.htm>.

issued the Proposal before it had collected all relevant data and conducted the necessary analyses to fully understand the operational risk charge's effect on the financial markets. It was not until October, three months into the notice and comment process, that the regulators began to gather more relevant data. This flies in the face of the structured notice and comment process as outlined in the APA.

From an accounting standpoint operational risk is fundamentally duplicative and unnecessary. For example, when conducting a quality of earnings report during pre-sale due diligence an accountant would categorize a lawsuit as a non-recurring event that is "unlikely to repeat" and "can be removed from the financial statements."⁶⁷ The Proposal's inclusion of timing losses, which are temporary financial statement errors that can be fixed, as operational losses conflict with concrete accounting standards.⁶⁸ Consequently, this calls into question the validity of operational risk charges.

Custodied Assets

Staff Accounting Bulletin (SAB) 121 would require banks to treat crypto assets held in custody as a liability on their balance sheet, with a corresponding asset.⁶⁹ Since banks must hold capital against any assets on their balance sheets, the capital requirements, even as they exist without finalizing the Proposal, would make it prohibitively expensive to custody these assets. The Proposal would worsen this by imposing an operational risk capital charge that is based on a bank's income, rather than assets, including fee-related income. Any fees generated from custodial services for all assets (including crypto assets) would increase a bank's operational risk capital charge. To the extent a bank can profitably custody crypto assets despite the operation of SAB 121, the Proposal's operational risk charge would erode or eliminate this profitability. Regulators should not hamstring new business opportunities that offer inherently safe and sound services that could benefit households or institutions.

Supplementary Leverage Ratio

Expanding the SLR could deter banks from engaging in the market for Treasury bonds. According to one article by the Fed, the SLR affects Treasury intermediation by affecting banks' "willingness and ability to intermediate in Treasury markets, especially during periods of increased demand for intermediation."⁷⁰ Banks have not "expanded their trading capacity at anywhere near the magnitude of the growth of the market itself" because of the introduction of the SLR.⁷¹ This is what led the Fed to alleviate the burdens of the SLR in March 2020 by exempting Treasuries from the SLR calculation.⁷² Yet, without any economic justification, regulators are expanding the application of the SLR to all banks with more than \$100 billion in assets. This uniform application of the SLR could significantly hamper Treasury bond

⁶⁷ <https://www.mossadams.com/articles/2023/07/quality-of-earnings-report>.

⁶⁸ 88 FR 64180

⁶⁹ <https://www.sec.gov/oca/staff-accounting-bulletin-121>.

⁷⁰ <https://www.federalreserve.gov/econres/notes/feds-notes/dealers-treasury-market-intermediation-and-the-supplementary-leverage-ratio-20230803.html>.

⁷¹ <https://news.bloomberglaw.com/capital-markets/rewiring-of-worlds-biggest-bond-market-will-transform-trading>.

⁷² <https://news.law.fordham.edu/jcfl/2021/03/19/the-supplementary-leverage-ratio-and-its-impact-on-the-bond-market/>.

intermediation.⁷³ The arbitrary expansion of the SLR without any substantive justification is an abuse of the regulators' discretion.

Treasury Bonds

In general, the Proposal would make it more difficult for banks to hold assets on their balance sheets. The colossal issuance of Treasury bonds to fund exorbitant federal government spending and service current debt issuances is hard for the market to absorb.⁷⁴ Regulations, and the stringent capital requirements in the Proposal, will "make it more expensive for banks to intermediate in government bond markets."⁷⁵ As a result, hedge funds are performing "basis trades," or buying Treasuries and selling futures contracts with underlying Treasury bonds by "borrowing in the repo market to finance the trade and provide leverage"⁷⁶—all in order to earn the difference on the bid-ask spread.⁷⁷ This is the market's reaction to a government-imposed restriction on banking activity. U.S. debt needs investors or else the federal government will not be able to fulfill its current debt obligations and make discretionary and mandatory payments in defense and nondefense sectors.

Now, regulators are scrutinizing hedge funds for finding innovative ways to make money off Treasury bond trades for their investors.⁷⁸ If regulators remove incentives for hedge funds and broker-dealers to buy U.S. debt, then it is less likely these entities will want to actively trade Treasury bonds or repurchase agreements. Adding more "margin requirements and fees" by requiring more Treasury bonds to be centrally cleared will likely deter investment to some extent or "inadvertently increase system-wide risks."⁷⁹ The provisions in the Proposal coupled with the new central clearing of Treasury bonds, and the overall scrutiny of basis trades are putting the U.S. Treasury market between a rock and a hard place. The Proposal could put taxpayers at risk of higher costs and result in less liquidity in the Treasury bond market.⁸⁰

SVB's bond portfolio consisted of mostly held-to-maturity (HTM) securities.⁸¹ In March 2022, SVB's "HTM portfolio represented roughly 46 percent of its total assets."⁸² The aggressive increase in interest rates plunged the value of the HTM securities. Additionally, SVB's weak "corporate governance and risk management" ultimately led to its demise.⁸³ However, the Proposal would require Category III and IV banks "to include all AOCI components in common equity tier 1 capital, except gains and losses on cash-flow hedges where the hedged item is not

⁷³ <https://www.federalreserve.gov/newsevents/speech/bowman20240117a.htm>.

⁷⁴ <https://www.wsj.com/finance/why-treasury-auctions-have-wall-street-on-edge-8385f15e?st=qf25v3k5sy5k6kl>.

⁷⁵ <https://www.ft.com/content/41209996-35b0-49cd-bf4e-b7c39b651701>.

⁷⁶ <https://www.federalreserve.gov/econres/notes/feds-notes/recent-developments-in-hedge-funds-treasury-futures-and-repo-positions-20230830.html>.

⁷⁷ <https://www.ft.com/content/927aba63-ef73-44c4-a5df-a5872e988720>.

⁷⁸ <https://www.bloomberg.com/news/articles/2023-11-16/fed-s-barr-joins-chorus-warning-about-hedge-funds-basis-trades>.

⁷⁹ <https://www.ft.com/content/948bd246-7e05-4b52-8865-a680f107319e>.

⁸⁰ https://www.sec.gov/news/statement/peirce-statement-rules-improve-risk-management-12-13-23#_ftnref4.

⁸¹ <https://crsreports.congress.gov/product/pdf/R/R47855#:~:text=capital%20ratio%20%3D%20capital%20ris%EF%BF%BD,RWA%20to%20be%20well%2Dcapitalized..>

⁸² <https://oig.federalreserve.gov/reports/board-material-loss-review-silicon-valley-bank-sep2023.pdf>.

⁸³ *Id.*

recognized on a banking organization's balance sheet at fair value."⁸⁴ SVB's HTM securities "would not have been affected" by this requirement.⁸⁵ It is hard to imagine how this new capital requirement would offer any perceived benefit to the banking sector when it is the accounting classification of HTM securities that masked the true nature of SVB's financial situation. Instead, accounting adjustments that more clearly reflect the mark-to-market value of every bank security could prove to be a less onerous yet more viable option for stemming deposit outflows.⁸⁶

Countercyclical Capital Buffer

Under the Proposal, the countercyclical capital buffer (CCyB) would apply to Category IV banks without any empirical evidence and quantitative analysis to justify this change. In the event CCyB is raised from zero percent, new capital charges that apply to the biggest banks will now equally apply to all banks with more than \$100 billion in assets. This change should not be made without the proper data to justify that the benefits outweigh the costs. Moreover, the new application of the CCyB is another example of blanket regulation that contravenes P.L. 115-174.

Regulatory Capital Deductions

The Proposal would require Category III and IV banks to apply stricter capital deductions for the deferred tax assets (DTAs) and mortgage servicing assets (MSAs) they hold:

Under the proposal, banking organizations subject to Category III or IV capital standards would be required to deduct threshold items from common equity tier 1 capital and apply other capital deductions that are currently applicable to banking organizations subject to Category I or II capital standards instead of the deductions applicable to all other banking organizations, thereby creating alignment across all banking organizations subject to the proposal.⁸⁷

This would apply capital deductions uniformly across banks with \$100 billion in assets—a direct contravention of the tailoring provisions explicitly provided in P.L. 115-174. There is no explicit justification for this amendment. It is probable that the Proposal implicitly assumes the collapse of SVB is a reasonable justification for the uniform application of these new provisions, and other provisions through the Proposal. However, as discussed below, using SVB's collapse as an excuse for blanket regulation of all regional banks is unjustified due to SVB's foibles.

Credit Valuation Adjustment Risk

Category III and IV banks would no longer be able to calculate derivatives exposure using an internal model—the capital ratios must be calculated using the standardized approach for counterparty credit risk (SA-CCR).⁸⁸ All banks with at least \$100 billion in assets "would be required to use SA-CCR to calculate regulatory capital ratios under the standardized approach,

⁸⁴ 88 FR 64036

⁸⁵ <https://crsreports.congress.gov/product/pdf/R/R47855#:~:text=capital%20ratio%20%3D%20capital%20ris%EF%BF%BD.RWA%20to%20be%20well%2Dcapitalized.>

⁸⁶ <https://www.wsj.com/articles/in-todays-banking-crisis-echoes-of-the-80s-thrift-delayed-recognition-risk-taking-deposit-insurance-svb-signature-cfdd2b37.>

⁸⁷ 88 FR 64037

⁸⁸ 88 FR 64033

expanded risk-based approach, and supplementary leverage ratio.”⁸⁹ The Proposal offers no empirical evidence to suggest this would eminently improve the derivatives market. This is also another example of regulators uniformly applying regulations, which directly conflict with the intent of P.L. 115-174.

The airline industry may be negatively impacted by these rule changes. The Proposal “would make it more expensive for banks to do clearly useful things, like helping airlines”⁹⁰ use derivatives to hedge jet fuel prices:

*Airlines have a distinctive operating cost structure in which jet fuel accounts for about 30%–40% of operating expenses resulting in significant financial risk exposure. Any fluctuations in jet fuel prices can lead to distressing financial repercussions for airlines, also because substantial competition with low cost carriers prevents simply passing on cost increases to customers. Historically, airlines deployed financial hedging to manage the risk exposure of jet fuel prices' volatility. Financial derivatives such as future contracts or options can enable airlines to attain future jet fuel requirements at a fixed prearranged price, lessening risk vulnerability to instabilities in jet fuel market spot prices.*⁹¹

Agricultural end-users are also likely to be harmed by the Proposal. The requirements for derivatives clearing may limit the services provided to the U.S. agricultural sector. One report from the U.S. Department of Agriculture estimated “that 94 percent of futures trading by farmers, and 87 percent of options trading, was on corn and soybean contracts.”⁹² Corn and soybean farmers should not have to absorb the cost increases that will result from the Proposal.

Regardless of the method used to calculate the capital requirements for credit valuation adjustment (CVA) risk, regulators still maintain full discretion to alter the ratios at will. According to the Proposal, “the primary Federal supervisor could require the banking organization to maintain an amount of regulatory capital that differs from the amounts required under the basic measure for CVA risk or the standardized measure for CVA risk.”⁹³ This self-appointed limitless discretion to alter the requirements is arbitrary and lacks any substantive justification.

Securitizations

Bankruptcy remoteness prevents the special purpose vehicle (SPV) sponsors from afflicting investors if the sponsor happens to collapse.⁹⁴ It appears that all asset classes for securitizations are treated the same under the Proposal:

⁸⁹ 88 FR 64056

⁹⁰ <https://www.semafor.com/article/01/11/2024/big-banks-mull-the-unthinkable-suing-the-fed>.

⁹¹ <https://www.sciencedirect.com/science/article/abs/pii/S0967070X18305651>.

⁹² <https://www.ers.usda.gov/webdocs/publications/99518/eib-219.pdf>.

⁹³ 88 FR 64154

⁹⁴ https://irathene.q4cdn.com/886888837/files/doc_presentations/2022/Understanding-Structured-Credit_FINAL.pdf.

*asset-backed commercial paper, auto loans/leases, RMBS, credit cards, commercial mortgage-backed securities, collateralized loan obligations, collateralized debt obligations squared, small and medium enterprises, student loans, other retail, and other wholesale*⁹⁵

The risk weights for the securitizations are multiplied by 8 percent. This is ignoring the fact that securitizations of these assets have different risk exposures. Moreover, there is a lack of empirical evidence to treat these securitizations uniformly. This arbitrary requirement is questionable.

Private Credit

Private credit funds are a market solution to a government-imposed headache. Private funds filling the financing void is just an example of the free market working to solve the problem the government created in the first place.⁹⁶ Government regulation in the form of Basel frameworks and the *Dodd-Frank Wall Street Reform and Consumer Protection Act* started to force banks to offload assets from their balance sheets to comply with government rules.⁹⁷ This is happening again now that the regulators have proposed even stricter capital requirements. For example, it was reported that JPMorgan Chase is securitizing its loan portfolio to comply with the new rules.⁹⁸ Government regulation is distorting the market by shifting assets to different corners of the financial markets. The full spectrum of costs, benefits, and circumstances should be considered before finalizing a rule of this magnitude.

Silicon Valley Bank

Since 2011, the Government Accountability Office (GAO) has been sounding the alarm over the federal financial regulators' reluctance to elevate supervisory actions when it is necessary to stymie irresponsible bank behavior. This is relatively concrete evidence that the recent bank failures were not, as the self-evaluation from the Fed asserted, a result of bipartisan legislation enacted in 2018 that tailored bank regulation.⁹⁹ Rather, the bank failures are a result of the regulators' continued failure to enforce regulations that are already on the books.

In the past, Congress has passed legislation that has further subjected the banking sector to a dizzying array of federal regulations. Fortunately, in 2018, Congress passed the bipartisan *Economic Growth, Regulatory Relief, and Consumer Protection Act* (EGRRCPA) to support regional and midsize banks so that they were not subjected to the same stringent rules as the largest banks in the U.S.

In the wake of the 2023 bank failures, the EGRRCPA and the prior Administration's alleged disempowerment of supervisors were immediately blamed for the failures. However, SVB was already well-regulated. For example:

⁹⁵ 88 FR 64265

⁹⁶ <https://www.wsj.com/finance/fed-rate-hikes-lending-banks-hedge-funds-896cb20b>.

⁹⁷ <https://www.govinfo.gov/content/pkg/PLAW-111publ203/pdf/PLAW-111publ203.pdf>.

⁹⁸ <https://www.frl.com/content/5612cba3-1580-4003-a0ac-6623cbe28ee6>.

⁹⁹ <https://www.federalreserve.gov/publications/files/svb-review-20230428.pdf>.

- SVB was already subject¹⁰⁰ to various enhanced prudential standards under the Fed’s Regulation YY, including a requirement to perform internal liquidity stress tests and maintain a contingency funding plan to address potential runs by its depositors.¹⁰¹ The fact is that SVB failed its internal liquidity stress test for a 30-day stress period and Fed examiners failed to follow up adequately.
- SVB was already required to have a risk committee and a chief risk officer to report and resolve any “risk-management deficiencies in a timely manner.”¹⁰² SVB had neglected to fill the chief risk officer position for a period of eight months, and by the Fed’s own admission, Fed staff could have issued a violation citing Regulation YY, but they chose not to.¹⁰³ Clearly, regulations were not the problem; rather, it was the failure to enforce the rules already on the books that led to SVB’s receivership.
- SVB was not subjected to the liquidity coverage ratio (LCR), but it was required to undergo quarterly internal liquidity stress tests. The Fed was aware of these tests and had access to the results but failed to act appropriately. Even if SVB was subject to the LCR, it would have resulted in SVB holding even more high-quality liquid assets (HQLA), such as Treasury bonds. However, it is difficult to see how holding more HQLA would have saved SVB when it faced a substantial liquidity crisis caused by the losses associated with its inventory of devalued Treasury bonds and agency mortgage-backed securities.
- It is worth noting the market value of SVB’s bond portfolio declined because of the Fed’s rapid interest rate hikes. This exposed SVB to substantial interest rate risk (IRR), which ultimately put SVB in a position where it could not liquidate enough assets to fulfill its customers’ deposit withdrawals. As outlined in SVB’s annual SEC filing, the bank was required to submit annual comprehensive capital analysis and review plans to the Fed and undergo stress testing every other year.¹⁰⁴ FDIC regulations also required SVB to submit a resolution plan. SVB submitted a plan in December 2022.

The real source of SVB’s demise was the Fed’s failure to promptly supervise and enforce rules on SVB. According to the GAO’s preliminary report on SVB and Signature, the GAO warned the FDIC and the Fed about issues with properly escalating “supervisory concerns” as early as 2011.¹⁰⁵ The prompt corrective action framework, “which was designed in 1991 to improve regulators’ ability to identify and promptly address deficiencies at depository institutions and minimize losses to the Deposit Insurance Fund—did not result in consistent actions to elevate concerns.”

In 2011, the Federal Reserve’s Office of the Inspector General (OIG) also released a report highlighting the Fed’s inadequate escalation of supervisory actions.¹⁰⁶ The report examined the failures of state member banks from 2009 to 2011. The OIG determined that “examiners identified key safety and soundness risks, but did not take sufficient supervisory action in a

¹⁰⁰ https://financialservices.house.gov/uploadedfiles/2023-03-23_fsc_majority_-_letter_to_frbsf_and_frboard_final_v2.pdf.

¹⁰¹ <https://www.ecfr.gov/current/title-12/chapter-II/subchapter-A/part-252>.

¹⁰² <https://www.law.cornell.edu/cfr/text/12/252.22>.

¹⁰³ <https://www.wsj.com/articles/svb-silicon-valley-bank-collapse-chief-risk-officer-f6e1fcfd>.

¹⁰⁴ <https://ir.svb.com/financials/sec-filings/default.aspx>.

¹⁰⁵ <https://www.gao.gov/assets/gao-23-106736.pdf>.

¹⁰⁶ https://oig.federalreserve.gov/reports/Cross_Cutting_Final_Report_9-30-11.pdf.

timely manner to compel the Boards of Directors and management to mitigate those risks. In many instances, examiners eventually concluded that a supervisory action was necessary, but that conclusion came too late to reverse the bank's deteriorating condition."¹⁰⁷ The OIG also pointed out how the Federal Reserve Bank of Chicago was too slow in escalating its supervisory actions against Irwin Union Bank and Trust (IUBT).

In a 2015 report, GAO critiqued regulators again.¹⁰⁸ The 2015 report found that "regulators could have provided earlier and more forceful supervisory attention to troubled institutions" in the 1980s savings and loan crisis and the 2008 financial crisis.

The Fed was making the same mistakes several years prior to the passage of EGRRCPA. Supervisory failures contributed to SVB's collapse, not tailoring bank regulation. Even the most recent OIG report pointed out that the EGRRCPA's impact was significantly more limited.¹⁰⁹

Lastly, the Fed did not prioritize supervision of the actual financial risks embedded in SVB's IRR. The Fed's report on SVB admits that the Fed deferred an IRR exam "to the third quarter of 2023 in order to prioritize governance and liquidity exams." The report goes on to say that the Fed "should have conducted comprehensive IRR and investment portfolio reviews, with adequate resources, and communicated findings through [matters requiring immediate attention]."

Small Businesses

The Proposal claims that the regulators do not have to analyze the effects of the new regulations on small entities. However, under federal statute, small entities are broadly defined, and are not restricted to small banking organizations.¹¹⁰ Under Section 3 of the *Small Business Act*, a small business concern is defined as "including but not limited to enterprises that are engaged in the business of production of food and fiber, ranching and raising of livestock, aquaculture, and all other farming and agricultural related industries, shall be deemed to be one which is independently owned and operated, and which is not dominant in its field of operation."¹¹¹ In the code of federal regulations, a small business concern is defined as "a concern, including its affiliates, that is independently owned and operated, not dominant in the field of operation in which it is bidding on Government contracts, and qualified as a small business under the criteria in 13 CFR Part 121 and size standards in this solicitation."¹¹² The broad definitions could imply that the regulators need to determine the significant economic impact of higher capital

¹⁰⁷ Id.

¹⁰⁸ <https://www.gao.gov/products/gao-15-365>.

¹⁰⁹ https://www.davispolk.com/insights/client-update/silicon-valley-bank-failure-different-view-federal-reserve-oig-report?utm_source=yutube&utm_medium=email&utm_campaign=2023-10-18%20silicon%20valley%20bank%20failure%20%20%20different%20view%20of%20the%20federal%20reserve%20oig%20report.

¹¹⁰ [https://uscode.house.gov/view.xhtml?req=\(title:5%20section:601%20edition:prelim\)%20OR%20\(granuleid:USC-prelim-title5-section601\)&f=treesort&edition=prelim&num=0&jumpTo=true](https://uscode.house.gov/view.xhtml?req=(title:5%20section:601%20edition:prelim)%20OR%20(granuleid:USC-prelim-title5-section601)&f=treesort&edition=prelim&num=0&jumpTo=true).

¹¹¹ <https://www.govinfo.gov/content/pkg/COMPS-1834/pdf/COMPS-1834.pdf>.

¹¹² https://www.law.cornell.edu/definitions/index.php?width=840&height=800&iframe=true&def_id=6faac0fcffbd719ed27dcfa2b6f6e070&term_occur=2&term_src=Title:48:Chapter:1:Subchapter:H:Part:52:Subpart:52.2:52.219-8.

requirements on small business lending. Currently, the Proposal does not provide a quantitative analysis of the economic impact on small business lending.

Banks with less than \$100 billion in assets could see costs go up because market risk could apply to them because of the “boundary between the trading book and banking book.”¹¹³ Additionally, smaller banks rely on larger banks for services that will be subjected to increased operational risk charges, such as “hedging derivatives, securities brokerage, credit card processing, loan servicing, and billing/payment services.”¹¹⁴ These new costs may be passed down to smaller banks.

Some community banks rely on larger banks to issue credit cards. For example, “many community banks that offer credit cards do so through an agent relationship with an issuing bank. For many that is TCM Bank, operated by the Independent Community Bankers of America.”¹¹⁵ If costs to issue revolving credit go up this could negatively impact community bank customers.

Under the Proposal, the new 65% risk-weight for “investment-grade” corporate debt only applies to publicly traded companies.¹¹⁶ Private companies are excluded from the relaxed risk weights. This makes it more expensive, and less likely, for banks to extend credit to private businesses. Small private businesses do not have access to capital markets like publicly traded companies. This is a quintessential example of the federal government picking winners and losers.

Consumer Finance

The provisions in the Proposal are already forcing banks to rethink how they will allocate credit to consumers. According to the *Financial Times* at least one bank has already threatened to end revolving lines of financing for “credit card customers.”¹¹⁷

In aggregate, potential federal regulations on the credit card market could devastate access to short term lines of credit for millions of Americans. Higher capital requirements for credit cards in conjunction with new Consumer Financial Protection Bureau (CFPB) regulations on credit card late fees,¹¹⁸ and threats from Congress to further regulate credit card routing,¹¹⁹ aim to enervate the credit card market to a point where the product will be significantly more expensive for small businesses and consumers to access lines of credit. The Proposal’s economic analysis does not consider the collective impact of these regulations. In fact, the costs the Proposal will impose on credit card lending are not discussed at all. The economic analysis only observes

¹¹³ <https://www.maverbrown.com/en/perspectives-events/publications/2023/07/overhaul-of-regulatory-capital-requirements-proposed-by-us-banking-regulators>.

¹¹⁴ *Id.*

¹¹⁵ <https://thefinancialbrand.com/news/banking-trends-strategies/durbin-2-0-threat-banks-credit-unions-brace-for-significant-impact-154844/#~:text=Merchant%20groups%20have%20hailed%20the,largely%20funded%20by%20interchange%20fees>

¹¹⁶ 88 FR 64053

¹¹⁷ <https://www.ft.com/content/b6d22697-40dd-46e7-bc07-e6c9caafb21e>.

¹¹⁸ <https://www.consumerfinance.gov/about-us/newsroom/cfpb-proposes-rule-to-rein-in-excessive-credit-card-late-fees/>.

¹¹⁹ <https://www.atr.org/letter/atr-organizes-coalition-letter-opposing-credit-card-competition-act-of-2023/>.

lending services as a whole. This falls short of what is necessary to provide an apt assessment of the implications of higher capital requirements on the credit card market.

Economic Analysis

The Proposal lacks a substantive cost-benefit analysis. Ignoring costs contravenes court precedent that found “[n]o regulation is ‘appropriate’ if it does significantly more harm than good.”¹²⁰ The Proposal’s economic analysis fails to justify the heightened capital requirements. According to the Committee on Capital Markets Regulation, “[w]hile the analysis acknowledges that the Proposed Rule’s capital increases could reduce banks’ lending and capital markets activities, it does not quantify those reductions or the resulting economic costs. Nor does the analysis substantiate or quantify the Proposed Rule’s purported benefits for financial stability.”¹²¹ The Proposal also fails to adequately explicate the potential increase in costs for activities such as “custody and asset management.”¹²² The Congressional Research Service (CRS) notes that:

if regulators raise risk weights to be higher than is commensurate with the activity’s actual risk, then banks would be too disincentivized to engage in an activity, and economic efficiency would fall (or the activity would migrate out of the banking system).¹²³

Economic impact data should have been collected and analyzed prior to issuing the Proposal. Collecting the economic data during the comment period¹²⁴ and then releasing the results for comment after the comment period has closed is not in line with the APA notice and comment process. In fact, “[t]he process of notice and comment rulemaking is not to be an empty charade. It is to be a process of reasoned decision-making. One particularly important component of the reasoning process is the opportunity for interested parties to participate in a meaningful way in the discussion and final formulation of rules.”¹²⁵

The knock-on effects of increasing the amount of capital banks must hold will lead to a significant increase in prices throughout the economy. Businesses “tend to pass on cost increases far more quickly than cost reductions.”¹²⁶ As the cost of borrowing increases, or services cease to exist, due to government-mandated capital controls, businesses will likely pass down these costs to consumers. This effect that “[o]utput prices tend to respond faster to input increases than to decreases” is widely observed in the producer and consumer goods markets.¹²⁷ The Proposal has not analyzed the cumulative effects of new capital requirements on the broader economy at a granular level. The dearth of a proper economic analysis using quantifiable data is grounds for

¹²⁰ *Michigan v. Env’tl. Prot. Agency*, 135 S. Ct. 2699, 192 L. Ed. 2d 674, 25 Fla. L. Weekly Supp. 523, 83 U.S.L.W. 4620 (2015).

¹²¹ <https://www.fdic.gov/resources/regulations/federal-register-publications/2023/2023-regulatory-capital-rule-large-banking-organizations-3064-af29-c-123.pdf>.

¹²² *Id.*

¹²³ <https://crsreports.congress.gov/product/pdf/R/R47855#:~:text=capital%20ratio%20%3D%20capital%20ris%EF%BF%BD,RWA%20to%20be%20well%2Dcapitalized>.

¹²⁴ <https://www.federalreserve.gov/newsevents/pressreleases/bcreg20231020b.htm>.

¹²⁵ *Conn. Light and Power Co. v. Nuc. Reg. Com’n*, 673 F.2d 525 (D.C. Cir. 1982).

¹²⁶ <https://www.cuna.org/content/dam/cuna/advocacy/priorities/documents/True-Impact-of-Interchange-Regulation-CornerstoneAdvisors-June-2023.pdf>.

¹²⁷ <https://www.jstor.org/stable/10.1086/262126>.

the withdrawal of the Proposal because it fails to conform with the provisions outlined in the APA.

The analysis admits that it does not consider the Proposal's effect on the SCB.¹²⁸ The SCB maintains a floor of 2.5 percent of RWA, which would consequently rise because the Proposal increases RWAs. The full analysis is incomplete and needs further evaluation before any rule can be finalized.

The Proposal fails to show the calculations and methodology used to determine certain estimates in the economic analysis.¹²⁹ For example, the Proposal estimates that RWAs "associated with banking organizations' lending activities would increase by \$380 billion for holding companies subject to Category I, II, III, or IV capital standards."¹³⁰ The Proposal claims that the benefits will outweigh the costs and cites a few academic papers.¹³¹ However, the papers do not specifically analyze the provisions of the Proposal and how they would affect bank lending activity.

The burdens of the Proposal "would slightly decrease marginal risk-weighted assets attributable to retail and commercial real estate exposures."¹³² Limiting retail exposure would potentially include a situation where banks limit offerings or increase costs for certain consumer finance products such as auto loans, credit cards, bank accounts, money transfers, and student loans. The Proposal is also admitting that the heightened capital requirements would force banks to reduce their exposure to loans originated to "small-and medium-sized businesses."¹³³ The provisions in the Proposal would require banks to hold more capital to account for RWA exposure to retail and commercial real estate exposure. Banks could either hold onto these exposures or release them and let a nonbank service these products. Either way, the federal government is distorting the market for retail lending and commercial real estate.

The Proposal fails to incorporate an economic analysis of trading activity that would justify the higher capital requirements. The evidence of benefits is few and far between. The analysis states that "existing empirical studies on the relationship between capital requirements and market liquidity are limited and empirical evidence on causal effects of higher capital requirements on liquidity is mixed."¹³⁴ Additionally, more stringent "capital requirements on market making activity and market liquidity remains a research question needing further study."¹³⁵ This does not prove that the benefits of the Proposal outweigh the costs. In fact, "the agency must examine the relevant data and articulate a satisfactory explanation for its action, including a 'rational connection between the facts found and the choice made.'"¹³⁶ The analysis is incomplete and thus deviates from the appropriate notice and comment process in the APA.

¹²⁸ 88 FR 64169, n. 465

¹²⁹ https://punchbowl1.news/wp-content/uploads/FILE_5283.pdf.

¹³⁰ 88 FR 64169

¹³¹ *Id.*, n. 469

¹³² 88 FR 64170

¹³³ 88 FR 64039

¹³⁴ *Id.*

¹³⁵ 88 FR 64171

¹³⁶ *Motor Vehicle Mfrs. Ass'n v. State Farm Mutual Automobile Ins. Co.*, 463 U.S. 29 (1983).

The regulators need to tread carefully or risk exposing their arbitrary Proposal to future litigation. The Proposal is economically significant and needs clear congressional authorization pursuant to the major questions doctrine.¹³⁷ Currently, the Proposal is an abuse of regulators' discretion and deviates from congressional intent. P.L. 115-174 clearly intends for regulators to tailor and differentiate regulation among banks. Instead, the Proposal's regulatory uniformity contradicts statute. The regulators also fail to analyze both the holistic and granular impacts on the broader U.S. economy.

* * * *

Thank you again for inviting me to this hearing. I look forward to answering your questions.

* * * *

Appendix A: Risk-Based Capital Surcharges for Global Systemically Important Bank Holding Companies; Systemic Risk Report (FR Y-15)

The regulators are also proposing to make changes to the global systemically important bank holding company (GSIB) surcharge.¹³⁸ This requirement to hold extra equity capital only applies to Category I banks.

The Proposal is expanding the definition of "financial institution" to include "savings and loan holding companies, private equity funds, asset management companies, and exchange-traded funds."¹³⁹ The arbitrary decision to add these entities to the expanded definition could deter investment in small businesses and limit the availability of funding through private credit vehicles. Committing capital to private funds would increase a GSIB surcharge and require banks to hold more capital. Although footnote twenty-three states that private equity fund portfolio companies would not be included in the new definition unless they meet the definition of "financial institution," the fact that private equity funds are roped into the definition could deter GSIBs from committing capital to private credit funds,¹⁴⁰ or other funds dedicated to managing small private companies. Ultimately, pension funds and their beneficiaries will feel the reverberations of reduced returns if deals fail to execute due to GSIB's reluctance to commit capital.

All exchange-traded funds (ETFs), except bond ETFs, are added to the new definition of "financial institution." This will reduce bank capital investment in ETFs managed by other asset management firms, but also stymie investment in a GSIB's own ETF portfolio. Ultimately, this reduces liquidity in capital markets. The Proposal fails to offer a substantive and empirical assessment for why the definition needs to be expanded to include ETFs.

¹³⁷ *West Virginia v. EPA*, No. 20-1530 (U.S. Jun. 30, 2022).

¹³⁸ <https://www.govinfo.gov/content/pkg/FR-2023-09-01/pdf/2023-16896.pdf>.

¹³⁹ 88 FR 60391

¹⁴⁰ <https://www.ft.com/content/c3c3d1f3-0ebc-4199-b650-1562e8e7c8a4>.

Regarding asset management, the Proposal ignores the concept of bankruptcy remoteness for managing assets held in a special purpose vehicle (SPV). It also could have a detrimental effect on the efficacy and returns for bank loan funds offered by asset management firms. Bank loan funds have proven to pose as a durable hedge against the Fed's interest rate hikes. According to Morningstar, "[o]ver a 12-month trailing period ending Aug. 9, the average bank-loan fund has returned 7.1% while the overall bond market has lost 2.9%."¹⁴¹

The Proposal also wants to amend the calculation to include the agency model, or a GSIB's guarantee of a client performance during over the counter (OTC) derivatives transactions. This may deter GSIBs from acting as derivatives clearing intermediaries under the agency model.

The inclusion of securities not listed on an exchange or registered with the SEC would negatively impact investment in private companies. Small private business with less than 500 employees would be impacted. Moreover, the number of private companies far outstrips the number of public companies in the U.S.¹⁴² In fact, 87 percent of U.S. businesses with more than \$100 million "in revenue are private."¹⁴³

Certificates of deposit (CDs) are low risk and pose little redemption risk because of the penalty depositors face if they withdraw their funds before the maturity date.¹⁴⁴ Even transferable CDs pose little risk and offer "higher returns."¹⁴⁵ The justification for including any type of CD in a GSIB's surcharge calculation is tenuous at best.

Applying derivatives to the calculation for cross-jurisdictional activities would likely include credit-linked notes (CLNs). This is noted by the Proposal when it states that the omission of derivatives from this calculation may "present opportunities for a banking organization to use derivatives to structure its exposures in a manner that reduces the value of its systemic indicators without reducing the risks the indicator is intended to measure."¹⁴⁶ However, the Proposal fails to highlight that the regulators' proposed increase in capital requirements is what is forcing banks to lean on CLNs "to reduce regulatory capital charges on the loans they make."¹⁴⁷

Moreover, the Proposal dismisses the structural benefits of CLNs and other synthetic securitizations. In some cases, these instruments utilize SPVs, which maintain the advantage of bankruptcy remoteness. The Fed pointed out that "a Board-regulated institution transfers the risk of a reference portfolio of on-balance sheet exposures to a special purpose vehicle using a guarantee or credit derivative. The special purpose vehicle issues credit-linked notes to investors, and the Board-regulated institution takes the cash proceeds of the notes as collateral supporting the special purpose vehicle's performance on the guarantee or credit derivative."¹⁴⁸ The Fed has even admitted that directly issuing CLNs "is similar to practices commonly used for mitigating

¹⁴¹ <https://www.morningstar.com/markets/5-top-performing-bank-loan-funds>.

¹⁴² <https://www.hamiltonlane.com/en-us/insight/staying-private-longer>.

¹⁴³ Id.

¹⁴⁴ <https://www.investopedia.com/pros-and-cons-of-cds-5223947>.

¹⁴⁵ <https://www.cnbc.com/select/what-are-brokered-cds/>.

¹⁴⁶ 88 FR 60394

¹⁴⁷ <https://www.wsj.com/finance/banking/bank-synthetic-risk-transfers-basel-endgame-62410f6c>.

¹⁴⁸ <https://www.federalreserve.gov/supervisionreg/legalinterpretations/reg-q-frequently-asked-questions.htm>.

credit risk that the Board recognizes in its capital rule.”¹⁴⁹ The Fed goes on to say that “[t]hrough a directly issued credit-linked-note transaction, firms can, in principle, transfer a portion of the credit risk on the referenced assets to the credit-linked-note investors at least as effectively as the synthetic securitizations that qualify under the capital rule.”¹⁵⁰ The Proposal should explicitly authorize the usage of capital markets-based tools to mitigate credit risk.

The Proposal includes reciprocal or “sweep” deposits in the short-term wholesale funding indicator.¹⁵¹ This would hamper the usage of reciprocal deposits, which offers a service to spread deposits around to various participating banks, including community banks, to ensure depositors’ funds stay under the \$250,000 deposit insurance limit. Reciprocal deposits should be removed from the short-term wholesale funding indicator because they are fundamentally different from brokered deposits.

Additionally, the vilification of short-term wholesale funding is unwarranted. In 2021 the Fed published a study showing how “[g]lobal banks mainly use” short-term wholesale funding “to finance liquid, near risk-free arbitrage positions.”¹⁵²

The Proposal admits the cost of compliance would compound the increase in capital requirements found in the bank capital rule. The provisions in the Proposal would amount to a “\$13 billion aggregate increase in the risk-based capital requirements of domestic GSIBs.”¹⁵³

The arbitrary and capricious nature of the Proposal calls its validity and legality into question.

Appendix B: Long-Term Debt Requirements for Large Bank Holding Companies, Certain Intermediate Holding Companies of Foreign Banking Organizations, and Large Insured Depository Institutions

The regulators are proposing that non-GSIB bank holding companies (banks) “issue and maintain minimum amounts of long-term debt.”¹⁵⁴ Ostensibly, this would mitigate the risk of uninsured deposits withdrawing from banks that rely on their deposits.¹⁵⁵ However, this would also leverage banks and propagate bank instability.¹⁵⁶ A new government-imposed “substantial layer of liabilities” ahead of uninsured deposits would further subject banks to more regulatory oversight and scrutiny.¹⁵⁷ Imposing long-term debt (LTD) on banks is also akin to additional deposit insurance¹⁵⁸ because it introduces a new moral hazard for uninsured depositors.¹⁵⁹ If the LTD reduces “the likelihood” of uninsured depositors from withdrawing it would not only

¹⁴⁹ <https://www.federalreserve.gov/supervisionreg/legalinterpretations/reg-q-frequently-asked-questions.htm>.

¹⁵⁰ <https://www.federalreserve.gov/supervisionreg/legalinterpretations/reg-q-frequently-asked-questions.htm>.

¹⁵¹ 88 FR 60395

¹⁵² <https://www.federalreserve.gov/econres/feds/files/2021032pap.pdf>.

¹⁵³ 88 FR 60397

¹⁵⁴ 88 FR 64526

¹⁵⁵ 88 FR 64527

¹⁵⁶ <https://www.finregrag.com/p/bank-resilience-equity-capital-versus>.

¹⁵⁷ 88 FR 64527

¹⁵⁸ <https://www.mayerbrown.com/en/perspectives-events/publications/2023/08/long-term-debt-requirements-proposed-for-us-regional-banks>.

¹⁵⁹ 88 FR 64528

increase a bank's debt load but also signal to all depositors that their funds will be safe even if bank management takes greater risks.¹⁶⁰ Introducing a new moral hazard would increase bank instability, not mitigate it.

The Proposal "provides a means for *de facto* extending deposit insurance through regulation."¹⁶¹ The World Bank and International Monetary Fund (IMF) have discussed how deposit insurance enhances instability. With deposit insurance, "banks are encouraged to finance high-risk, high-return projects. As a result, deposit insurance may lead to more bank failures and, if banks take on risks that are correlated, systemic banking crises may become more frequent."¹⁶² LTD is no different. LTD acts as a form of insurance for depositors that could propagate moral hazard concerns, amplify regulatory scrutiny, and exacerbate bank instability.

The Proposal further entrenches regulators' control of banks. This is evidenced by the Proposal's admission that the Fed "reserve[s] the authority" to increase or lower a bank's LTD.¹⁶³ The Fed is also allowed to regulate whether a bank may repurchase its LTD¹⁶⁴ and what type of debt securities may be included in LTD.¹⁶⁵ Additionally, the Proposal prohibits banks from issuing external short-term debt without any consideration of the costs versus the benefits.¹⁶⁶ The increase in regulatory control of the banks covered under this Proposal has not been proven to improve the overall stability of the banking sector.

The LTD minimums provided in the Proposal are effectively meaningless. Apart from the notice and opportunity for a bank to respond, an agency has seemingly unlimited discretion to raise or lower LTD minimums and add or subtract debt securities that qualify as eligible LTD.¹⁶⁷

The Credit Suisse debacle is a perfect example of the legal risk associated with mandating banks to issue LTD. The terms and conditions of the new UBS additional tier 1 bonds (AT1s) combined "with the legislative framework give the Swiss authority the capability to determine whether a viability event has occurred, even if the capital ratio threshold has not been breached."¹⁶⁸ In a lawsuit filed in Japan, investors are suing the brokers that sold them the Credit Suisse AT1s, claiming that they "did not mention the viability provision in a brochure typically provided to buyers of foreign securities."¹⁶⁹ Forcing banks to issue LTD ironically opens banks up to more operational risk, which would be held accountable under the more stringent operational risk charges in the Proposal. Although the Proposal prevents banks from offering external LTD that can be converted into equity prior to a bank entering resolution, it does not prohibit conversion to equity during resolution. Moreover, "U.S. intermediate holding companies (IHCs) of foreign

¹⁶⁰ 88 FR 64527

¹⁶¹ <https://www.maverbrown.com/en/perspectives-events/publications/2023/08/long-term-debt-requirements-proposed-for-us-regional-banks>.

¹⁶² https://papers.ssrn.com/sol3/papers.cfm?abstract_id=629183.

¹⁶³ 88 FR 64530

¹⁶⁴ *Id.*

¹⁶⁵ 88 FR 64531

¹⁶⁶ 88 FR 64542

¹⁶⁷ 88 FR 64533

¹⁶⁸ <https://www.ft.com/content/d8a4dc31-ac20-4bac-8167-c32e3e282bcb>.

¹⁶⁹ <https://www.bloomberg.com/news/articles/2023-12-04/credit-suisse-at1-fallout-widens-in-japan-with-more-lawsuits>.

banking organizations”¹⁷⁰ would be required to issue internal LTD with a conversion trigger that would give the Federal Reserve the authority to require the “IHC to convert or exchange all or some of the eligible internal LTD into common equity tier 1 capital on a going-concern basis.”¹⁷¹

The Proposal’s goal is for banks to issue external LTD to institutional investors, not retail investors. However, demand for LTD is uncertain following the collapse of Credit Suisse.

The Proposal would fundamentally alter the structure of the debt liabilities held by banks. The economic analysis assumes there will be demand for LTD from institutional investors. However, the Proposal admits that academic “literature on subordinated bank debt does not always find historically that price signals from such debt led such banks to limit their growth or take action to improve their safety and soundness.”¹⁷² The benefits of LTD are unclear. In fact, there is a “potential lack of understanding and experience among market participants with LTD-based protection for deposits.”¹⁷³

The Proposal claims that requiring new LTD will save \$800 million per year in assessments.¹⁷⁴ However, the regulators admit that the Proposal “does not consider whether, or to what extent, deposit insurance assessments, or a change in the level of deposit insurance assessments, could have indirect effects on estimated costs and benefits of this proposal.”¹⁷⁵ Additionally, “the size of the estimated LTD needs and costs presented in this section do not account for either of these potential effects of the Basel III proposal.”¹⁷⁶ Without analyzing the compounding effects of additional capital requirements, it is likely that the costs of implementing new LTD would be higher than anticipated.

The Proposal will raise costs throughout the U.S. economy. The regulators admit that “LTD is generally more expensive than the short-term funding banking organizations could otherwise use, the proposal is likely to raise funding costs in the long run.”¹⁷⁷ Additionally, regional banks will see income decline. Category IV banks will see “a twelve-basis point permanent decline in NIMs.”¹⁷⁸ The banks may have to increase “interest rates on new loans” to offset the cost of LTD.¹⁷⁹

The size and scope of the new LTD requirements could “strain the market capacity to absorb the full amount of such issuance if issuance volume exceeds debt market appetite for LTD instruments.”¹⁸⁰ This illiquidity is further compounded by the higher capital requirements for market risk as outlined in the bank capital rule.

¹⁷⁰ 88 FR 64526

¹⁷¹ 88 FR 64540

¹⁷² 88 FR 64551

¹⁷³ *Id.*

¹⁷⁴ *Id.*

¹⁷⁵ 88 FR 64551, n. 95

¹⁷⁶ 88 FR 64551, n. 97

¹⁷⁷ 88 FR 64552

¹⁷⁸ 88 FR 64553

¹⁷⁹ *Id.*

¹⁸⁰ *Id.*

Members of Congress led a letter questioning the unnecessary uniformity of the Proposal as it applies to Categories II, III, and IV banks—all with varying asset sizes that should be treated differently.¹⁸¹ This is another example of regulators circumventing Congress and contravening P.L. 115-174. The Proposal highlights how it believes issuing LTD will enable more market discipline, but it also states that the “scope for these effects is uncertain for a number of reasons including but not limited to potential lack of understanding and experience among market participants with LTD-based protection for deposits.”¹⁸² So, it calls into question whether any empirical analysis has been conducted to determine whether the desired effects would materialize.

Instead of relying on additional leverage and heightened interest rates on loans to save losses to the Deposit Insurance Fund (DIF), policies expanding the usage of reciprocal deposits should be considered. Understanding how monetary policy affects bank stability should also be more carefully observed. Some academics have questioned whether quantitative easing contributed to the surge in uninsured deposits in recent years.¹⁸³

The Proposal claims that the collapses of SVB, Signature, and FRB changed the dynamic of the banking sector such that it justifies the implementation of LTD requirements for banks. However, each of these banks harbored foibles that ultimately led to their downfall.

The arbitrary and capricious nature of the Proposal calls its validity and legality into question.

¹⁸¹ <https://twitter.com/RepTimmons/status/1727418546941026718>.

¹⁸² 88 FR 64551

¹⁸³ <https://www.chicagobooth.edu/review/did-fed-contribute-svbs-collapse>.

Chairman BARR. Thank you. Mr. Guynn, you are now recognized for 5 minutes.

STATEMENT OF RANDALL GUYNN, CHAIR, FINANCIAL INSTITUTIONS, DAVIS POLK

Mr. GUYNN. Thank you Chairman Barr, Ranking Member Foster, and members of the subcommittee. Thank you for inviting me to speak today.

Starting last July, the U.S. banking agencies issued a series of proposed regulations that would significantly increase the going-concern capital of the largest U.S. banks. Like an excise tax, this will increase the cost and decrease the supply of credit to businesses and families. The agencies would also impose a new gone-concern capital requirement on large regional banks in the form of long-term debt that is subordinate to all runnable liabilities.

Let me highlight a few points about this.

First, if you combine the going-concern and the gone-concern capital requirements those two proposals would fall most heavily on the regional banks. They would nearly double the current capital requirements of those banks. This would substantially eliminate tailoring between the GSIBs and the regional banks, giving the regional banks a powerful incentive to grow larger to remain competitive.

Second, the Basel III Endgame proposal would increase the required capital for market risk by 77 percent. This will increase the cost and reduce the supply of market making. Markets will become less liquid. It will become more expensive for businesses and local governments to raise debt and equity capital. It will make it more expensive for manufacturers, farmers, and others to hedge their risks.

Third, the Basel III Endgame would subject U.S. banks to significantly higher capital requirements than banks in the U.K., Europe, and Asia. Virtually every other country has implemented the international framework in a capital-neutral way, but the U.S. proposal would not. In particular, the international framework imposes an output floor equal to 72.5 percent of the standardized approach for credit risk, but the United States would impose a floor of 100 percent. Even if the U.S. proposal were capital neutral, U.S. banks would be subject to higher capital requirements than their foreign competitors. That is because the Fed uses stress testing to set capital requirements. Foreign banks are subject only to a capital conservation buffer of 2.5 percent, whereas most large U.S. banks are subject to a stress capital buffer that is higher than 2.5 percent and never lower.

Fourth, by imposing a new capital tax on credit risks the proposal will increase the cost and reduce the supply of credit. This will result in more and more credit being supplied to the economy by non-bank financial institutions, where there is less visibility, less liquidity, and less capital in an integrated financial system that creates more stability risk, even for banks. The market share of non-bank financial institutions has doubled since 1980, from 30 percent to nearly 60 percent of all credit supplied in the U.S. economy, and the Basel III Endgame proposal would encourage this trend.

Fifth, I cannot recall another rule that would have such a big effect on the U.S. economy with so little supporting data. Although the regulators said they performed a holistic review of capital requirements, they did not release any data from that review, and certainly no rigorous cost-benefit analysis.

Finally, the opposition to the U.S. proposal is unprecedented. I cannot recall another proposal that received so many dissents from agency principals or so many negative comments from such a diverse cross-section of the public and by Members of Congress on both sides of the aisle.

I am happy to answer any questions that members of the subcommittee may have.

[Prepared statement of Mr. Guynn follows:]

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STATEMENT OF
RANDALL D. GUYNN
BEFORE

THE SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND MONETARY POLICY
OF THE HOUSE COMMITTEE ON FINANCIAL SERVICES

UNITED STATES HOUSE OF REPRESENTATIVES

WASHINGTON, D.C.

JANUARY 31, 2024

**RULES WITHOUT ANALYSIS: FEDERAL BANKING PROPOSALS UNDER THE
BIDEN ADMINISTRATION**

RANDALL D. GUYNN BIOGRAPHY

My name is Randall D. Gynn and I am Chairman of the Financial Institutions Group at Davis Polk & Wardwell LLP, where I have worked since 1986. I am the author, co-author or editor of numerous books and other publications on U.S. bank regulation, including *Lessons Learned from SVB's Sudden Failure and Related Contagion*, Yale Law School (Dec. 1, 2023); *Resolution of US Banks and Other Financial Institutions*, in *Debt Restructuring* (3d ed. Oxford University Press 2022); *Bank Resolution and Crisis Management* (Oxford University Press 2016); *Regulation of Foreign Banks & Affiliates in the United States* (9th ed. Thomson Reuters 2016); *Framing the Too Big to Fail Problem: the Path to a Solution*, in *Across the Great Divide: New Perspectives on the Financial Crisis* (Hoover Institution and Brookings Institution, 2014); *The Too Big to Fail Problem: The Path to a Solution* (Bipartisan Policy Center 2013); *Are Bailouts Inevitable?*, *Yale Journal on Regulation* (2012). I have co-taught a seminar on the history and regulation of money, banking and crypto assets for seven straight years at BerkeleyLaw. I represent a large number of banks and other financial institutions, but I am here today in my individual capacity and not on behalf of any client. The views I express are my own, and not necessarily those of Davis Polk, any client or any other organization with which I have been affiliated.

Introduction

Since last July, the U.S. federal banking agencies¹ (**agencies**) have issued a series of proposed regulations that would significantly increase the going-concern and gone-concern capital, or **GLAC**,² requirements and the resolution planning requirements applicable to U.S. banking organizations with \$100 billion or more in total consolidated assets (**large banking organizations** or **LBOs**).

This package of proposed regulations includes proposed amendments to the U.S. risk-based capital requirements (**B3E proposal**)³ to implement the Basel III endgame international framework (**B3E International Framework**);⁴ proposed amendments to the capital surcharge applicable only to U.S. global systemically important banking organizations (**GSIBs**) known as the GSIB surcharge;⁵ a proposed extension and expansion of a portion of the GLAC requirements currently applicable only to the U.S. GSIBs under the Federal Reserve's rule on total loss-absorbing capacity (**TLAC**)⁶ to all LBOs – namely, the long-term debt (**LTD**) requirement at both the holding company (**HC**) and insured depository institution (**IDI**) levels and the clean holding company requirements at the HC level (**GLAC proposal**);⁷ and proposed amendments to the resolution planning requirements for bank holding companies (**BHCs**) and IDIs designed in part to extend some of the requirements currently applicable only to the U.S. GSIBs to all LBOs.⁸ The Federal Reserve's Vice Chair for Supervision has also said the Federal Reserve plans to amend the stress scenario framework underlying the calculation of the stress capital buffers (**SCBs**) for each LBO annually in the supervisory stress-testing process,⁹ presumably to increase the going-concern capital requirements of all LBOs still further, in addition to the significant increase in capital requirements contemplated by the B3E proposal.

Various principals at the agencies have indicated that they also plan to revise the existing liquidity requirements to reflect lessons learned from the failures of Silicon Valley Bank (**SVB**), Signature Bank and First Republic Bank last spring.¹⁰

The proposed amendments would implement these significant increases in capital and other enhanced prudential standards in a way that would largely eliminate the existing tailoring of these standards among various categories of LBOs. The existing tailoring was mandated by Section 401 of the Economic Growth, Regulatory Relief, and Consumer Protection Act of 2018 (**EGRRCPA**),¹¹ which was enacted by Congress with substantial bipartisan consensus.¹² The proposed amendments would do so by extending virtually all of the capital requirements

¹ Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation.

² GLAC stands for gone-concern loss-absorbing capacity, but it means the same thing as gone-concern capital.

³ 88 Fed. Reg. 64028 (Sept. 18, 2023) (first published by the agencies on July 27, 2023).

⁴ Basel Committee on Banking Supervision, *Basel III: Finalising post-crisis reforms* (Dec. 7, 2017).

⁵ 88 Fed. Reg. 60385 (Sept. 1, 2023).

⁶ 82 Fed. Reg. 8266 (Jan. 24, 2017). TLAC is the sum of going-concern capital and GLAC requirements.

⁷ 88 Fed. Reg. 83364 (Sept. 19, 2023).

⁸ 88 Fed. Reg. 64626 (Sept. 19, 2023) (BHCs); 88 Fed. Reg. 64579 (Sept. 19, 2023) (IDIs).

⁹ See note 49 below.

¹⁰ See, e.g., Michael J. Hsu, Acting Comptroller of the Currency, *Building Better Brakes for a Faster Financial World* (Jan. 18, 2024).

¹¹ Pub. L. No. 115-174, 132 Stat. 1296, § 401 (2018).

¹² The EGRRCPA passed the House with the support of 225 Republicans and 33 Democrats. In the Senate, 50 Republicans and 16 Democrats voted in favor of the legislation.

currently applicable only to the U.S. GSIBs to all LBOs, except the GSIB surcharge and the enhanced supplementary leverage ratio (**eSLR**).

A disproportionate amount of the costs of this flattening of the existing tailoring regime will fall on the regional bank LBOs. For example, the combined impact of the B3E proposal and the GLAC proposal would be to double the combined going-concern capital and gone-concern capital requirements that currently apply to the regional bank LBOs, as shown on [Exhibit A](#). The agencies have calibrated the proposed LTD requirement using the capital refill method, which is the same method used to calibrate the LTD requirement applicable to the U.S. GSIBs. That method makes sense for the U.S. GSIBs, which have all adopted a single-point-of-entry (**SPOE**) recapitalization within resolution strategy in their resolution plans under Section 165(d) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (**Dodd-Frank Act**). That strategy needs sufficient loss-absorbing capacity to fully recapitalize a firm's material IDI and non-IDI subsidiaries assuming the capital of those subsidiaries has been fully depleted. But the regional bank LBOs have not adopted SPOE resolution strategies so a capital refill method of calibrating any LTD requirement probably imposes unjustified costs on them. In addition, the proposed GLAC requirement would require regional bank LBOs, but not the U.S. GSIBs, to satisfy the proposed minimum LTD requirement at both the HC and IDI levels. Finally, because the proposed LTD requirement would require the LTD to be subordinated to all runnable liabilities, it is equivalent to a requirement to double the going-concern capital of the regional bank LBOs in the form of more Tier 2 subordinated debt capital.

This disproportionate impact on the regional bank LBOs would give them a powerful economic incentive to consolidate to achieve a scale closer to that of the U.S. GSIBs to avoid becoming uncompetitive with the U.S. GSIBs and with the largely unregulated nonbank financial sector,¹³ which already provides nearly 60% of the credit to the U.S. economy.¹⁴ Despite the apparent policy of the Biden Administration to discourage further consolidation among the non-GSIB LBOs,¹⁵ this powerful economic incentive will likely result in a banking system with a distribution curve shaped like a barbell. The U.S. GSIBs and a few regional bank LBOs will be at one end of the distribution curve and the community banks and mid-sized banks will be at the other end of the curve, with few if any regional bank LBOs in the middle.

Despite the magnitude of the proposed going-concern and gone-concern capital increases, the agencies have provided virtually no data, and certainly no rigorous cost-benefit analysis, to justify these significant increases.

The banking agencies implicitly acknowledged that they had not provided sufficient data by asking the LBOs for data on which to analyze the economic impact of the proposal in October,

¹³ See, e.g., Debopriyo Bhattacharyya et al., *The Global Banking Annual Review 2023: The Great Banking Transition*, McKinsey & Company, 26-38 (October 2023).

¹⁴ See, e.g., Michael S. Barr, Federal Reserve Vice Chair for Supervision, *Why Bank Capital Matters* (Dec. 1, 2022) ("In fact, nonbank financial intermediaries, broadly defined, fund nearly 60 percent of the credit to the U.S. economy today.").

¹⁵ Executive Office of the President, Exec. Order No. 14036 Sec. 5(e), 86 Fed. Reg. 36987, 36992 (July 9, 2021); Assistant Attorney General Jonathan Kanter, *Promoting Competition in Banking* (June 20, 2023) ("The time is indeed ripe for us to re-examine how we assess bank mergers under the statutory framework that Congress has enacted."); CFPB Director Rohit Chopra, Statement at December Open Meeting of the FDIC (Dec. 14, 2021).

more than two months after the B3E proposal was first published.¹⁶ But they compounded the problem of lack of data-based justification by closing the comment period on the B3E proposal on the same day that the data submissions were due, rather than giving the public an opportunity to comment on their new economic impact and cost-benefit analysis at the same time as the B3E proposal itself.

This is curious since the Vice Chair for Supervision stated in his first speech and several times thereafter that he had started a holistic review of capital standards months before the B3E proposal was published. Yet none of the data presumably generated from that review has ever been released, despite several requests from several members of Congress.¹⁷

As a result of the initial insufficiency and timing of any subsequent data analysis, the agencies' package of proposals may not satisfy the requirements of the Administrative Procedure Act (APA), which requires agencies to provide a reasonable basis for their proposed regulations, arguably including supporting data at or before the time they are proposed so that the public has a meaningful opportunity to comment on the data.

This lack of data is particularly concerning in the case of the B3E proposal since it was issued for public comment despite an unprecedented level of dissent among the principals at the agencies and from the public. For example, Federal Reserve Governors Christopher Waller and Michelle Bowman, and FDIC Vice Chair Travis Hill and FDIC Director Jonathan McKernan, all dissented.¹⁸ While Federal Reserve Chair Jerome Powell and Federal Reserve Governor Philip Jefferson did not dissent from putting the B3E proposal out for comment, they expressed serious reservations about the B3E proposal.¹⁹

The public similarly filed an unprecedented number of substantive comments, with an overwhelming majority of those substantive comments being opposed to the B3E proposal or some portion of it. The comments came from a broad cross-section of the population, including a large number of banks and nonbank customers, counterparties and end users, as well as numerous members of Congress on both sides of the aisle. With such unprecedented opposition from so many principals at the agencies and such a large variety of banks, customers, counterparties and end-users, as well as members of Congress on both sides of the aisle, the agencies will have to be very careful in proceeding to the next step on the B3E proposal to comply with the requirements of the APA as articulated by the courts. Finally, because the stress capital buffer is the ultimate determinant of an LBO's capital requirements, it is impossible for the agencies or the public to properly assess the economic or cost-benefit impact of the B3E or GLAC proposals, without knowing what amendments the Federal Reserve will propose to the

¹⁶ Press Release, Board of Governors of the Federal Reserve System, Federal Reserve Board launches data collection to gather more information from the banks affected by the large bank capital proposal it announced earlier this year (Oct. 20, 2023).

¹⁷ See, e.g., Letter from Andy Barr, Chairman of the Financial Institutions and Monetary Policy Subcommittee of the House Financial Services Committee to Michael S. Barr, Vice Chair for Supervision (Oct 19, 2023); Letter from Bill Foster, Ranking Member of the Financial Institutions and Monetary Policy Subcommittee of the House Financial Services Committee, and other members of Congress to the agencies (Jan. 16, 2024).

¹⁸ Statement by Governor Christopher J. Waller (July 27, 2023); Statement by Governor Michelle W. Bowman (July 27, 2023); Statement by FDIC Vice Chair Travis Hill (July 27, 2023); Statement by FDIC Director Jonathan McKernan (July 27, 2023).

¹⁹ Statement by Chair Jerome H. Powell (July 27, 2023); comments by Governor Philip Jefferson (July 27, 2023). Kyle Campbell, *Fed's Jefferson voices concerns over Basel III capital proposal*, American Banker (July 27, 2023).

stress-testing scenario framework that underlies the SCB. Those amendments need to be disclosed and considered by the public before the B3E or GLAC proposals are finalized.

Strong Capital Requirements

Virtually everyone agrees that U.S. banking organizations should be subject to strong capital requirements and that they were undercapitalized on the eve of the global financial crisis of 2008. There is also a consensus that the capital and other prudential standards should be tailored so that the largest, most systemically important, U.S. banking organizations are subject to the highest going concern capital requirements and enhanced prudential standards.

This includes subjecting all of the largest, most systemically important, U.S. banking organizations to capital and liquidity stress testing, recovery and resolution planning and, in the case of the U.S. GSIBs, an extra layer of going concern capital known as the GSIB surcharge²⁰ and an extra layer of gone-concern capital known as gone-concern loss-absorbing capacity or GLAC that can be used to restore the going concern capital of their material bank and nonbank subsidiaries in the highly unlikely event that those subsidiaries suffer enough losses to cause their going concern capital to be fully depleted. Together, going-concern capital and gone-concern loss-absorbing capacity is referred to as total loss-absorbing capacity (**TLAC**). Under the Federal Reserve's current TLAC rule,²¹ most of a GSIB's GLAC is required to be maintained in the form of long-term debt that is subordinated to the GSIB's *runnable liabilities*, including uninsured demand deposits.²²

Tailoring Among Different Categories of LBOs

Consistent with this tailoring of capital and other prudential standards so that the largest, most systemically important, U.S. banking organizations are subject to the highest standards, and community banks and mid-sized banks are exempt from most of those standards, Congress enacted Section 401 of the Economic Growth, Regulatory Relief and Consumer Protection Act of 2018 (**EGRRCPA**).²³ That Act of Congress, which continues to be *binding law* on the U.S. banking agencies, *requires* them to further tailor capital and other enhanced prudential standards among the LBOs based on their total assets and other characteristics, reserving the highest standards for U.S. LBOs with total assets of \$250 billion or more.²⁴

In implementing this congressional mandate, the Federal Reserve issued a regulation that divided the largest U.S. banking organizations into four categories. Category I consists of the U.S. GSIBs. Category II consists of non-GSIB LBOs with \$700 billion or more in total consolidated assets or *both* \$100 billion or more in total consolidated assets *and* \$75 billion or more in cross-jurisdictional exposure. Category III are LBOs that are not Category I or II LBOs but have \$250 billion or more in total consolidated assets or *both* \$100 billion or more in total consolidated assets *and* \$75 billion or more in any of the following risk-based indicators: (1) weighted short-term wholesale funding, (2) nonbank assets or (3) off-balance sheet exposure.

²⁰ 12 C.F.R. Parts 208 and 217.

²¹ 82 Fed. Reg. 8266 (Jan. 24, 2017).

²² *Id.*, at 8267.

²³ Pub. L. No. 115-174, 132 Stat. 1296 (2018).

²⁴ *Id.*, § 401.

Category IV LBOs are those with \$100 billion or more in total consolidated assets but less than \$250 billion of total consolidated assets that do not meet any of the specific risk-based indicators for Category III organizations.²⁵

As a result of these laws and regulations, the U.S. LBOs would have nearly twice the common equity tier 1 (CET1) going concern capital *after* a stress event more severe than the 2008 global financial crisis, as shown on [Exhibit B](#). They also have approximately three times more liquid assets relative to their total deposits and total liabilities than they had in 2008, as shown on [Exhibit C](#). They are also subject to enhanced liquidity requirements, capital and liquidity stress testing, and recovery and resolution planning at either the parent level or the insured depository institution (IDI) level, or both, as shown in [Exhibit D](#). The U.S. GSIBs have also been required to increase their “usable” TLAC, which is the sum of their going concern capital and GLAC, to approximately six times the level they had in 2008, as shown in [Exhibit E](#).

Purpose of B3E International Framework

Almost everyone agrees that going concern capital requirements should be more risk-sensitive and comparable. As a result, the U.S. banking agencies agreed to the B3E International Framework.²⁶ That framework was designed to make the standardized methods for calculating risk weights more risk-sensitive and the risk-weights for various types of risks less variable and more comparable. The leaders of the Basel Committee on Banking Supervision (BCBS) and the leading U.S. participants in that process stressed that the purpose of B3E was *not* to increase capital requirements in the aggregate, even though the changes may result in increases in capital for some types of risks with offsetting decreases in capital for other types of risks.²⁷

Capital Neutrality

Consistent with these goals of the B3E International Framework, various principals and officers at the Federal Reserve gave public assurances that the international framework would be implemented in the United States so that it was capital neutral. The intention was to modify U.S. capital requirements so that the standardized tests would be more risk-sensitive and risk weights less variable and more comparable, but without increasing capital requirements in the aggregate.²⁸ During his Senate nomination hearing, Mr. Barr responded to various questions

²⁵ 84 Fed. Reg. 59032, 59035 (Nov. 1, 2019).

²⁶ Basel Committee on Banking Supervision, *Basel III: Finalising post-crisis reforms* (Dec. 7, 2017).

²⁷ See, e.g., Mario Draghi, Chairman of the Group of Governors and Heads of Supervision, the oversight body of the BCBS, GHOS Media, beginning at 32:05 (Dec. 7, 2017); Andreas Dombret, Member of Executive Board at Deutsche Bundesbank (Dec. 2017); Mark Carney, Bank of England and former Chair of the Financial Stability Board, Financial Stability Report Q&A (Nov. 30, 2016); William Coen, Secretary General of the Basel Committee on Banking Supervision and former officer at the Federal Reserve and the OCC, GHOS Media, beginning at 33:19.

²⁸ See e.g., Mark Van Der Weide, Federal Reserve General Counsel, Remarks on an ABA panel (Jan. 6, 2022) (“We’re also committed to putting these [Basel III endgame] reforms in place in a way that’s roughly capital neutral for the U.S. banking system.”); Neil Roland, *US Fed aims to adopt last Basel III part by January 2023 with ‘capital neutral’ calibrations across the system*, Lexis-Nexis (June 3, 2021) (“‘If we can’t find the right dials to turn inside the Basel III end-game risk-based reforms we’ll look at other parts of the capital framework’ to ensure that it’s ‘no more stringent than the capital framework we had before,’ Fed General Counsel Mark Van Der Weide said at a webinar yesterday.”); Testimony of Randal K. Quarles, Federal Reserve Vice Chairman for Supervision, Hearing Before the House Committee on Financial Services, 116th Cong. at 17 (Dec. 4, 2019) (responding to a question about the federal banking agencies’ plans for the implementation of Basel III endgame, Mr. Quarles stated, “they are essentially capital neutral. I think that we will be able to do that by looking at everything as a whole rather than implementing them piecemeal.”).

about capital and tailoring to the effect that the U.S. banking system was strongly capitalized and tailoring makes sense.²⁹

Breakdown in Consensus for Capital Neutrality and Tailoring

The consensus for capital neutrality and tailoring started to break down almost immediately after Michael Barr was confirmed as Vice Chair for Supervision at the Federal Reserve.

Holistic Review of Capital Standards

In his first speech after being confirmed as Vice Chair for Supervision, Mr. Barr stated that he would conduct a “holistic review” of capital standards.³⁰ Later that year, Vice Chair Barr stated that in reviewing these capital standards he and the Federal Reserve staff would be humble and skeptical about the optimal level of capital. This was the first sign that the consensus about capital neutrality and tailoring might be breaking down.³¹ He repeated his plan to conduct a holistic review of capital requirements several times,³² but did not say what he considered to be a sufficient level of capital. It became clear over time, however, that by being humble about the optimal level of capital, Vice Chair Barr meant that when in doubt about the optimal level of capital requirements, regulators should err on the side of overcapitalizing the U.S. banking system rather than on the side of undercapitalizing it.

Sudden Failure of Silicon Valley Bank and Related Contagion

The next sign that the consensus about capital neutrality and tailoring was breaking down was Vice Chair Barr’s responses to the failure of SVB. In a report that was either his report or a report of the full Board of Governors,³³ SVB’s failure was attributed to three principal factors: (1) a failure of bank risk management 101 by senior management at SVB by mismanaging SVB’s extraordinarily high interest rate risk and liquidity risk,³⁴ (2) the tailoring of capital and other

²⁹ Hearing Before the Senate Banking Committee on Nominations of Michael S. Barr, Jamie E. Lizarraga, and Mark Toshiro Uyeda, 117 Cong. 123, 24 (May 19, 2022) (testimony of Michael S. Barr) (responding to questions from members of the committee, Mr. Barr stated, “Capital in the banking system today is quite strong” and “I think that tailoring or a graduated approach, a tiered approach makes sense for the financial system.”).

³⁰ Michael S. Barr, Vice Chair for Supervision, *Making the Financial System Safer and Fairer*, (Sep. 7, 2022).

³¹ Michael S. Barr, Vice Chair for Supervision, *Why Bank Capital Matters* (Dec. 1, 2022).

³² See, e.g., Hearing Before the Senate Banking Committee on Oversight of Financial Regulators: A Strong Banking and Credit Union System for Main Street, 117 Cong. at 11 (Nov. 14, 2022); Hearing Before the House Financial Services Committee on ‘The Federal Regulators’ Response to Recent Bank Failures, 118 Cong. at 201 (March 29, 2023); Hearing Before the House Financial Services Committee on Oversight of Prudential Regulators, 118 Cong. at 150 (May 16, 2023); Hearing Before the House Financial Services Committee at 129 (March 29, 2023).

³³ Review of the Federal Reserve’s Supervision and Regulation of Silicon Valley Bank (April 2023). The report was labeled as a report of the full Board, but it was issued under a cover letter from the Vice Chair for Supervision. But in response to a question about whether the Board voted on or reviewed the report, Mr. Barr responded, “No, it is a report of the vice chair for supervision under my statutory authorities. It was not a report of the board.” Hearing Before the House Financial Services Committee at 21 (May 16, 2023). See also Federal Reserve Governor Michelle Bowman, *Responsive and Responsible Bank Regulation and Supervision* (June 25, 2023) (“Although the report was published as a report of the Board of Governors, it was the product of one Board Member, and was not reviewed by the other members of the Board prior to its publication.”).

³⁴ *Id.* at 12. The fundamental nature of this failure is reflected in the Security and Exchange Commission’s (SEC’s) Guide 3, which was first issued in 1976 and requires all publicly traded banking organizations to disclose statistical information about their interest rate and other material risks that have been the core risks of banking since the dawn of fractional reserve banking in Italy in the 14th century and Great Britain in the 17th century. See Raymond De Roover, *The Rise and Decline of the Medici Bank, 1397-1494*, at 2 (Harvard University Press, 1963); Usher, Abbott Payson, *The Early History of Deposit Banking in Mediterranean Europe Volume I*, at 181 (Harvard University Press, 1943); R.D. Richards, *The Early History of the Bank of England*, at 233 (1958) (1929).

enhanced prudential standards among LBOs as mandated by EGRRCPA,³⁵ and (3) a “shift in culture” under the “direction of the Vice Chair for Supervision,” including “pressure to reduce burden on firms, meet a higher burden of proof for a supervisory conclusion, and demonstrate due process when considering supervisory actions.”³⁶ Because the Vice Chair for Supervision has repeatedly referred to this report as his report,³⁷ I will refer to it as the Barr Report in the rest of my written statement and in my oral testimony.

A subsequent report by the Federal Reserve’s Office of Inspector General (**OIG Report**) agreed with the Barr Report that the principal causes of SVB’s failure was the mismanagement of interest rate risk and liquidity risk by senior SVB management and serious deficiencies in supervision.³⁸ But it disagreed with the second and third factors in the Barr Report. Instead of attributing SVB’s failure to the tailoring mandate in EGRRCPA, the OIG report stated that the impact of the tailoring mandate was limited to the relatively short period of time when SVB had less than \$100 billion in assets.³⁹ Similarly, instead of attributing SVB’s failure to a shift in supervisory culture directed from the top, the OIG report attributed it to the supervisory staff’s failure on the ground to focus on SVB’s most salient risks,⁴⁰ such as its extraordinary interest rate and liquidity risks.⁴¹ The OIG Report also noted that the Federal Reserve’s supervisory staff had allowed SVB to function without a Chief Risk Officer for most of 2022,⁴² despite its extraordinarily high interest rate risk and liquidity risk.

What is most surprising about the supervisory blind spot about interest rate risk is that it occurred during a period when Federal Reserve Chairman Jerome Powell made one public statement after another that the Federal Reserve Open Market Committee (**FOMC**) intended to progressively increase interest rates as high as necessary to bring inflation down from 9.1% to its long-term target of 2%.⁴³ It also continued after Mr. Barr was confirmed as Vice Chair for Supervision on July 13, 2022 and long after his predecessor’s term as Vice Chair for Supervision had expired on October 13, 2021.

B3E Proposal

The final sign that the consensus on capital neutrality and tailoring had completely broken down was the issuance of the notice of proposed rulemaking on July 27, 2023, to amend U.S. capital standards to implement the B3E International Framework.

³⁵ Review of the Federal Reserve’s Supervision and Regulation of Silicon Valley Bank, at 10-11 and 86.

³⁶ *Id.* at 11. The former Vice Chair for Supervision issued a statement and made a press statement, stating he never told the staff to go easy on the banks. Randal Quarles, *Statement Regarding the Federal Reserve Report on the Failure of Silicon Valley Bank* (April 28, 2023); Victoria Guida, *Quarles hits back at Barr’s SVB report*, PoliticoPro (April 28, 2023). Instead, he stated that he directed the staff to focus on what’s really important – like interest rate and liquidity risk – and to stop paying excessive attention to routine administrative matters. He said he would often use the phrase, “And if they won’t do what’s really important, smite them hip and thigh.” Kyle Campbell, *For Fed supervision, cultural shortcomings are nothing new*, American Banker (May 8, 2023).

³⁷ See note 33.

³⁸ Office of Inspector General for the Board of Governors of the Federal Reserve System, *Material Loss Review of Silicon Valley Bank* (Sept. 25, 2023).

³⁹ *Id.* at 30. See also Davis Polk, *Silicon Valley Bank failure – A different view of the Federal Reserve OIG report* (Oct 18, 2023); Randall Guynn, Margaret Tahyar & Kirill Lebedev, *A Tale of 2 SVB Reports: Where the Fed’s Barr and OIG Differ*, Law 360 (Nov. 13, 2023).

⁴⁰ OIG Report, at 41.

⁴¹ *Id.* at 25.

⁴² *Id.* at 14.

⁴³ See, e.g., Transcript of Press Conference after the Federal Open Market Committee Meeting, (March 16, 2022); Transcript of Press Conference after the Federal Open Market Committee Meeting (July 27, 2022).

Instead of proposing amendments limited to making the U.S. standards more risk-sensitive and resulting in risk weights that were more comparable among U.S. and non-U.S. banking organizations, the B3E proposal would substantially increase U.S. going concern capital requirements in the aggregate with the largest increases in the required capital for market risk and operational risk. According to the agencies' own estimates, which some have argued are too low,⁴⁴ the B3E proposal would increase risk weights by 20% and common equity tier 1 (CET1) capital by 16% in the aggregate and by 19% for Category I and II banks,⁴⁵ with both risk weights and CET1 capital being increased for market risk by a whopping 77%.⁴⁶ It would also introduce a new standardized approach for operational risk that would significantly increase capital requirements for operational risk based on business volume without any reduction for track records of low operational losses.⁴⁷

Opposition to B3E Proposal

There is sharp disagreement over whether the largest banks should be subject to these higher proposed capital requirements. Critics have observed that virtually all of the banking agency principals have repeatedly assured the public that the largest banks are well-capitalized and resilient.⁴⁸ Nevertheless, the Federal Reserve, the FDIC and the Acting Comptroller all approved the B3E proposal over an unprecedented number of dissents and expressions of concern.

Virtually No Supporting Data or Cost-Benefit Analysis

The preamble to the B3E proposal stated that “[t]he agencies assessed the likely effect of the proposal on economic activity and resilience, and expect that the benefits of strengthening capital requirements for large banking organizations outweigh the costs.” But the agencies have provided virtually no data to support that conclusion. Moreover, because the B3E proposal overlaps with the stress capital buffer requirement, it is not possible to assess the full impact of the B3E proposal without knowing the changes that the Federal Reserve plans to make to the SCB requirement, which the Federal Reserve Vice Chair for Supervision has said it will make.⁴⁹

⁴⁴ According to the Bank Policy Institute (BPI), the B3E proposal is more likely to result in a capital increase of over 20%, with the GSEs needing to increase capital by 25%. BPI estimated that capital charges for banks with high levels of fee income could see their capital requirements surge by more than 50% because of the new operational risk charges. See Bank Policy Institute and American Bankers Association, Comment Letter on Proposed Rule to Revise the Capital Requirements Applicable to Large Banking Organizations and Banking Organizations with Significant Trading Activity, 11 (Jan. 16, 2024). The Financial Services Forum estimates that capital requirements for the U.S. GSEs could increase by more than 30 percent. Financial Services Forum, American Bankers Association, Bank Policy Institute and Securities Industry and Financial Markets Association Comment Letter on Proposed Rule to Revise the Capital Requirements Applicable to Large Banking Organizations and Banking Organizations with Significant Trading Activity (Dec. 22, 2023).

⁴⁵ 88 Fed. Reg. at 64169.

⁴⁶ *Id.*, at 64168.

⁴⁷ 88 Fed. Reg. at 64030.

⁴⁸ Hearing Before the House Financial Services Committee on Monetary policy, 117th Cong. 24 (June 23, 2022) (testimony of Jerome H. Powell) (“[T]he banking system in particular is very strong, well-capitalized.”); Federal Reserve Vice Chair for Supervision, Hearing Before the House Financial Services Committee on Oversight of Prudential Regulators, 118 Cong. 1 (May 16, 2023) (testimony of Michael S. Barr) (“Overall, banks have strong capital and liquidity.”); Martin J. Gruenberg, FDIC Chair, Remarks on the FDIC’s Third Quarter 2023 Quarterly Banking Profile (Nov. 29, 2023) (“The banking industry . . . remained well capitalized.”); Hearing Before the Senate Banking Committee on Oversight of Financial Regulators: Protecting Main Street Not Wall Street, 118 Cong. 17 (Nov. 14, 2023) (testimony of Michael J. Hsu) (“OCC supervised banks in the aggregate have strong levels of regulatory capital.”).

⁴⁹ See Hearing Before the Senate Banking Committee on Recent Bank Failures and the Federal Regulatory Response, 118 Cong. 9-10, (March 28, 2023) (testimony of Michael S. Barr) (“We will need to enhance our stress testing with multiple scenarios so that it captures a wider range of risk and uncovers channels for contagion, like those we saw in the recent series of events.”); Michael S. Barr, *Holistic Capital Review*, (July 10, 2023) (“The stress test should evolve to better capture the range of salient risks that banks face.”)

The Federal Reserve Vice Chair for Supervision also suggested that the B3E proposal was justified by a holistic review of capital requirements, but the agencies did not provide a copy of that review, including any supporting data, for public comment.

Optimal Capital Studies

The preamble cites a handful of third-party studies suggesting that U.S. capital levels are currently below the optimal level.⁵⁰ But it does not explain how the banking agencies determined that those particular studies were reliable, why they justified the B3E proposal or why they are more accurate than competing studies that suggest the U.S. capital levels are about right.

Sudden Failure of Silicon Valley Bank – Part II

The agencies indicated in the preamble to the GLAC proposal that an extra layer of gone-concern loss-absorbing capital in the form of subordinated LTD needs to be imposed on the regional bank LBOs regardless of the statutory tailoring requirements to prevent a recurrence of the banking turmoil in March 2023.⁵¹ The Vice Chair for Supervision has similarly stated that the tailoring regime needs to be revisited in light of that turmoil.⁵²

The Real Lesson from SVB's Failure

But the sudden failures of Silicon Valley Bank, Signature Bank and First Republic Bank did not occur because of insufficient capital, excessive tailoring or a less intense supervisory culture. They occurred because of a stunning failure by senior SVB management to properly manage its extraordinary interest rate risk and liquidity risk. They also occurred because of an equally stunning failure by the supervisory staffs of the California Department of Financial Protection and Innovation (**DFPI**), the Federal Reserve Bank of San Francisco and the Board of Governors to detect or take prompt and decisive action against SVB in light of its extraordinary exposure to interest rate risk and liquidity risk. This double blind spot is baffling since interest rate risk and liquidity risk, along with credit risk, have been the core risks of banking since the dawn of fractional reserve banking in Italy in the 14th century and Great Britain in the 17th century.⁵³ These are not new or insignificant risks in the post-modern era.

Moreover, as shown on the figure attached as Exhibit E, SVB was clearly insolvent on a fair value basis by the end of the third quarter and fourth quarters 2022. This should have been obvious to both SVB's senior management and the supervisory staffs of the California DFPI, the Federal Reserve Bank of San Francisco and the Board of Governors. The unrealized losses on both its available-for-sale (**AFS**) and held-to-maturity (**HTM**) bond portfolios were publicly

⁵⁰ *Regulatory Capital Rule: Large Banking Organizations and Banking Organizations With Significant Trading Activity*, 88 Fed. Reg. 64028, 64169 note 469 (Sept. 18, 2023).

⁵¹ 88 Fed. Reg. 64524, 64527 (Sept. 19, 2023).

⁵² See Hearing Before the House Financial Services Committee on 'The Federal Regulators' Response to Recent Bank Failures', 118 Cong. 100 (testimony of Michael S. Barr) ("You know, the Federal Reserve System of Supervision and Regulation is based on a tailored approach where firms between \$50 and \$100 billion are really part of the regional banking organization group. Firms \$100 billion and above are in the large and foreign banking organization group. And even within that, there are distinctions between firms at \$100 to \$250 and \$250 and above. And I think part of the problem is that that framework, which really focuses on asset size, is not sensitive to the kinds of problems we saw here with respect to rapid growth and a concentrated business model. That's one of the reasons why, you know, earlier this year I announced that we were going to have a novel supervision group that really focuses on these kinds of issues.")

⁵³ See note 34.

disclosed in SVB's call reports and its parent's SEC filings. The information was not hidden from view simply because the unrealized losses in its AFS portfolio were not reflected in its reported capital as a result of the opt-out for accumulated other comprehensive income (AOCI). In other words, extending the AOCI requirement to the AFS portfolio of the regional bank LBOs will not give the market – or the supervisors – any new information about insolvency on a fair value basis that was not already available to them.

SVB had invested a massive influx of uninsured deposits received during the Covid-19 pandemic in a portfolio of long-dated, fixed-rate U.S. Treasury and mortgage-backed securities, betting that inflation would be transitory and that the Federal Reserve would not need to increase interest rates to battle inflation. Instead, inflation persisted and the Federal Reserve increased interest rates to reduce it, resulting in large unrealized losses in SVB's bond portfolio. In addition, 95% of SVB's deposits were uninsured and largely concentrated in venture capital funds and their portfolio companies, exposing SVB to a high risk that they would run at the first sign of trouble. The question is not why its concentrated uninsured depositor base ran with such intensity in March 2023, but why they didn't run earlier.

No reasonable amount of capital could have saved SVB in light of its basic risk management deficiencies and the related failures of the supervisory staff to detect and take prompt and decisive actions in light of the bank's extraordinary interest rate and liquidity risks. One of the real lessons of SVB's sudden failure and related contagion is that no amount of capital is a complete substitute for good risk management and supervisory oversight.

Unfounded Fear

Compounding these problems, many if not all of SVB's depositors could not readily determine over SVB weekend which of their deposits were claims against SVB and which had been safely swept off its balance sheet into third-party money market funds. This observation is supported by more than a hundred calls that my colleagues and I fielded from panicked SVB depositors over SVB weekend. I believe this uncertainty intensified the panic among those depositors because they feared they might have, say \$150 million of exposure to Silicon Valley Bank, when in fact they only had \$10 million of exposure, with \$140 million safely swept into third-party money market funds.

This good faith but probably unfounded fear also fueled contagion. Most of SVB's uninsured depositors may have had enough cash to meet payroll in the days and weeks following SVB's failure without the FDIC's extraordinary guarantee of all uninsured deposits, if they had known with certainty that the majority of their potential exposure to SVB had been safely swept off SVB's balance sheet. This belief is supported by the large number of deposit sweep agreements we collected and my colleagues reviewed feverishly over SVB weekend. By Sunday late afternoon, just before the FDIC announced that it would guarantee all uninsured deposits at SVB and Signature Bank, my colleague who reviewed the documentation said she was highly confident that the vast majority of SVB deposits in its sweep programs she reviewed had in fact been safely swept off SVB's balance sheet into third-party money market funds that would not be lost by SVB's failure.

Guarantee of Uninsured Deposits – A Costly Miscalculation Based on Imperfect Information?

SVB's depositors might not have lobbied the FDIC, Treasury, Federal Reserve or White House as intensively to invoke the systemic risk exemption to the least-cost test⁵⁴ so the FDIC could protect all uninsured depositors against losses, if they had had better information during SVB weekend. More importantly, the FDIC, Treasury, Federal Reserve and White House might not have invoked the systemic risk exemption – at great cost to the Deposit Insurance Fund and ultimately to the surviving U.S. banks in the form of extraordinary deposit insurance assessments to cover that cost – to protect uninsured depositors if they knew that most of SVB's uninsured depositors probably could have met their payroll obligations in the days and weeks following SVB's failure with deposits that had been safely swept into third-party money market funds.

This is a major information problem which, if true, is easily fixable through better disclosure and better supervision, as long as the agencies recognize that it may have been one of the fundamental problems that contributed to the magnitude and speed of the run on SVB.

Adverse Impact of B3E Proposal on Businesses and Households

I will not attempt to describe the full array of costs and risks that would be imposed by the B3E proposal, the GLAC proposal or the resolution planning proposals on the LBOs and the wider U.S. economy. Those costs and risks are described better and more completely in the unprecedented number of comment letters that have been filed in response to the B3E proposal, the GLAC proposal and the resolution planning proposals. Instead, I will describe some of the key risks and costs that would be imposed on businesses and households if the B3E proposal were finalized as proposed.

Mortgage Lending. The B3E proposal would impose higher capital requirements on mortgage lending, making it more expensive for large U.S. banks to make residential mortgage loans. These higher capital requirements would function like an excise tax, reducing the supply or increasing the cost of mortgage loans made by large U.S. banks, or both, depending on the elasticity of demand.

- The B3E proposal would do so by:
 - Establishing risk weights for residential mortgage loans that are 20 percentage points higher than the Basel Framework, with the highest capital charges for mortgage loans with smaller down payments, which are frequently issued to first-time homebuyers or LMI borrowers;
 - This deviation from the Basel international standard would adversely affect the availability or cost of residential real estate loans from large U.S. banks without any commensurate benefits to U.S. financial stability.

⁵⁴ See 12 U.S.C. §§ 1823(c)(4) (least-cost test); 1823(c)(6) (systemic risk exception to least-cost test).

- The disproportionately greater adverse impact on first-time home buyers and LMI borrowers conflicts with the goals of various government programs designed to provide first-time home buyers and LMI borrowers with access to home ownership.
 - The reason given for this deviation was to avoid disadvantaging smaller banking organizations that would otherwise be generally subject to higher risk weights for the same residential mortgage exposure under the standardized approach.
 - The standardized approach continues to serve as a floor to the ERB approach, so it is difficult to see what incremental advantage the agencies are concerned about.
- Imposing restrictions on the amount of mortgage servicing assets (**MSAs**) that Category III and IV banks may include in CET1 capital;
- Imposing punitive capital requirements for first- and second-lien mortgages to the same borrower;
- Introducing a new standardized capital requirement for operational risk, which would require large banks to hold additional capital based on the amount of fees they earn from servicing mortgages; and
- Introducing a new standardized approach for calculating RWAs for securitization exposures, which are expected to materially increase the capital required for mortgage loan securitization vehicles.

SMEs. The B3E proposal would also impose higher capital requirements on extensions of credit to, or investments in, small and medium-sized enterprises (**SMEs**) relative to similar exposures to larger businesses, even when the credit risk of the SME is equivalent to that of a large business.

- These higher capital requirements would also operate like an excise tax on credit or equity exposures to SMEs, resulting in a reduction in the supply or increase in the cost of extensions of credit to or equity investments in SMEs by large U.S. banks, or both, depending on the elasticity of demand.
- The B3E proposal would do so by:
 - Applying a 65% risk weight to credit exposures to an investment grade issuer if the issuer or its parent is publicly listed, but it would apply a 100% risk weight if neither the borrower nor its parent is publicly listed.
 - Given that only a few SMEs are publicly listed companies, credit exposures to investment grade SMEs would almost never qualify for the 65% risk weight.
 - By eliminating the 100% risk weight for non-significant equity exposures, all equity exposures to non-public SMEs would be subject to a 400% risk weight, effectively quadrupling the risk weight applicable to equity exposures to nonpublic SMEs.

Consumer Finance. The B3E proposal would impose higher capital requirements on consumer financing activities, including credit card and home equity credit facilities, which allow consumers to meet emergency or unforeseen needs (e.g., unforeseen medical bills) and promote financial inclusion (e.g., unbanked or underbanked consumers often use credit cards as their first step toward building a credit history). These higher capital charges would similarly act like an excise tax on consumer financing, resulting in a reduction in the supply or increase in the cost of consumer financing provided by large U.S. banks, or both, depending on the elasticity of demand.

- The B3E proposal would do so by:
 - Imposing risk weights for regulatory retail exposures that are 10% higher than the Basel Framework;
 - Imposing a 10% credit conversion factor (CCF) on the unused portion of unconditionally cancellable credit facilities, meaning that large U.S. banks would be required to have capital against a 10% drawdown rate even for the portion of a credit card or home equity line of credit that has not, in fact been drawn down;
 - Including interest and fees earned from credit card and home equity lines in the interest, lease and dividend component and services component, respectively, of a large U.S. bank's business indicator, producing disproportionately higher operational risk RWAs from increased business volumes; and
 - Imposing higher capital charges on securitized credit card and home equity lines under SEC-SA.

Corporate and Municipal Finance in the Capital Markets. The B3E proposal would increase the capital requirements for market risk by an estimated 77% primarily to address periods of severe market stress without providing any data-driven justification for such a significant increase. Indeed, there is no evidence that large U.S. banks had insufficient capital for market risk during numerous recent periods of severe market stress or that the Federal Reserve's stress capital buffer requirement does not already ensure that they will have sufficient capital to suffer losses and continue providing market making services during prolonged periods of severe market stress, including market illiquidity when they cannot hedge or close out positions.

This significant increase in capital requirements for market risk would harm American businesses and municipalities by raising the cost of debt and equity raised in the U.S. capital markets, while reducing market liquidity, without any data-driven justification that large U.S. banks would otherwise be insufficiently resilient during periods of extreme market stress. This impact could have a very negative effect on American businesses, municipalities and retail investors since American businesses and municipalities depend on liquid capital markets to raise

more than half their debt and equity financing and U.S. retail investors depend on deep market liquidity to reduce the risks and costs of investing in American businesses.⁵⁵

In particular, the proposed new capital requirements for market risk would harm U.S. businesses and municipalities in a variety of ways, including by:

- Implementing the haircuts for structured finance transactions (**SFTs**) haircuts so that collateralized transactions are treated as unsecured, adversely impacting markets for repurchase agreements and stock borrowing where pension funds lend their securities to manage retiree distributions;
- Implementing credit valuation adjustments (**CVA**) in a manner that would adversely impact manufacturers' ability to hedge legitimate commercial risk such as exchange rates or commodity prices and alternatively failing to exempt corporate end users or client-cleared trades from CVA; and
- Implementing the market risk proposals in a way that adversely impacts market liquidity since shocks are applied to trading assets under both the SCB and FRTB.
 - This would result in circumstances where required capital can exceed the actual size of the exposures.
 - It would also result in excess capital and reduced market liquidity by failing to adequately recognize portfolio diversification and long-standing risk management practices.

The agencies seem to understand there is no justification for such a significant increase in capital by admitting that “[t]he overall effect of higher capital requirements on market making activity and market liquidity remains a research question needing further study.”⁵⁶

The proposal also completely ignores the fact that the proposed increase in capital for severe market stress overlaps with the Global Market Shock component of the Federal Reserve's stress testing, which already increases the stress capital buffer to address the risks of severe market stress. Both the proposed increase in capital for market risk in the B3E proposal and the Federal Reserve's stress testing are designed to address the same problem – namely, to ensure that large U.S. banking organizations have sufficient capital to both absorb losses during periods of severe market shocks and have sufficient capital after suffering those losses to provide market making and other capital markets services to the market throughout the business cycle.

Tailoring. The B3E proposal would largely eliminate tailoring of capital requirements among the LBOs violation of the tailoring mandate contained in Section 401 of EGRRCPA or its animating spirit. This feature will harm U.S. businesses and households over time by creating a powerful economic incentive for Category III and IV banking organizations to consolidate into banking organizations with a scale closer to that of the U.S. GSIBs to be able to spread the increased capital costs imposed by the B3E proposal over a larger base so they can remain

⁵⁵ See, e.g., Coalition for Derivatives End-Users, Comment Letter on Proposed Rule to Revise the Capital Requirements Applicable to Large Banking Organizations and Banking Organizations with Significant Trading Activity, 10-11 (Jan. 16, 2024).

⁵⁶ 88 Fed. Reg. at 64170-64171.

competitive with the Category I and II firms. This would reduce the option of businesses and households to obtain banking services from regional banks and turn the distribution of the U.S. banking system into a barbell of large and small banking organizations, with virtually no banking organizations in the middle.

Any government efforts to restrain such consolidation through policies against bank mergers will ultimately fail as a result of economic forces. The financial condition of regional banks that are prevented by government fiat from spreading the increased costs of the B3E proposal over a larger scale through merger and consolidation will almost certainly deteriorate over time, increasing the risk of depositor runs and ultimately failure that would result in costly emergency sales in an FDIC receivership.

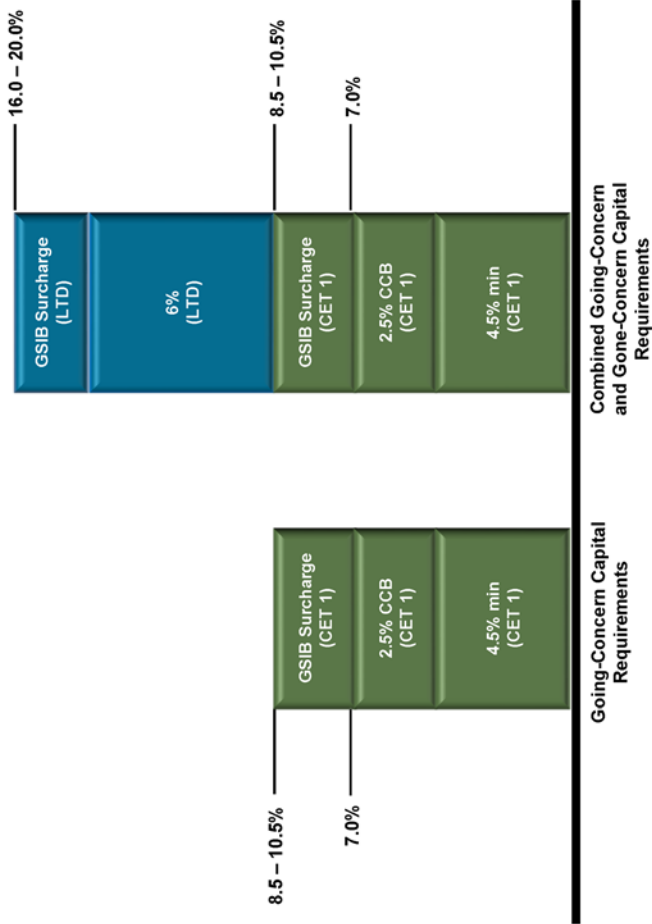
Conclusion

The U.S. capital framework includes a stress capital buffer that is the determining factor in the level of capital requirements applicable to the U.S. LBOs. Neither the Basel III framework generally nor the B3E International Framework assumes an SCB regime like that in the United States. Nor does any country other than the United States use their stress-testing regimes to impose capital buffers on their systemically important banks. This results in U.S. LBOs being subject to higher capital requirements than their non-U.S. counterparts. Thus, even if the agencies implemented the B3E International Framework in a capital neutral way and with full tailoring, the U.S. LBOs would all be subject to higher capital requirements than their non-U.S. counterparts. But by proposing to implement the B3E International Framework in a way that significantly increases the capital requirements on U.S. LBOs, without eliminating the overlap with the U.S. stress-testing regime, the agencies would impose even higher capital requirements on U.S. LBOs relative to their non-U.S. counterparts. I wonder whether that is really the right way to run a U.S. railroad.

Exhibit A

Disproportionate Impact on Regional Bank LBOs

Disproportionate Impact on Regional Bank LBOs



Source: Modeled on Davis Polk Visual Memorandum, Federal Reserve's Final Rule on Total Loss-Absorbing Capacity and Eligible Long-Term Debt, Slide 18 (Jan. 11, 2017).

Exhibit B

Capital Then and Now

Common Equity Tier 1 Ratios of U.S. GSIBs

U.S. GSIBs would have higher risk-based capital ratios today in a severely adverse stress environment than actual risk-based capital ratios in 2008.

U.S. GSIBs would have nearly twice as much CET1 capital after absorbing losses from stress than actual T1 capital in 2008...
...because today they are starting with more than 2.5x of higher quality CET1 capital compared to the T1 capital they had in 2008.

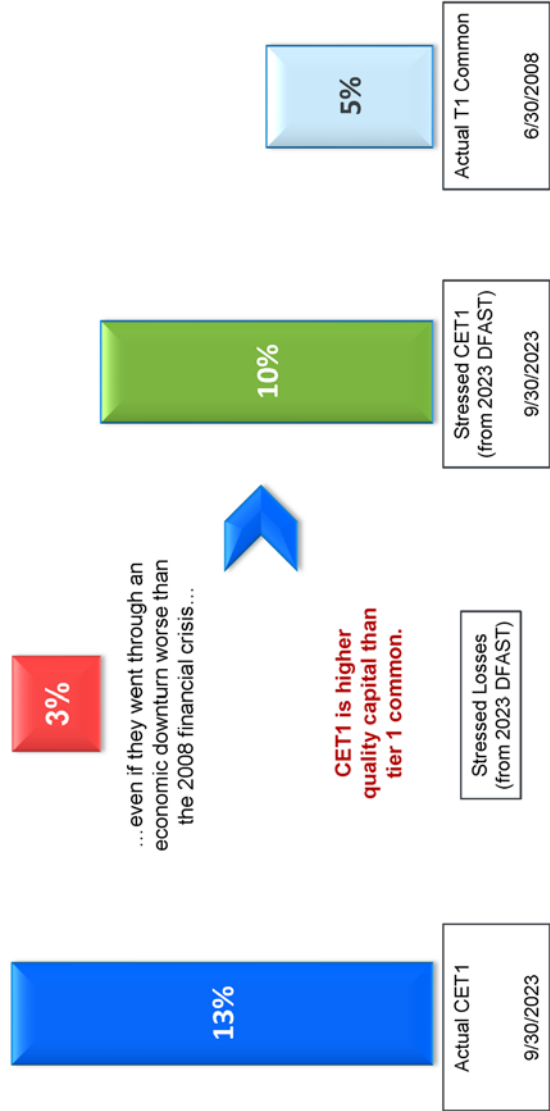


Exhibit C

Liquidity Then and Now

Liquidity Ratios of U.S. GSIBs

U.S. GSIBs have 3.5x and nearly 3x more liquid assets relative to their total liabilities and deposits, respectively, today than they did in 2008.

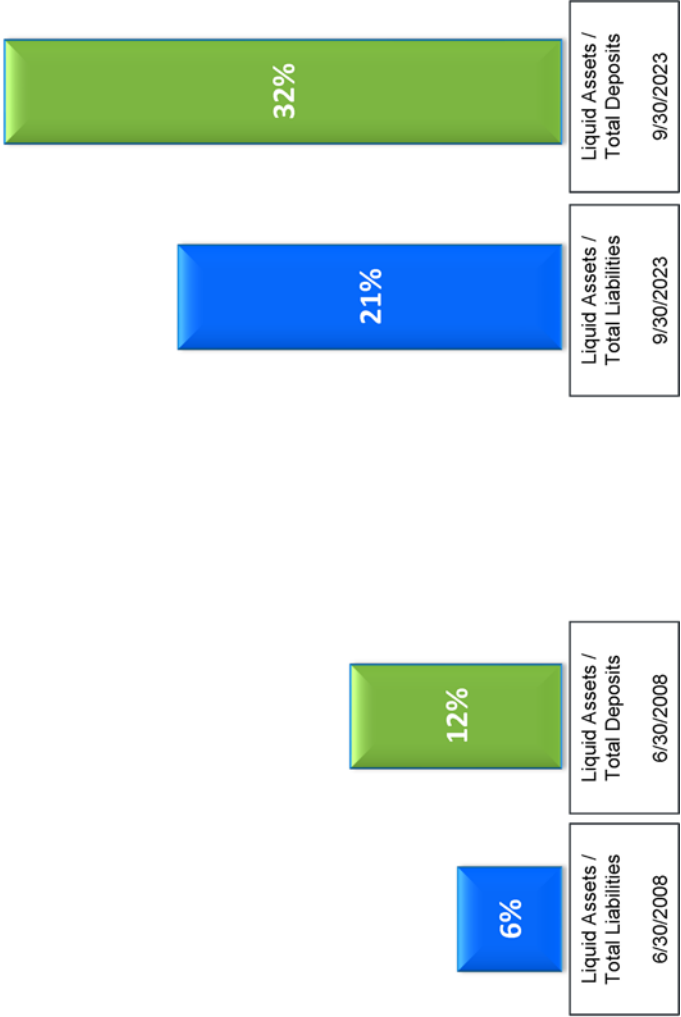


Exhibit D

Tailoring of Prudential Standards

Enhanced Regulatory Requirements Post Financial Crisis

Regulation	Less than \$10B assets	\$10B to \$50B	\$50B to \$100B	Category IV (1)	Category III (2)	Category II (3)	Category I U.S. G-SIBs
Recovery Plans							✓
TLAC Requirement							✓
G-SIB Surcharge							✓
Enhanced SLR (5% / 6%)							✓
AOCI Included in Basel 3 capital						✓	✓
Advanced Approach Risk Weighted Assets						✓	✓
Countercyclical Capital Buffer (if Deployed)					✓		✓
Supplementary Leverage Ratio (3%)					✓		✓
Single Counterparty Credit Limits					✓		✓
Section 165(d) Resolution Plans					✓		✓
Company-Run Stress Testing					Biennial	Annual	Annual
Supervisory Stress Testing				Biennial	Annual	Annual	Annual
Capital Planning (CCAR) / Stress Capital Buffer (SCB)				"Flexible" Annual	Annual	Annual	Annual
Liquidity Coverage Ratio				Reduced (70%) / None	Full / Reduced (85%)	Full	Full
Internal Liquidity Stress Testing				Quarterly	Monthly	Monthly	Monthly
Liquidity Risk Management				Tailored	✓	✓	✓
Risk Committee			✓	✓	✓	✓	✓
Durbin Amendment (Interchange Fee Restrictions)		✓	✓	✓	✓	✓	✓
Subject to Regulation by CFPB	Certain Products	✓	✓	✓	✓	✓	✓
Prompt Corrective Action Tools	✓	✓	✓	✓	✓	✓	✓
Volcker Rule	Eligible for Exemption	✓	✓	✓	✓	✓	✓

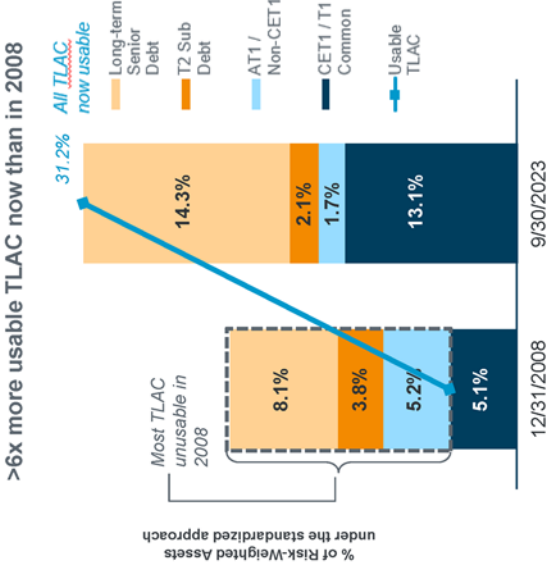
Exhibit E

Usable TLAC Then and Now

Usable TLAC

U.S. GSIBs have substantially increased and restructured their equity and long-term unsecured debt so that all of it can now be used to absorb losses without threatening financial stability.

- TLAC consists of equity plus long-term unsecured debt that can be converted to common equity in bankruptcy
- U.S. GSIBs now have >6 times more usable TLAC
- In 2008, long-term senior debt not usable without imposing losses pro rata on short-term senior debt (e.g., commercial paper)
- Subordinated debt and non-CET1 were considered unusable in 2008 because of market confusion about loss waterfall
- U.S. GSIBs have restructured themselves to make all external unsecured long-term debt at top-tier parent level structurally or contractually junior to all external short-term debt
- Enough long-term debt (senior + subordinate) to recapitalize U.S. GSIBs at full Basel III capital levels under conditions twice as severe as 2008



All capital ratios presented on an aggregate (weighted average) basis. Long-term senior debt in 2008 is estimated based on the long-term non-subordinated borrowings of parent holding companies of all U.S. GSIBs

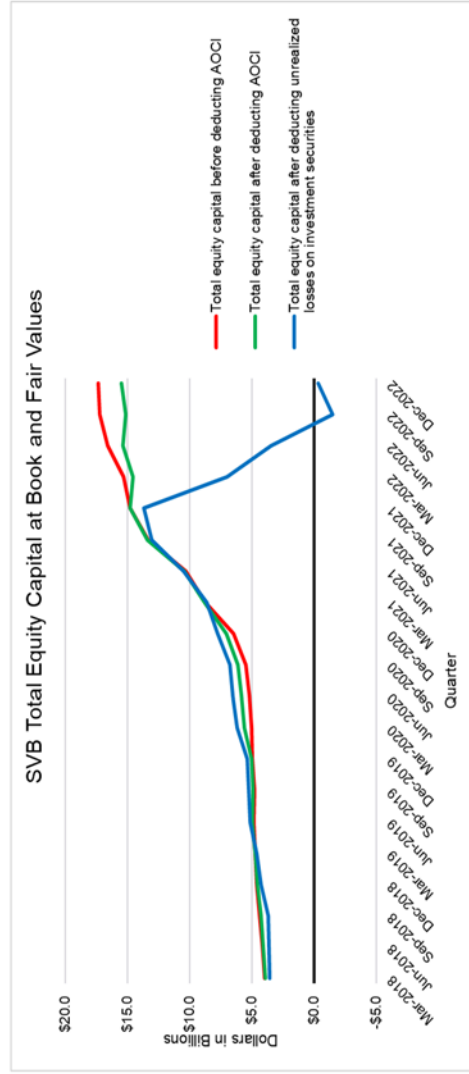
Exhibit F

SVB Insolvency on Fair Value Basis

SVB – What happened?

Insolvent on a fair value basis at 12/31/2022 and 3/9/2023 when the run began

As shown below, SVB was *clearly* insolvent on a fair value basis at 12/31/2022 solely because of the unrealized losses in its investment securities portfolio. In fact, it became insolvent during Q3 2022. Assuming its long-term, fixed rate loans reflected a similar rate of unrealized losses because of interest rate risk and its other loans reflected a significant rate of unrealized losses because of credit or other risks, SVB was *deeply* insolvent on a fair value basis at 12/31/2022.



Source: Davis Polk based on SVB's call reports at each date

Chairman BARR. Thank you, Mr. Guynn. Professor Kress, you are now recognized for 5 minutes.

STATEMENT OF PROFESSOR JEREMY KRESS, ASSISTANT PROFESSOR OF BUSINESS LAW, STEPHEN M. ROSS SCHOOL OF BUSINESS, UNIVERSITY OF MICHIGAN

Mr. KRESS. Chairman Barr, Ranking Member Foster, members of the subcommittee, thank you for inviting me to testify at today's hearing. By way of background, I am an Assistant Professor of Business Law at the University of Michigan's Stephen M. Ross School of Business and Co-Faculty Director of the University of Michigan's Center on Finance, Law, and Policy. My research focuses on bank regulation, systemic risk, and financial stability. Prior to entering academia, I was an attorney at the Federal Reserve Board where, among other things, I worked on the initial implementation of the Basel III capital rules.

The Federal banking agencies have recently proposed several rules that would increase capital levels for the U.S.'s largest banks. Taken together, these rules will better calibrate large banks' capital requirements to the risks these banks pose to society and reduce the likelihood of financial crises that could devastate the economy.

Regrettably, the banking sector has responded to these proposals by spreading misinformation in an effort to delay and defeat them.

I will make three points in my testimony today. First, higher capital is essential to making the U.S. banking system safer and more efficient. Over the past 15 years, policymakers have repeatedly provided public backstops to banks, either directly or indirectly, through Federal Reserve lending facilities, fiscal support measures, and equity injections. Stronger capital requirements will help counter the poor incentives that these rescues have fostered and reduce the need for such extraordinary interventions in the future. Ensuring that large banks maintain sufficient capital is especially critical in light of questions that have arisen about authorities' ability to resolve systemic banking organizations following the disorderly collapse of Credit Suisse and three U.S. domestic systemically important banks last year.

Second, stronger bank capital levels will promote credit availability throughout the economic cycle. Better capitalized banks lend more during economic and financial stress, precisely when households and businesses need credit the most. Recent U.S. experience confirms that higher capital is consistent with sustained credit creation and economic expansion. Indeed, the Dodd-Frank Act and initial Basel III rules raised bank capital requirements during what became the longest U.S. expansion on record, exposing as false banks' contemporaneous warnings about the potential dire consequences of increased capital. The pending Basel III Endgame rules will foster, not threaten, credit availability as most of the proposed capital increase is associated with large banks' trading and fee-generating businesses, not their lending activities, and the risk weights for many categories of traditional loans will actually decrease under the proposal.

Third, the banking sector is trying to invent new legal standards in a brazen attempt to defeat these rules. Requiring banks to fund

themselves with more equity will not impair credit availability but it will modestly reduce bank stock prices, share buybacks, and executive compensation. To avoid this outcome, large banks are attempting to hold their regulators to legal standards that simply do not exist.

Congress has subjected rulemaking by some agencies, including the Securities and Exchange Commission, to various forms of cost-benefit analysis. However, Congress has not imposed any cost-benefit requirement on the Federal banking agencies, and for good reasons. Quantifying the benefits of a banking crisis averted is a nearly impossible task. The law that does govern rulemaking by the Federal banking agencies, the Administrative Procedure Act, requires only reasoned decisionmaking, a standard that current proposals assuredly meet. Indeed, the level of analysis in the current proposals is at least equal to, and many cases exceeds, prior Federal banking agency rules. Make no mistake: if the current proposals are legally deficient, so too are the vast majority of the deregulatory rule adopted under the Trump Administration with far less reasoned analysis.

In sum, the current proposals will strengthen large banks' capital cushions, reduce the likelihood of future financial crises, and position large banks to remain a source of credit to households and businesses throughout the economic cycle. The banking agencies should finalize these proposals without delay and without materially weakening their provisions.

Thank you, and I look forward to your questions.

[Prepared statement of Mr. Kress follows:]

Testimony of Jeremy C. Kress
Assistant Professor of Business Law
University of Michigan Stephen M. Ross School of Business
Before the U.S. House of Representatives Committee on Financial Services
Subcommittee on Financial Institutions and Monetary Policy
“Rules Without Analysis: Federal Banking Proposals Under the Biden Administration”
Wednesday, January 31, 2024

Chairman Barr, Ranking Member Foster, Members of the Subcommittee, thank you for inviting me to testify at today’s hearing. By way of background, I am an Assistant Professor of Business Law at the University of Michigan’s Stephen M. Ross School of Business and Co-Faculty Director of the University of Michigan’s Center on Finance, Law & Policy. My research focuses on bank regulation, systemic risk, and financial stability. Prior to entering academia, I was an attorney at the Federal Reserve Board of Governors where, among other things, I worked on the initial implementation of the Basel III capital rules.

The federal banking agencies have recently proposed several rules that would increase capital levels for the United States’ largest banks.¹ Taken together, these rules will better calibrate large banks’ capital requirements to the risks these banks pose to society and reduce the likelihood of financial crises that could devastate the economy.² Regrettably, the banking sector has responded to these proposals by spreading misinformation in an effort to defeat them.

I will make three points in my testimony today. First, higher capital is essential to make the U.S. banking system safer and more efficient. Over the past 15 years, policymakers have repeatedly provided public backstops to banks, either directly or indirectly, through Federal Reserve lending facilities, fiscal support measures, and equity injections. Stronger capital requirements will help counter the poor incentives that these rescues have fostered and reduce the need for such extraordinary interventions in the future. Ensuring that large banking organizations maintain sufficient capital is especially critical in light of questions that have arisen about authorities’ ability to resolve systemic banking organizations following the disorderly collapse of Credit Suisse and three U.S. domestic systemically important banks in 2023.

Second, stronger bank capital levels will promote credit availability throughout the economic cycle. Better capitalized banks lend more during economic and financial stress, precisely when

¹ See Regulatory Capital Rule: Large Banking Organizations and Banking Organizations with Significant Trading Activity, 88 Fed. Reg. 64028 (proposed Sept. 18, 2023) [hereinafter Proposed Rule]; Regulatory Capital Rule: Risk-Based Capital Surcharges for Global Systemically Important Bank Holding Companies; Systemic Risk Report, 88 Fed. Reg. 60385 (proposed Sept. 1, 2023); Long-Term Debt Requirements for Large Bank Holding Companies, Certain Intermediate Holding Companies of Foreign Banking Organizations, and Large Insured Depository Institutions, 88 Fed. Reg. 64524 (proposed Sept. 19, 2023).

² Although I am generally supportive of all three rules, there is a strong case for requiring large banking organizations to maintain even more equity in lieu of the proposed long-term debt requirement. See Letter from Anat R. Admati, George G.C. Parker Prof. of Fin. & Econ., Stanford Graduate Sch. of Bus., to Ann E. Misback, Sec’y, Bd. of Governors of the Fed. Rsrv. Sys. (Jan. 16, 2024), https://www.federalreserve.gov/SECRS/2024/January/20240124/R-1815/R-1815_012424_157242_507285256923_1.pdf; Letter from Dennis Kelleher, Co-Founder, Pres. and Chief Exec. Off., Better Markets, Inc., to Off. of the Comptroller of the Currency (Jan. 16, 2024), <https://bettermarkets.org/wp-content/uploads/2024/01/Better-Markets-Comment-Letter-Long-Term-Debt-Requirements-for-Large-Banking-Organizations.pdf>.

households and businesses need credit the most. Recent U.S. experience confirms that higher capital is consistent with sustained credit creation and economic expansion. Indeed, the Dodd-Frank Act and initial Basel III rules raised bank capital requirements during what became the longest U.S. expansion on record, exposing as false banks' dire warnings about the potential negative consequences of increased capital.³ The pending Basel III Endgame rules will foster—not threaten—credit availability, as most of the proposed capital increase is associated with large banks' trading and fee-generating businesses—not their lending activities—and the risk-weights for many categories of traditional loans actually decrease under the proposal.

Third, the banking sector is trying to invent new legal standards in a brazen attempt to defeat these rules. Requiring banks to fund themselves with more equity will not impair credit availability, but it will modestly reduce bank stock prices, share buybacks, and executive compensation. To avoid this outcome, large banks are attempting to hold their regulators to legal standards that simply do not exist. Congress has subjected rulemaking by some agencies, including the Securities and Exchange Commission, to various types of cost-benefit tests.⁴ However, Congress has not imposed any cost-benefit requirement on the federal banking agencies. And for good reason: quantifying the benefits of a banking crisis averted is a nearly impossible task.⁵ The law that does govern rulemaking by the federal banking agencies—the Administrative Procedure Act—requires only “reasoned decision making,”⁶ a standard the current proposals assuredly meet. Indeed, the level of analysis in the current proposals is at least equal to, and in many cases exceeds, prior federal banking agency rules. Make no mistake: if the current proposals are legally deficient, so too are the vast majority of the deregulatory rules adopted under the Trump Administration with far less reasoned analysis.⁷

To be sure, some public commenters have noted that targeted adjustments to the current proposals may be appropriate, such as with respect to clean energy tax-equity investments and high loan-to-

³ See, e.g., *Goldman Warns About Resurgence of Shadow Banking*, REUTERS (Jan. 27, 2011), <https://www.reuters.com/article/us-davos-goldman-idUSTRE70Q54X20110127/> (quoting Goldman Sachs CEO Gary Cohn warning that “too much regulation could ultimately stifle economic growth as new requirements for banks to hold more and more capital would ultimately drive up the cost of services to clients”); *Citi CEO Pandit Criticizes Some Basel Rules*, REUTERS (Oct. 25, 2010), <https://www.reuters.com/article/us-citigroup-pandit/citi-ceo-pandit-criticizes-some-basel-rules-idUSTRE69O4WD20101025/> (quoting Citi CEO Vikram Pandit warning that “increased capital requirements could impede the economic recovery ‘by raising the cost of credit precisely when credit is needed the most’ and preventing many potential borrowers from qualifying for loans”).

⁴ See 15 U.S.C. §§ 77b(b), 78c(f), 80a-2(c), 80b-2(c) (providing that when the SEC “is engaged in rulemaking ... and is required to consider or determine whether an action is necessary or appropriate in the public interest, the Commission shall also consider ... whether the action will promote efficiency, competition, and capital formation”). To be sure, these statutory provisions are not explicit cost-benefit requirements; however, they are far closer than any standard to which the federal banking agencies are subject. See Donna M. Nagy, *The Costs of Mandatory Cost-Benefit Analysis in SEC Rulemaking*, 57 ARIZ. L. REV. 129, 133-34 (2015).

⁵ See John C. Coates IV, *Cost-Benefit Analysis of Financial Regulation: Case Studies and Implications*, 124 YALE L.J. 882, 906-69 (2015); Jeffrey N. Gordon, *The Empty Call for Benefit-Cost Analysis in Financial Regulation*, 43 J. LEGAL STUD. S351, S373-75 (2014).

⁶ *Motor Vehicle Mfrs. Ass’n of U.S., Inc. v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 52 (1983).

⁷ See, e.g., Prudential Standards for Large Bank Holding Companies, Savings and Loan Holding Companies, and Foreign Banking Organizations, 84 Fed. Reg. 59230, 59259-60 (Nov. 1, 2019) (presenting a cursory, one-page “impact assessment” of the Federal Reserve Board’s tailoring rules); Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, 84 Fed. Reg. 61974 (Nov. 14, 2019) (invoking “supervisory experience” or “experience” almost 50 times to justify weakening the Volcker Rule).

value residential mortgages. The banking agencies have indicated their openness to such changes to the extent consistent with bank safety-and-soundness. This is a sign of the public notice-and-comment process working as intended. Given the proposals' focus on market and operational risk, targeted reforms to the credit risk framework would be unlikely to detract from the proposals' central objective of improving the safety and efficiency of the U.S. banking system.

In sum, the current proposals will strengthen large banking organizations' capital cushions, reduce the likelihood of future financial crises, and position large banks to remain a source of credit to households and businesses throughout the economic cycle. I urge the banking agencies to finalize these proposals without delay and without weakening their provisions. The remainder of my testimony is based, in large part, on a comment letter I filed on behalf of 30 scholars of banking and finance in support of the Basel III Endgame capital proposal (hereinafter, the "Proposed Rule").⁸

I. The Proposed Rule Will Make the Banking System Safer and More Efficient

The Proposed Rule marks the culmination of the United States' implementation of the Basel Committee on Banking Supervision's framework for improving the banking system's resilience in response to the 2008 financial crisis. The Proposed Rule also begins to correct the regulatory weaknesses exposed in 2023 by three of the four largest bank failures in U.S. history. The Proposed Rule's enhancements to the U.S. regulatory capital framework are critical for strengthening the largest U.S. banking organizations and reducing the likelihood of future financial crises at remarkably modest, if any, cost.

As an initial matter, it is helpful to clarify what bank capital is, and what it is not. Contrary to a common misconception, bank capital is not money that is "set aside" or locked away in a vault. Bank capital requirements simply establish the minimum extent to which a bank must fund itself through equity rather than through debt. Far from being unavailable for the bank to use, bank capital is never idle. It is a source of funds that banks routinely deploy for lending, trading, and other activities.

Bank capital requirements strengthen the banking system in three ways. First, capital requirements protect banks' safety and soundness by ensuring that they maintain a financial cushion to absorb losses. Banks prefer to fund themselves with debt because equity is a more expensive funding source from the bank's perspective.⁹ Banks' reliance on debt can pose a threat to the financial

⁸ Letter from Anat R. Admati et al., to Ann E. Misback, Sec'y, Bd. of Governors of the Fed. Rsv. Sys. (Jan. 16, 2024), https://www.federalreserve.gov/SECRS/2024/January/20240124/R-1813/R-1813_012424_157239_392133404915_1.pdf. I am grateful to Professors Stephen Cecchetti, Kermit Schoenholtz, Kathryn Judge, and Anat Admati for their assistance in drafting the letter and helping to shape my views on bank capital.

⁹ However, the *social* cost of equity funding is far lower than the *private* cost to banks. Legal provisions that lower the private cost of debt funding for banks—the tax deductibility of interest payments, the limited liability of shareholders in bankruptcy, and the range of public guarantees for deposits and other bank liabilities—do *not* affect the social cost. In fact, greater reliance on equity funding counters what are in effect government subsidies to bank shareholders for using debt funding. See Anat R. Admati, Peter M. DeMarzo, Martin F. Hellwig & Paul Pfleiderer, *Fallacies, Irrelevant Facts, and Myths in the Discussion of Capital Regulation: Why Bank Equity is Not Socially Expensive* (Oct. 22, 2013); see also ANAT ADMATI & MARTIN HELLWIG, *THE BANKERS' NEW CLOTHES: WHAT'S WRONG WITH BANKING AND WHAT TO DO ABOUT IT* (2d ed., 2024); Anat R. Admati & Martin F. Hellwig, *The Parade*

system as a whole. As a result of high leverage, even modest losses can deplete a bank's capital and impair its functioning or even render it insolvent. When a large part of the banking system is insufficiently capitalized, an adverse shock can lead to widespread failures, as the United States experienced in 2008. This vulnerability reflects a key externality: through runs, fire sales, and reduced supply of credit, a bank's failure imposes costs on other intermediaries, as well as on households and nonfinancial firms. Capital requirements thus aim to ensure that banks internalize these spillover costs by maintaining a capital cushion sufficient to function effectively even under stress.

Second, capital requirements create better incentives for bank shareholders and executives to manage risk. In nonfinancial businesses, creditors typically discipline borrowers by demanding additional compensation for assuming a higher risk of default. These market mechanisms are less effective in banking, however, because explicit and implicit government guarantees protect bank creditors from losses in the event of a bank insolvency. This is a moral hazard problem: creditors who expect to be shielded from losses do not monitor banks and, as a result, tolerate excessive risk taking. Capital requirements ensure that shareholders have sufficient "skin in the game" to monitor and discipline bank managers. When a bank's shareholders face more downside risk, they are more likely to insist that executives manage risk prudently. Conversely, when capital is scarce, both shareholders and managers may favor gambling for resurrection.

Third, capital requirements lower the costs to the public and to healthy banks when a poorly managed bank fails. Consider the 2023 bank failures. The collapses of Silicon Valley Bank, First Republic Bank, and Signature Bank collectively imposed an estimated \$34.1 billion loss on the Deposit Insurance Fund (DIF).¹⁰ Had these large banks been required to maintain more capital, their shareholders would have been forced to internalize the costs of their losses. Instead, the FDIC must now recoup nearly half of these DIF losses by imposing special fees on surviving banks, with the costs ultimately falling on some combination of banks' depositors and borrowers. Absent higher capital requirements, this approach of post hoc assessments perversely subsidizes risk-taking and taxes prudent management, encouraging a race to the bottom among depositories.

II. The Proposed Rule Will Promote Credit Availability Throughout the Economic Cycle

In addition to preventing financial crises that can devastate households and businesses, strong capital funding supports a more stable supply of credit across the economic cycle. By strengthening banks' capital cushions, the Proposed Rule will help to ensure that the largest banking organizations can continue lending even under stressful economic conditions.

Better capitalized banks lend more during economic and financial stress, precisely when households and businesses need credit the most. In general, the supply of bank credit is procyclical. When the economy slows, borrower default risk rises and banks' capital ratios typically decline, encouraging greater caution. Experience shows that better capitalized banks have a bigger cushion

of Bankers' New Clothes Continues: 44 Flawed Claims Debunked (Stanford Univ. Graduate Sch. of Bus. Rsrch. Paper No. 15-58, 2024), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2292229.

¹⁰ See Remarks by Chairman Martin J. Gruenberg on Oversight of Prudential Regulators Before the Committee on Financial Services, United States House of Representatives (Nov. 15, 2023), <https://www.fdic.gov/news/speeches/2023/spnov1523.html>

to support lending during challenging economic times. For example, the Basel Committee on Banking Supervision's Research Task Force observed that "a country whose banks enter a crisis with a one percentage point higher capital ratio experiences 0.29 percentage points higher annual loan and 0.18 percentage points higher GDP growth in the following five years, compared to other countries."¹¹ Thus, the task force determined, "bank capital ... significantly lower[s] the cost of a crisis by sustaining bank lending during the resulting recession."¹²

Because they have skin in the game, well-capitalized banks also have a stronger incentive to scrutinize potential borrowers, leading to a more efficient allocation of credit. Screening is most important in a fragile economic environment, when lenders must identify projects that will prosper in adverse conditions. Yet, it is precisely in these circumstances that the quality of lending by poorly capitalized banks often suffers: to postpone or conceal losses that might cause their failure, weak banks are prone to sustain lending to zombie firms, helping to transform cyclical recessions into persistent stagnation.¹³

Recent U.S. experience also confirms that raising capital requirements is consistent with sustained credit creation and economic expansion. In the aftermath of the 2008 financial crisis and the Dodd-Frank Act of 2010, policymakers substantially increased bank capital requirements during what became the longest U.S. expansion on record. Focusing on bank performance and credit availability between 2013 and 2019, one analysis found that banks made *more* loans and maintained their profitability, even as they increased their capital levels.¹⁴ The authors concluded: "To be as clear as we can possibly be, higher capital requirements have not hurt banks [and] they have not hurt borrowers ... [I]t is difficult to find any social costs associated with increasing capital requirements and improving the resilience of the financial system."¹⁵ This assessment is consistent with the Basel Committee's Research Task Force, which found that "in normal times, bank capital does not seem to be negatively correlated with loan growth."¹⁶

In theory, an extremely high capital requirement might impede bank lending, but the Proposed Rule does not come close to reaching this tipping point. There is an ample body of literature assessing the economic trade-offs associated with higher capital requirements. While the results are sensitive to assumptions and modeling techniques, the weight of the evidence suggests that setting capital requirements for large banks in the range contemplated by the Proposed Rule poses little risk of impairing the supply of credit. This conclusion is consistent with the banking agencies' assessment of the Proposed Rule's impact: "Although a slight reduction in bank lending could result from the increase in capital requirements, the economic cost of this reduction would be more than offset by the expected economic benefits associated with the increased resiliency of the financial system."¹⁷

¹¹ Basel Comm. on Banking Supervision, *The Costs and Benefits of Bank Capital—A Review of the Literature* 10 (Bank for Int'l Settlements, Working Paper No. 37, June 2019), <https://www.bis.org/bcbis/publ/wp37.pdf>.

¹² *Id.* at 11.

¹³ See, e.g., Caballero, Ricardo, Takeo Hoshi & Anil K. Kashyap, *Zombie Lending and Depressed Restructuring in Japan*, 98 AM. ECON. REV. 1943 (2008).

¹⁴ Stephen G. Cecchetti & Kermit L. Schoenholtz, *Setting Bank Capital Requirements*, *Money and Banking Blog* (Oct. 12, 2020), <https://www.moneyandbanking.com/commentary/2020/10/11/setting-bank-capital-requirements>.

¹⁵ *Id.*

¹⁶ See Basel Comm. on Banking Supervision, *supra* note 11, at 11.

¹⁷ Proposed Rule, *supra* note 1, at 64167.

In addition to the broad empirical evidence on capital levels, there are two reasons specific to the Proposed Rule that it will not impair credit availability: (1) the Proposed Rule applies to less than one percent of U.S. banks, and (2) the majority of the proposed increase in capital requirements is associated with large banks' trading and fee-generating businesses, not their lending activities.

First, the Proposed Rule applies to only 37 large banking organizations, and the biggest proposed capital increases are concentrated among eight global systemically important banks. The Proposed Rule does not apply to the nation's 4,500 community and mid-sized banks. While large banking organizations account for a large share of financial activity, the business model of community and mid-sized banks focuses more on relationship lending, reflecting their local presence and knowledge of their communities. This relationship-based lending model is critically important for the small businesses that drive employment and local economic activity.¹⁸ Community and mid-sized banks hold a far higher proportion of their assets in small business loans compared to large banks,¹⁹ and borrowers report better outcomes when working with smaller banks.²⁰ Rather than impairing their ability to supply credit, the Proposed Rule could help level the competitive playing field for community and mid-sized banks by ensuring that the largest banking organizations maintain capital levels commensurate with their risks. For comparison, the Tier 1 leverage ratio of the eight GSIBs is only about 7%, while that of community banks exceeds 10%.²¹

Second, the Proposed Rule will not impair credit provision because the majority of the proposed capital increase is associated with large banks' trading and fee-generating businesses, not their lending activities. As the agencies' impact analysis shows, the proposed increase in risk-weighted assets associated with trading activity is more than double the proposed increase associated with lending.²² The Proposed Rule would actually decrease risk-weighted assets for some categories of loans, including retail exposures and commercial real estate.²³ To the extent that the largest banks optimize their balance sheets to reduce the Proposed Rule's capital impact, those adjustments could result in a relatively greater focus on lending. As Bank Policy Institute CEO Greg Baer stated, "Clearly, under the proposal, the best thing you could do is be a bank that all it does is make loans."²⁴ In sum, the Proposed Rule will not adversely impact credit availability and, in fact, will better equip large banks to serve borrowers throughout the economic cycle.

¹⁸ See Eldar Beiseitov, *Small Banks, Big Impact: Community Banks and Their Role in Small Business Lending*, FED. RSRV. BANK OF ST. LOUIS (Oct. 20, 2023), <https://www.stlouisfed.org/publications/regional-economist/2023/oct/small-banks-big-impact-community-banks-small-business-lending>.

¹⁹ See BD. OF GOVERNORS OF THE FED. RSRV. SYS., AVAILABILITY OF CREDIT TO SMALL BUSINESSES (Oct. 2022), <https://www.federalreserve.gov/publications/2022-october-availability-of-credit-to-small-businesses.htm>.

²⁰ See FED. RSRV. BANKS, 2023 REPORT ON EMPLOYER FIRMS: FINDINGS FROM THE 2022 SMALL BUSINESS CREDIT SURVEY 7 (2023), https://www.fedsmallbusiness.org/-/media/project/smallbizcredittenant/fedsmallbusinesssite/fedsmallbusiness/files/2023/2023_sbcs-employer-firms.pdf.

²¹ See Sabrina Pellerin, *Bank Capital Analysis Semiannual Update*, FED. RSRV. BANK OF KAN. CITY, (2023), https://www.kansascityfed.org/documents/9905/Bank_Capital_Analysis_Report_-_2Q_2023_-_final.pdf.

²² Proposed Rule, *supra* note 1, at 64169-70.

²³ See *id.*

²⁴ *Capital Wrap: A Roundup From Capitol Account's Basel Endgame Event*, CAPITOL ACCOUNT (Oct. 27, 2023), <https://www.capitolaccountdc.com/p/capital-wrap-a-roundup-from-capitol>.

III. The Proposed Rule Addresses Salient Risks in the Banking System

In addition to strengthening large banks' capital requirements, the Proposed Rule makes several specific adjustments to the United States' regulatory capital framework that will help address salient risks in the banking system. This section examines three such enhancements: (1) reducing reliance on banks' internal models, (2) enhancing the market risk framework, and (3) applying appropriately stringent capital rules to Category III and IV banking organizations.

1. Reducing Reliance on Internal Models

The Proposed Rule improves the existing capital framework by standardizing the calculation of banks' credit and operational risk capital requirements instead of relying on banks' internal models. Since the United States implemented Basel II, the largest U.S. banking organizations have used internal models to calculate their risk-weighted assets for credit, operational, and market risk. Although banks' internal models in theory enhance the capital framework's risk sensitivity, significant flaws with this approach have become apparent over time. For example, since each bank selects its own modeling assumptions, capital ratios are not necessarily comparable across firms. Indeed, as the agencies noted in the Proposed Rule, reliance on internal models has "produced unwarranted variability across banking organizations in requirements for exposures with similar risks."²⁵ The Basel Committee has likewise found that inconsistency in modeling assumptions may skew a bank's capital ratio by as much as five percent.²⁶ In addition, although supervisors attempt to back-test banks' internal models to ensure that they do not inappropriately underestimate risk exposure, empirical validation using historical data is often limited by the fact that severe credit risk and operational risk losses occur sporadically. Reliance on banks' internal models also introduces unnecessary complexity into the capital framework and inhibits market participants from accurately assessing banks' financial condition.

To address these issues, the Proposed Rule disallows the use of internal models for credit and operational risk and instead requires large banking organizations to use standardized approaches. The proposed standardized methodologies under the expanded risk-based approach are meaningful improvements over internal models. Most importantly, the proposed standardized methodologies will enhance consistency across firms, ensuring that large banks maintain a comparable amount of capital for similar risk exposures. Further, the standardized methodologies will increase transparency and comparability so that supervisors and market participants may more accurately gauge large banking organizations' capital adequacy. The use of standardized methodologies for credit and operational risk will also help simplify aspects of the capital framework that have become excessively complex. For these reasons, the agencies should adopt their proposal to reduce reliance on internal models for credit and operational risk.

²⁵ Proposed Rule, *supra* note 1, at 64031.

²⁶ Basel Comm. on Banking Supervision, *Regulatory Consistency Assessment Programme (RCAP)—Analysis of Risk-Weighted Assets for Credit Risk in the Banking Book 3* (Bank for Int'l Settlements, April 2016), <https://www.bis.org/bcb/publ/d363.pdf>.

2. Enhancing the Market Risk Framework

In 2012, the banking agencies implemented the Basel 2.5 reforms to correct some of the most glaring weaknesses in the market risk capital framework that were exposed by the 2008 financial crisis.²⁷ It was widely understood, however, that these initial reforms would be followed by a more comprehensive reevaluation of the market risk framework. To that end, the Basel Committee has undertaken a decade-long fundamental review of the trading book to assess what improvements are necessary. The Proposed Rule would implement key aspects of the Basel Committee's fundamental review in the United States and thereby better protect large banking organizations against risks arising from their trading activity.

The proposed changes to the market risk framework are critical improvements to ensure that banks with significant trading activity maintain adequate capital cushions. Two enhancements are particularly notable. First, the Proposed Rule would better account for tail risk by replacing the existing value-at-risk measurement with an expected shortfall approach that is calibrated to a period of significant stress. This change will ensure that banks are better prepared to withstand low-probability, high-impact trading losses. Second, while the Proposed Rule retains an option for banks to use internal models to measure market risk, it would require more stringent supervisory approval of those models at the trading-desk level. Shifting the model approval process from the banking organization level to individual trading desks will ensure that only trading desks that can accurately reflect their risk via internal models are permitted to use this methodology to calculate their risk-weighted assets.²⁸ Taken together, these two reforms to the market risk framework will better protect against the types of trading losses that banks experienced in 2008.

3. Applying Appropriate Capital Rules to Category III and IV Banking Organizations

Finally, the Proposed Rule will ensure that large regional banks with between \$100 billion and \$700 billion in assets—so-called Category III and IV banking organizations—are subject to appropriate capital rules. When initially implementing Basel III, the banking agencies exempted banking organizations with less than \$250 billion in assets from certain key provisions, including the supplementary leverage ratio, the operational risk capital framework, and the requirement to recognize the effects of accumulated other comprehensive income (AOCI) in capital.²⁹ As a result, large regional banks were allowed to opt out of recognizing the capital impact of unrealized losses on their available-for-sale (AFS) investment securities. In 2019, policymakers further relaxed

²⁷ Risk-Based Capital Guidelines: Market Risk, 77 Fed. Reg. 53060 (Aug. 30, 2012).

²⁸ Empirical evidence has shown that banks strategically underreport risks in their trading books when they have lower equity capital, suggesting that stronger supervisory oversight of internal models is warranted. See Taylor A. Begley, Amiyatosh Purnanandam & Kuncheng Zheng, *The Strategic Underreporting of Bank Risk*, 30 REV. FIN. STUDS. 3376 (2017).

²⁹ Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Capital Adequacy, Transition Provisions, Prompt Corrective Action, Standardized Approach for Risk-weighted Assets, Market Discipline and Disclosure Requirements, Advanced Approaches Risk-Based Capital Rule, and Market Risk Capital Rule, 78 Fed. Reg. 62018 (Oct. 11, 2013).

capital rules for large regional banks, permitting banks with up to \$700 billion in assets to exclude AOCI's capital impact, among other regulatory "tailoring."³⁰

A lasting lesson of the 2023 turmoil is that large regional banking organizations should be subject to a capital framework that is more closely aligned with the very largest banks. The banking turmoil in early 2023 highlighted that distress experienced by Category III and IV banking organizations can destabilize the broader system.³¹ Moreover, as a result of the extraordinary interventions by the banking agencies to stem the panic and resolve the failed banks, investors may expect a similar treatment for Category III and IV banks in the future. That is, they will again expect policymakers to invoke systemic risk exceptions as needed to restore stability even in cases where the relevant banks egregiously failed to manage risk.³² To limit the resulting moral hazard, such banks must be subject to appropriately stringent capital rules that will compel them to internalize the potential spillovers from their failure.

The Proposed Rule will help ensure that the surviving Category III and IV banking organizations operate within a capital framework that is commensurate with the consequences of their potential failure. Most notably in light of recent events, the Proposed Rule will eliminate the AOCI opt-out for Category III and IV banking organizations, thereby requiring them to recognize unrealized losses on AFS securities in their regulatory capital. In addition, the proposal will require Category IV banks to comply with the supplementary leverage ratio and the countercyclical capital buffer in light of their macroprudential significance. The Proposed Rule will further mandate that Category III and IV banks, which had previously been exempted from advanced approaches requirements, calculate their capital ratios under the "dual stack" approach. This reform will ensure that Category III and IV banks' capital requirements are appropriately robust and risk sensitive. This change will not substantially increase regulatory burden because the new expanded risk-based approach is generally based on standardized methodologies and will not require Category III and IV firms to implement the complex internal models that were previously the basis for the advanced approaches.

IV. Criticisms of the Proposed Rule Are Unconvincing

Opponents of stronger capital requirements for large banking organizations have advanced several arguments against the Proposed Rule. This section addresses three such criticisms: (1) the Proposed Rule will increase systemic risks by shifting financial activity to nonbanks; (2) the Proposed Rule will impair U.S. banks' international competitiveness; and (3) the banking agencies lack legal authority to implement the Proposed Rule. As explained below, each of these claims lacks merit.

³⁰ Changes to Applicability Thresholds for Regulatory Capital and Liquidity Requirements, 84 Fed. Reg. 59230 (Nov. 1, 2019); Prudential Standards for Large Bank Holding Companies, Savings and Loan Holding Companies, and Foreign Banking Organizations, 84 Fed. Reg. 59032 (Nov. 1, 2019).

³¹ For a discussion of the 2023 banking turmoil, see SVB AND BEYOND: THE BANKING STRESS OF 2023 (Viral V. Acharya, Matthew P. Richardson, Kermit L. Schoenholtz & Bruce Tuckman, eds., 2023).

³² 12 U.S.C. § 1823(c)(4)(G).

1. Effect on Nonbanks

Critics of the Proposed Rule have alleged that strengthening capital requirements for large banking organizations will increase systemic risks by shifting financial activity to the lightly regulated nonbank sector. However, it is not necessarily the case that bolstering large bank capital requirements will cause financial activity to migrate to nonbanks. In fact, large banks may compete even more effectively when the Proposed Rule is implemented because stronger capital cushions will better prepare them to withstand fluctuations in the economic cycle. Indeed, as previously mentioned, one analysis that focused on the impact of Dodd-Frank and Basel III on credit provision found that banks *increased* their share of credit provision to the nonfinancial sector between 2013 and 2016.³³ Moreover, academic research has shown that some nonbank financial companies already maintain twice as much equity capital funding as comparable banks.³⁴ These findings demonstrate that bank capital requirements alone are not determinative of how the financial sector provides credit to the real economy.

In any case, the migration of financial activity to nonbanks is no justification for allowing large banking organizations to operate with insufficient capital. Where the nonbank sector poses significant risks to financial stability, the proper response is to address these risks directly. Policymakers have mechanisms, including through the Financial Stability Oversight Council, to mitigate risks to financial stability posed by nonbank financial companies. Policymakers should use these tools to ensure that these companies do not trigger another financial crisis. The banking agencies should not, however, shirk their statutory responsibility to protect the safety and soundness of the banking system merely to keep financial activity within the banking perimeter.

2. International Competitiveness

Opponents of the Proposed Rule also contend that stronger capital requirements will impair U.S. banks' international competitiveness. This is a popular argument whenever the banking agencies propose to strengthen domestic safeguards, including when the United States implemented Dodd-Frank and Basel III after the 2008 crisis. Empirical evidence demonstrates, however, that concerns about international competitiveness are misguided. Indeed, after the United States implemented Dodd-Frank and Basel III over the banking sector's "gold plating" objections, U.S. banks outperformed their European competitors.³⁵ In the decade following Dodd-Frank, U.S. banks beat European banks on stock price appreciation, net interest margin, and return on assets, among other performance metrics.

U.S. banks' outperformance makes sense precisely because capital makes our financial system strong and resilient. The real risk to international competitiveness is not stronger capital rules, but rather lax prudential regulation. Indeed, the trend of U.S. banks outperforming European banks eventually reversed in 2023, after the United States rolled back some of its post-2008 safeguards

³³ Cecchetti & Schoenholtz, *supra* note 14.

³⁴ Erica Jiang, Gregor Matvos, Tomasz Piskorski & Amit Seru, *Banking Without Deposits: Evidence from Shadow Bank Call Reports* (Nat'l Bureau of Econ. Rsch., Working Paper No. 26903, 2020).

³⁵ See, e.g., Matheiu Simoens & Rudi Vander Vennet, *Bank Performance in Europe and the US: A Divergence in Market-to-Book Ratios*, 40 FIN. RSCH. LETTERS 101672 (2021).

and experienced another banking crisis due, in part, to lax oversight of large regional banks.³⁶ The lessons are clear: U.S. banks perform best when they are subject to appropriate prudential regulation and the system as a whole is resilient to adverse shocks.

Even if stronger capital rules were to cause some financial activity to migrate overseas, the banking agencies should not prioritize banks' international competitiveness over the stability of the U.S. financial system. Unlike certain jurisdictions, such as the United Kingdom, U.S. regulators do not have a statutory mandate to promote the financial sector's international competitiveness.³⁷ Instead, Congress instructed the banking agencies to prioritize the safety and soundness of the U.S. banking system. This policy choice was both deliberate and wise, because setting financial regulatory policy to maximize international competitiveness would assuredly lead to a destructive race-to-the-bottom. As Bank of England Governor Andrew Bailey observed with respect to the UK's international competitiveness mandate from before the 2008 financial crisis: prioritizing international competitiveness "didn't end well for anyone."³⁸

Finally, the United States is not bound to the international Basel Committee standards as a ceiling on domestic regulation, as some in the banking sector insist. The international Basel accords establish *minimum* regulatory standards and do not in any way prevent jurisdictions from establishing stronger rules when warranted. As the Chair of the Basel Committee, Pablo Hernandez de Cos, recently told the *Financial Times*: "By their very nature Basel agreements only set minimum regulatory standards. If any jurisdiction thinks that for its own banking sector the implementation of Basel III is not enough ... then it's absolutely justified to go beyond the minimum requirements. And that not only is acceptable; I would say that it is needed."³⁹

3. Legal Authority

Critics have further contended that the agencies lack legal authority to adopt the Proposed Rule. Nothing could be further from the truth. Congress has granted the banking agencies wide discretion to set capital requirements and thereby protect the banking system. The International Lending Supervision Act (ILSA) directs the banking agencies to "cause banking institutions to achieve and maintain adequate capital by establishing minimum levels of capital for such banking institutions and by using such other methods as the appropriate Federal banking agency *deems appropriate*."⁴⁰ ILSA likewise grants the banking agencies authority to "establish such minimum level of capital for a banking institution as the appropriate Federal banking agency, *in its discretion*, deems to be necessary or appropriate in light of the particular circumstances of the banking institution."⁴¹

³⁶ See, e.g., Robin Wigglesworth, *Europe is Having a Better Banking Crisis Than the US*, FIN. TIMES (Mar. 23, 2023), <https://www.ft.com/content/81e811d1-c45e-47f5-b70e-1a4638b43010>.

³⁷ See Financial Services and Markets Act 2000, § 1EB (instructing the Financial Conduct Authority to "facilitate[e] the international competitiveness of the economy of the United Kingdom (including in particular the financial services sector)").

³⁸ Andrew Bailey, Chief Exec., Fin. Conduct Auth., *The Future of Financial Conduct Regulation* (Apr. 23, 2019), <https://www.fca.org.uk/news/speeches/future-financial-conduct-regulation>.

³⁹ Laura Noonan, *Basel Chair Backs Stringent US Proposals on Bank Capital*, FIN. TIMES (Jan. 18, 2024), <https://www.ft.com/content/dafc7d80-b052-40f2-b1a5-54f103608a48>.

⁴⁰ 12 U.S.C. § 3907(a)(1) (emphasis added).

⁴¹ 12 U.S.C. § 3907(a)(2) (emphasis added).

ILSA's legislative history makes clear that Congress intended for the banking agencies to have wide latitude in establishing capital requirements:

The Committee believes that establishing adequate levels of capital is properly left to the *expertise* and *discretion* of the agencies. Therefore, in order to clarify the authority of the banking agencies to establish adequate levels of capital requirements, to require the maintenance of those levels, and *to prevent the courts from disturbing such capital*, the Committee has provided a specific grant of authority to the banking agencies to establish such levels of capital.⁴²

Nothing in the Dodd-Frank Act or any subsequent legislation curtailed the agencies' legal authority to set capital requirements as they deem appropriate. Critics contend that the Proposed Rule violates the Economic Growth, Regulatory Relief, and Consumer Protection Act's (EGRRCPA's) "tailoring" mandate, which requires the Federal Reserve to "differentiate among companies on an individual basis or by category."⁴³ This claim is incorrect. The EGRRCPA's tailoring provision applies only to "enhanced prudential standards" that the Federal Reserve issues pursuant to section 165 of the Dodd-Frank Act. The Proposed Rule, however, does not establish enhanced prudential standards pursuant to Dodd-Frank—rather, it sets minimum capital adequacy requirements as required by ILSA. Indeed, it is clear that the Proposed Rule relies on the banking agencies' broad authority under ILSA, not the Dodd-Frank Act, because all three agencies issued the proposal jointly, whereas only the Federal Reserve has authority to establish enhanced prudential standards under Dodd-Frank. Moreover, the Proposed Rule applies to insured depository institutions that are not owned by bank holding companies, which are exempt from section 165 of Dodd-Frank. Thus, allegations that the Proposed Rule violates the EGRRCPA's tailoring provision are inaccurate because the Proposed Rule does not rely on Dodd-Frank's statutory authority.

Finally, even if the EGRRCPA's tailoring provision did apply, the Proposed Rule does not violate it. The tailoring provision requires the Federal Reserve to "differentiate among companies on an individual basis or by category, *taking into consideration their capital structure, riskiness, complexity, financial activities ..., size, and any other risk-related factors that the Board of Governors deems appropriate.*"⁴⁴ As discussed above, the failures of Silicon Valley Bank, Signature Bank, and First Republic Bank in early 2023 had devastating effects on the U.S. financial system, and two of these failures prompted policymakers to invoke the systemic risk exception. The Proposed Rule's establishment of stronger capital rules for Category III and IV banking organizations is consistent with EGRRCPA's tailoring mandate in light of these firms' demonstrated systemic importance. Moreover, the Proposed Rule maintains distinctions between Category I banking organizations and smaller, but still systemically important, firms. For example, Category I banking organizations remain subject to the G-SIB surcharge and the enhanced supplementary leverage ratio, while Category II, III, and IV banking organizations are not. In sum, the Proposed Rule is appropriately tailored to address the risks of various different types of banks.

⁴² S. Rep. No. 98-122, at 16 (1983) (emphasis added).

⁴³ 12 U.S.C. § 5365(a)(2).

⁴⁴ *Id.*

Chairman BARR. We will now turn to member questions. The chair now recognizes himself for 5 minutes for questioning.

You know, I just fail to, at the outset, understand the logic of this idea that in order to protect the economy and financial stability we have to destroy the economy. That does not make sense to me. I note with interest that many of my colleagues on the other side of the aisle, and stakeholders from across the ideological spectrum, have expressed significant concerns with many aspects of the Basel III Endgame.

There is a reason why there is bipartisan concern, because on a bipartisan basis we do not believe, Congress does not believe that the way to protect the economy is to destroy the economy. Many comments on the proposal relate to treatment of mortgages or green energy tax credits. Both issues are examples of unintended consequences from a proposal that contained shocking deficient analysis.

Yet concerns and comments have been expressed from a wide variety of stakeholders, covering far more issues than just mortgages and tax credits, including issues concerning market risks, abandonment of internal models, and more.

The bottom line for commenters is concern about the unknown and unestimated negative effects on credit availability and costs from the proposal from homebuyers, consumers, manufacturers, disadvantaged communities, municipalities, and businesses, large and small.

Mr. Baer, can you touch on the treatment of market risk in the Basel III proposal and talk about likely impacts?

Mr. BAER. Thank you, Congressman, Mr. Chairman. I mean, market risk is a very complicated subject. It is very difficult to measure, but it can and is measured in the proposal.

The problem is it is covered twice. After the financial crisis there was a realization that value-at-risk models, which cover problems that happen most of the time but not all of the time, were not a sufficient measure, and you needed to actually look into the tail of risk and cover the worst case. The United States did that, the Federal Reserve, through the global market shock, and basically had stresses worse than the global financial crisis.

The rest of the world did not adopt a stress test like the Fed. Instead, it went off and worked on a market risk add-on or supplement to Basel, which it called, oddly, the Fundamental Review of the Trading Book. That did effectively the same thing as the global market shock, and now everywhere else in the world they are going to adopt the Fundamental Review of the Trading Book as the measure for market risk, and only in the United States are we apparently on a path to adopting both and doing a pure double count.

I should say there are some other issues within the Fundamental Review of the Trading Book. There are some assumptions that do not make a whole lot of sense. There is an expected shortfall method that really disqualifies the use of models in a lot of cases where they ought to be used. There is something called things that cannot be modeled, and you then get a punitive stress test or standardized charge.

There are problems within the Basel proposal, but the largest problem is the overlap.

Chairman BARR. Yes. This double counting, I think, is really at the core of why this proposal would make our economic system less competitive internationally.

Mr. Baer, can you quickly also discuss the proposed abandonment of internal models and whether in doing so financial institutions' risk profiles and portfolios will be homogenized and thereby actually threaten financial stability?

Mr. BAER. Sure. It is an excellent point. In the United States for the largest banks, we are currently using what is called the advanced approach, is well named, whereby granular bank models are used as opposed to just lumping together classes of loans that do not have a lot in common, which is what standardized approaches do. That system has been in operation since 2011, under extraordinarily stringent guidance from the agencies, and they have at no point between then and now raised any concerns about the accuracy. There has never been an action against a bank.

More importantly, when Basel, when it adopted its standardized approach, it assumed that standardized approach would have applied at 72.5 percent of where it landed because banks would be able to use internal models. Only in the United States are they proposing to eliminate the use of models and effectively set the standardized charge at 100 percent. That will certainly herd banks, as you know, into asset classes that are favored by the standardized approach.

Chairman BARR. Mr. Guynn, really quick. Vice Chair Barr has argued that the effects of this onerous proposal are modest, amounting to increased average loan costs of just a few basis points. Can you discuss whether you believe that there would be a more substantial impact through this proposal?

Mr. GUYNN. I do think that other economists have looked at this and suggested that there is going to be a much bigger impact. Certainly the biggest impact is operational risk that will affect the cost of loans as well, and the market risk, although it is not directed at lending, it is directed at raising debt and equity capital in the capital markets, and it will increase the cost there.

Chairman BARR. Mr. Guynn, how important is it for the Fed to provide the public and regulated institutions with sufficient time to comment on the rule's quantitative impact study.

Mr. GUYNN. I think that is incredibly important. I think one of the surprises here is that they did not do the quantitative impact study at the same time they released the rule but I think people need 60 to 90 days, I think, to actually absorb it and comment on it appropriately.

Chairman BARR. My time has expired, but again, I mean, it is possible to prevent disease by killing the patient, but I do not think we should kill the patient.

With that I yield and recognize the ranking member for 5 minutes.

Mr. FOSTER. Thank you, Mr. Chair, and to our witnesses. This is your chance to go on the record with a prediction. Which of you—and I will not go down the line here—would predict that if this proposal goes ahead essentially as proposed, that large U.S. banks will no longer be competitive and no longer be increasing their market share? Are you predicting that if we go ahead and adopt rules that

will require slightly higher capital requirements for large U.S. banks that they will become uncompetitive and lose market share?

Mr. BAER. Ranking Member Foster, I think that will be line of business by line of business. We have seen them losing market share for some time now in mortgage lending—

Mr. FOSTER. In the whole. In the whole, do you expect—because we had these predictions as we were writing Dodd-Frank that if we went ahead like this that they would be crushed by offshore competitors. That has not happened. Are you predicting it will happen if this goes ahead now, in the whole. Will an aggregate effect make U.S. banks lose market share?

Mr. BAER. Yes. If—

Mr. FOSTER [continuing]. they will decline. Okay.

Mr. BAER. Certainly, capital markets—

Mr. FOSTER. Mr. Bashur—

Mr. BAER [continuing]. across the board.

Mr. BASHUR. I think it would definitely put a lot of strain on them.

Mr. FOSTER. No. Will they become uncompetitive compared to offshore banks—that is the question—which are held to lower capital requirements?

Mr. BASHUR. I think that the strain, over time, could make them much more uncompetitive.

Mr. FOSTER. But you are not predicting it will. Okay. Next?

Mr. GUYNN. I think their costs will go up relative to the foreign competitors, but there are a lot—

Mr. FOSTER. Do you think that is different—but that is a double-edged sword. Will the net effect—

Mr. GUYNN [continuing]. but there are a lot of factors that affect whether you are competitive or not, and I think that they will continue to be competitive, but they will face higher costs because of this capital proposal.

Mr. KRESS. Capital makes us strong. U.S. banks will continue outperforming their international competitors, just as they did after the Dodd-Frank Act I 2010, despite complaints about gold-plating that we heard from the banking sector.

Mr. FOSTER. No, another issue that gets brought up a lot is this issue of double counting, that the stress test already counts them, but the choice of the stress conditions is a tough one. If you could take very realistic near-term stress conditions, will banks remain well capitalized? For example, if China invades Taiwan, the supply of integrated circuits is shut down to the world, there is a worldwide blockade on China, and every business in the United States relies on importing Chinese goods, marking them up. They will find supply chain—they are shut down.

You know how many banks will fail under that circumstance? Is that a realistic test? It is my impression that the stress tests do not even come close to that level of stress, and yet it is a quite plausible geopolitical possibility, unfortunately.

When you talk about double counting, in a situation where you have not actually stressed the banks as much as they plausibly could, by worst case geopolitical events, how do you think about that?

Mr. BAER. Sure. Both the Fundamental Review of the Trading Book (FRTB), under Basel, and the Fed's Global Modeling Studies (GMS), global market shock, are agnostic as to the cause of the stress. Basically they look at how much are spreads going to blow out across all types of securities and then how much illiquidity is there going to be, that is, for how long will the institution be unable to see that security. Now that could be because of war, pestilence, you name it.

Both of them are pretty calibrated around the worst moments of the global financial crisis, and then some. I think it is a reasonable assumption that if there were the upsets of the type that you saw, it is difficult to imagine a worse upset than we saw in 2009, and it is also difficult to imagine that you want to capitalize market making for U.S. capital market on that assumption. At that point perhaps there is a role for the government, but it is certainly not a reason to capitalize the banks every day for a scenario significantly worse than the worst moments of 2009, and then do it twice.

Mr. FOSTER. Okay.

Mr. KRESS. Thank you, Ranking Member Foster. I think two points. One, the banking of last year demonstrated that we absolutely need more variability in our stress test scenarios. The Federal Reserve had not stress tested against a rising interest rate environment, and we saw what happened, so; looking at implementing more variety in the scenarios is definitely something the Federal Reserve should do.

Second, on the issue of double counting, I just want to emphasize that minimum capital requirements and the stress tests do different things. Minimum capital requirements are calibrated to ensure that banks remain solvent, that their assets exceed their liabilities. The stress test, on the other hand, is designed to ensure that banks remain above their minimums, even during times of stress, because we know when banks approach their minimums, or go below their minimums, that is when they pull back on lending.

I do not think it is fair to characterize it as double counting because the mechanisms are supposed to do different things.

Mr. FOSTER. Thank you. My time is up, and I yield back.

Chairman BARR. The gentleman from Florida, Mr. Posey, is now recognized.

Mr. POSEY. Thank you, Mr. Chairman, and I thank the witnesses for appearing here today.

Mr. Baer, Mr. Bashur, Mr. Guynn, in early December, JP Morgan's CEO, Jamie Dimon, told the Senate Banking Committee that under the new capital rules, mortgages and small business loans would be more expensive, saving for retirement or college will be harder, consumer prices will rise, and the government infrastructure projects and corporate development will become more expensive. What do your research and experience suggest?

Mr. BAER. Let me just give mortgages as an example. I think the others are similar. Again, if you assume a 100 percent risk weight that basically means a \$100 loan, \$8 of capital, if you assume 8 is about the average. Under the current rules the risk weight for mortgages is 50 percent, so \$4. Under the advanced approaches being used by the largest banks, which are a more accurate gauge, it is 25 percent. Under Basel, as proposed, and agreed to in 2017,

and for the rest of the world, the risk weight is 25 percent. Under the U.S. proposal for loan-to-value ratios (LTVs) between 80 and 90 percent—so good, solid, highly collateralized loans—it is 95 percent if you include the stress capital buffer from the Fed, and for loans sold to the Government-Sponsored Enterprise (GSE) it is 150 percent.

We are talking 3, 4, 5 times current rates under the advanced approaches and what has been agreed to at Basel.

Again, back to a theme here, there is no analysis in that proposal to demonstrate why those levels of capital are necessary, no historical losses to justify that outcome.

Mr. POSEY. Incredible.

Mr. GUYNN. Greg focused on mortgages. Let me focus on small and medium-sized enterprises and infrastructure. The principal provision that affects the small businesses is one that basically says you have 100 percent risk weight unless you actually are investment grade and you have publicly listed securities, in which case it is a 65 percent risk weight; so, that means that the lending to the company that has listed securities will be cheaper than what it is to the small and medium-sized enterprise (SME). Most SMEs do not have listed securities, so they cannot qualify for the 65 percent risk weight. They will be borrowing at the 100 percent risk weight.

For infrastructure, the cause of the increased cost is the extremely high increase in capital requirements for market risk, which is an increase of 77 percent according to the agency's own estimate. That will substantially increase the cost and reduce the supply of market making. That makes markets less liquid. That makes it more expensive for local or even the Federal Government to finance its infrastructure because they will have to pay more of a risk premium when they borrow money to do those, and also it will be harder to hedge the risks of those.

Mr. POSEY. Thank you. Mr. Bashur?

Mr. BASHUR. I am very concerned about credit cards and the expansion of the supplementary leverage ratio because credit cards will be considered an off-balance-sheet exposure that would be in the denominator of the supplementary leverage ratio (SLR). Now, all of a sudden that is going to impact Category IV banks and their availability to issue new credit and then also the effect on retirees that are invested in collective investment trusts.

I think that the market risk capital requirements are going to significantly hamper liquidity there and then on top of that, if we are talking about double counting, I think just inherent in the proposal itself the application of the operational risk charges to every facet of every service that these banks offer is questionable.

Mr. POSEY. Thank you. When Silicon Valley Bank failed, Secretary Yellen kept repeating over and over and over that the banking system is well capitalized, which made me wonder about the need for Basel III. Mr. Kress, was she telling the truth?

Mr. KRESS. Congressman, I think there is a difference between the legal definition of well capitalized—10 percent equity—versus the normative question—

Mr. POSEY. Was she telling the truth?

Mr. KRESS. Legally, the banking system is well capitalized.

Mr. POSEY. Okay.

Mr. KRESS. That does not answer the question of whether it is well capitalized enough—

Mr. POSEY. I am running out of time.

Mr. KRESS [continuing]. for us to be comfortable with the activities that the banking sector is engaging in today.

Mr. POSEY. I would like to hear from the other gentlemen. Do you agree?

Mr. BAER. Yes. I do not think she was mincing words.

Mr. BASHUR. I agree.

Mr. GUYNN. None of the agencies have put forward any evidence to say that it is not sufficiently capitalized, and if you look at the recent history the banks have been a source of strength during coronavirus disease 2019 (COVID-19) and other things. There does seem to be plenty of evidence that they are well capitalized.

Mr. POSEY. Thank you. My time has expired, Mr. Chairman. I yield back. Thank you.

Chairman BARR. The gentleman yields.

The gentleman from California, Mr. Sherman, is recognized.

Mr. SHERMAN. Nothing is free. If we have maximum capital standards we reduce economic growth and hurt small business and first-time homebuyers. If we minimize the capital requirements then we increase economic risk, and we saw, in 2008, how first our economy was shaken to the core and then with the bailout our constitutional system and social contract was shook to the core.

What I think we can agree on is that poorly tailored regulations are bad. They reduce economic growth without reducing the bailout risk. I commend the regulators for trying to strengthen our banking system, but there are some poorly tailored regulations. One example that I will get to later is giving no credit for private mortgage insurance and thereby hurting first-time home buyers and people of color disproportionately.

These regulations are being sold as we are going to harmonize with Europe. It is Basel. It is something the whole world is doing, when, in fact, these regulations go far beyond Basel, in most cases. This is not harmony with Europe. This is an attempt to move toward higher standards than Europe has.

One area that sees where these regulations are inadequate, which might put me to the left of Mr. Kress, and that is on interest rate risk. Before 2019, banks with over \$250 million, I believe, had to recognize unrealized losses on available-for-sale securities. That is what the bill I have introduced, the Bank Safety Act, would require for all banks over \$100 billion.

What about the held-to-maturity securities? Silicon Valley Bank proved to us that you can bankrupt a bank by investing in long-term debt, and it does not matter which category you put it in, held-to-maturity or available-for-sale. If you buy enough of them you cannot just have a liquidity problem, you can have a solvency problem. Your bank can be bankrupt, and these regulations inadequately deal with that.

When it comes to stress testing, I have proposed the Effective Bank Regulation Act to say that the bank's stress testing should look at interest rates going down as one of the possible stresses. The response from bank regulators sitting right there was no, in-

terest rates going down only helps banks because we have these stupid depositor profit centers. Depositors will leave their money.

They do not, and Silicon Valley Bank went under.

Mortgage servicing rights are hurt by these proposals, and that is going to hurt home borrowers, and especially those first-time homebuyers.

I am concerned about the effect this will have on our capital markets. At a time when we passed the Bipartisan Infrastructure Act this is going to hurt municipal bonds and make it harder to do the very projects that we united to be in favor of.

As I mentioned, you have no credit for private mortgage insurance, and I want to thank Representatives Meeks and Beatty and Vargas and Horsford and others for joining me in sending a letter saying they need to reconsider that.

As Mr. Gwynn put it out, this regulation advantages the big borrowers with listed securities and penalizes banks for doing the one damn thing we want them to do, and that is to lend to local businesses, particularly on Ventura Boulevard. I cannot imagine why they did that.

Finally, as to the clean energy tax credits, this gives them zero value while preserving the value for the very analogous low-income housing credits.

We have a regulation that does nothing to learn from the Silicon Valley Bank, and it encourages banks, if they want to make a profit, to engage in risky, perhaps profitable, but risky bets on long-term, non-interest-rate-adjustable bonds without an interest rate hedge, and then it hurts first-time homebuyers, small businesses, and the environment.

Can I sneak in a question?

Chairman BARR. The gentleman's time has expired.

The gentleman from Missouri, Mr. Luetkemeyer, is now recognized for 5 minutes.

Mr. LUETKEMEYER. Thank you, Mr. Chairman, and I certainly appreciate and want to associate myself with the remarks of Mr. Sherman. He nailed one point after another that is problematic with this rule. He articulated not only the problem but the effect that it could have on our small businesses, in particular, and the different markets he was talking about. I applaud him for his remarks this morning.

As somebody who was a former regulator for a couple of years, and in the banking business for another 40-plus, I appreciate higher capital. I believe in higher capital. I think it is important. It solves a lot of problems but there is a limit, as Mr. Sherman just said, as to where that line should be.

After Dodd-Frank—I am not a big fan of Dodd-Frank but it actually worked from the standpoint of having the banks have more capital, and I think the ultimate stress test was about 3 or 4 years ago when we had the pandemic, and we survived that. Our banking system survived that. Our economy survived that, a result of strong banks. Now we are trying to go out here and put more capital in the banks, or in my mind, trying to appease the foreign folks. As Mr. Sherman has articulated, we are going beyond what they really want us to do.

I think part of this is a result of the three banks that failed last spring. It was not that the banks were under-capitalized. They would have had to have 25 to 30 percent capital. They were under-regulated. This rule, to me, tells me that the regulators are not doing their job, and I told them, when they were sitting in your chairs right there, this fiasco that happened last spring is 50 percent your fault, because you allowed a business model to exist, go unchecked. You knew it was wrong, your reports showed it was wrong, and yet you did nothing. This rule is a way for them to cover their rear ends. It looks like to me.

I asked myself the question, what problem are we trying to solve here? Mr. Baer, can you give me an answer to that question? What problem is this rule trying to solve?

Mr. BAER. Well, I will try to be kind.

Mr. LUETKEMEYER. You do not have to be. That is all right.

Mr. BAER. No, I think the genesis of this is that in 2017, agency staff agreed to Basel, and now they are getting around, belatedly, to implementing it and there are good arguments for having international standards and some similarities among capital requirements.

What I find is so perplexing and concerning about this proposal is that it is not really what they have done. They have added, in almost every case, to the Basel which they agreed to. The securities listing requirement that Randy talked about that disqualifies small businesses from access even to a 65 percent risk weight when the numbers show it should be 30 to 40. Well, that was jettisoned by both the European Union and the U.K. Of course, here we have the stress tests they do not have.

I understand the spirit—let us get Basel done—but this is not Basel.

Mr. LUETKEMEYER. Mr. Bashur, if you would answer that question as well, but considering this fact. I was in the Small Business Committee hearing and Vice Chairman of the Small Business Committee, and the other day we had a very, very respected economist there, and he said that this administration proposes about \$150 billion a year in new rules and regulations, costs that have to be assimilated into the budgets and the services and products that are sold by these businesses, especially small businesses. This is a huge barrier for them, a huge burden for them, and there is no Administrative Procedures Act requirement here, supposedly, that forces them to do any kind of a study.

How difficult is this to really be able to implement this, and should this be part of an economic study, with regards to—or should be a requirement of the Administrative Procedures Act?

Mr. BASHUR. I think that this rule lacks a substantive economic analysis that needs to be analyzed much more substantively, and I think that the effect on small businesses will be substantial. In fact, when I talked about credit cards earlier I think there could be an effect on actual spending which could impact small businesses.

In general, I think that with this proposal—and does this solve anything—this is a perfunctory measure. They are trying to follow through with what Basel has proposed, but again, that gets to the problem of why we are listening to Basel and not to you all.

I do admit that there are certain places in statute where Congress has said let's do a capital requirement. There is one for 50 percent for certain residential mortgages, but as a whole that is not the case. I still think that because of the uniform application of these rules across Categories I through IV banks that is in direct contradiction to S. 2155.

Mr. LUETKEMEYER. Thank you, and I see my time has expired. I yield back, Mr. Chairman.

Chairman BARR. The gentleman's time has expired.

The gentleman from Georgia, Mr. Scott, is recognized.

Mr. SCOTT. Thank you very much.

Professor Kress, I have expressed my deep frustration with this situation in our previous meeting on Basel III, and it seems like the Fed is being pulled in two directions. On the one hand, protecting the soundness of our banking system, and on the other hand, preserving the ability for millions of borrowers to buy a home. That is the situation we are in.

In your testimony you highlight, it seems to me, an openness by regulators to make some adjustments in the proposal. With respect to high loan-to-value residential mortgages, tell me, have you seen any recent indication of this happening? Please excuse my cold.

Mr. KRESS. Thank you, Congressman. I think this is a great example of the public notice and comment process working as intended. The agencies following the Administrative Procedure Act put the notice out for an initial 120-day period. They later extended that. The public has had now 173 days in which to comment, and they heard, as you noted, a lot of feedback on the residential mortgages front, and the agencies have indicated that they will take that into account.

The initial proposal laid out three different options for how to address residential mortgages, and it is too early to say what option they will use when they finalize.

Mr. SCOTT. Let me ask you this. If enacted, the provisions affecting mortgage lending in the Basel III Endgame proposal will require our Nation's largest banks to hold significantly more capital against certain mortgage loans, like those of borrowers with less than 20 percent down payment. Does that trouble you?

Mr. KRESS. Congressman, I think it is important to contextualize the businesses that these banks are in. The proposal affects the 37 largest banks in the country, out of 4,500. The depository institutions, the financial institutions that are providing loans to low-and moderate-income communities are primarily smaller community banks, credit unions, and in some cases non-depository institutions.

I do not want to overstate the effect because so much of the mortgage lending that you are concerned about is not being done by the 37 affected banking organizations.

Mr. SCOTT. Mr. Baer, let me come to you. What would be the impact of risk weights for mortgage loans if they are compounded with the operational risk charge and the Federal Reserve's stress tests?

Mr. BAER. Sure. I mean, obviously the effect would be profound, as I gave some numbers earlier. I mean, you are talking about a capital charge of probably three, four, maybe more times higher than historical loss experience would suggest and that Basel agreed

to. You know, you have already seen the market share of banks in mortgage decline precipitously over the last 10 years. There was a little bit of an uptick last year but I think you can expect that trend to continue.

It is important not only because banks tend to offer good loans, good prices, but also they have much more of an incentive to work with borrowers who get into trouble. Actually, that is also punished in the proposal. If you do a workout, that is considered a default.

In the nooks and crannies of this proposal there are a lot of other provisions that are at low-and moderate—

Mr. SCOTT. What about for mortgage loans intended to be sold to the government-sponsored enterprises?

Mr. BAER. I mean, I think this was probably unintended, but it is a good example of how disruptive the operational risk requirement is. You do not think of that as operational risk, but basically when a bank sells to the GSEs they only hold it for 60, 90 days. When they sell it they get a fee. That is not credit risk, but under the proposal that is operational risk because fee income is supposed to be a proxy for operational risk. So there you have a mammoth operational risk charge, which again results in a 150 percent risk—

Mr. SCOTT. Well—

Mr. BAER [continuing]. sell to the GSEs, which I assume they are going to fix.

Mr. SCOTT. You see, I am not the only one on this committee who is very frustrated with what is going on here. Tell me, why are they doing this?

Mr. BAER. I mean, in general, again, I think it is Basel adherence, but again with a lot of add-ons. The U.S. mortgage market, particularly with regard to mortgages, the mortgage market is different. U.S. banks are much more dependent on fee income than foreign banks, and so I do not think that got a lot of attention in Basel. U.S. banks are uniquely hit by the operational risk charges.

Mr. SCOTT. Thank you very much.

Chairman BARR. The gentleman's time has expired.

The gentleman from Georgia and vice chair of the subcommittee, Mr. Loudermilk, is now recognized.

Mr. LOUDERMILK. Thank you, Mr. Chairman. Thank you all for attending today. A very important conversation we are having. Very timely as well.

Before I get into my questions, though, I just want to reiterate something my colleagues have said before. The overhaul of banking regulations before us today is not just about the globally, systemically important banks. The proposal will affect regional and mid-sized banks as well as their customers but I do not think it is going to stop there either.

During the limited public comment period, the regulators heard from Georgians on all sides of the political spectrum who were concerned about this proposal. I have a few of their comments right here. I would love to read them all aloud, but we do not have time for that; so, I would like to insert all of those for the record.

Chairman BARR. Without objection.

[The information referred to can be found in the appendix.]

Mr. LOUDERMILK. Thank you, Mr. Chairman.

Following the 2008 financial crisis, Georgia lost more small and community banks than any other State. After Dodd-Frank and the regulations that were imposed, since I have been in Congress, we were very slow to see de novo banks and community banks reinstated. In fact, when I first came onto this Committee a few years ago we still had 15 counties in Georgia that did not have a small or community-owned bank, and there were two that had no bank whatsoever, and a lot of that was because of the regulation.

Now I have a whole suite of questions, but really I think I can summarize this. What you have heard today, on both sides of the aisle, there are a lot of problems with this regulation. Mr. Baer, I ask you first, would there be a downside to entirely withdraw this proposal, and given all the problems to reintroduce it in a way that addresses a lot of the concerns that you have heard about here today?

Mr. BAER. Yes, Congressman, I think that is completely appropriate and necessary in this case. Some of the changes that need to be made, based on the data and the analysis, were not even within the scope of the proposal. We have talked a little bit about the fact that the cost-benefit analysis, which is actually legally required—and I will get to that in a sec—is going on through a belated Quantitative Investment Strategy (QIS), where we are never really going to get a chance to analyze what those costs and benefits are. That also seems to merit re-proposal.

I would note, in answer to Professor Kress, that the Supreme Court has held, even though there is no explicit cost-benefit requirement in a statute, that does not mean that you do not consider the costs and benefits. In *Michigan v. EPA* in 2015, the Supreme Court actually ruled in a statute that said that the regulations should be appropriate and necessary. That included a cost-benefit analysis. In fact, the Court said, quote, Agencies have long treated costs as a centrally relevant factor when deciding whether to regulate. Consideration of costs reflects the understanding that reasonable regulation ordinarily requires paying attention to the advantages and the disadvantages of agency decisions, end quote.

I think that is what is necessary here and really did not happen in the first go-around.

Mr. LOUDERMILK. Okay. Thank you. Mr. Guynn, do you have thoughts on this? I mean, one of my concerns is seeing what happened post 2008, and a lot of that was because of capital requirements. I really do not want to see rural areas of Georgia go without local community banks and basically those areas be taken over just by the big players.

Same question to you. Would there be a downside to withdrawing the proposal entirely and then reissuing something that addresses these concerns?

Mr. GUYNN. I think that could be a good—well, I actually want to address also the question you asked at the beginning of your series of questions, which is will this have an impact on smaller banks or will it be limited to the large banking organizations.

It is very interesting because when the long-term debt requirement was first proposed, it currently only applicable to the GSIBs. Now my colleagues and I warned other banks that sometimes these requirements at the top have a tendency of coming to a theater

near you, and now they are actually coming to a theater near the large regional banks.

If high standards are good over time, they seem to be good for everybody, both big banks and small banks; and I think there is a risk that they will sort of be imposed downward.

Also there is this \$100 billion level, right? There is a cliff effect. If you are a smaller bank, and the economy may actually encourage you, and want you to grow larger and become more competitive, you will be deterred to do that because if you cross the \$100 billion threshold all of a sudden you are subject to all these increased capital long-term debt requirements.

Mr. LOUDERMILK. Thank you. Mr. Chair, I see I am out of time, and I yield back.

Chairman BARR. The gentleman's time has expired.

The gentleman from Illinois, Mr. Casten, is recognized.

Mr. CASTEN. Thank you, Mr. Chairman. Thanks to everybody for being here.

As a general matter, I do not think there is any problem with regulators saying we need to evaluate the risk of banks and make sure there is appropriate capital for the risk. I do have a concern when we are weighting things that are comparably risky in different ways. I have been pretty consistent on this, specifically with respect to the tax equity provisions, that the rules say that if you are using tax equity for new market housing it has one level of risk profile. If you are using it for energy investing it has four times the risk. Essentially banks would have to increase their capital holding by four times.

Mr. Baer, because I see you nodding your head, do you want to just give us a quick understanding of why banks use tax equity and how that is used to deploy energy projects?

Mr. BAER. Yes. Actually, I would commit to anybody. Matt Levine is a journalist who wrote a terrific explanation of the whole bank financing of energy tax credits, and it is sort of interesting, sort of legally, how it works. In effect it is a loan but it qualifies for equity tax credits but there is no question that it is a helpful thing.

What it really gets down to, as sort of an example of the proposal as a whole, what is the loss experience? The proposal includes no data on the loss experience for that business?

Mr. CASTEN. Yes, and I want to avoid speculating but—I just wanted, like—the comment that this is loan-like I think is the material part, because if I am buying your depreciation, if I am buying your interest payments on that, if I am buying your investment tax credit, I am buying something that is a known commodity. It is a fixed coupon, right—

Mr. BAER. Yes.

Mr. CASTEN [continuing]. effectively, and it looks like a loan; so, we are getting agreement on that.

Earlier this week the Bank of New York Mellon's CFO said that if the rule were to go ahead it will severely reduce, or even eliminate, the capacity of banks to invest in renewable energy projects. Are you hearing that from other members of yours as well?

Mr. BAER. Yes, I mean, I think actually some of our banks have commented to that effect. I mean, quadrupling the price of any-

thing is going to affect the supply, and I do not think these are terrifically profitable.

Mr. CASTEN. Okay. Mr. Kress, I know you were involved in a lot of the early work back in your Fed days, and I hope nobody asks me for my memory for like what I was doing 10 years ago. As you recall, was there a discussion in drafting up some of these early Basel rules when you were at the Fed about how this was going to affect clean energy markets, the risk experience of those clean energy tax credits?

Mr. KRESS. Based on my experience at the Fed, this is a perfectly normal part of the notice and comment process. You put a proposal out, receive comment, and then make changes, if necessary, consistent with safety and soundness. It happens all the time. It happened in the initial Basel III implementation. It happened in many other Dodd-Frank rules. This is an indicator that notice and comment is working as intended, that the Administrative Procedures Act is being followed.

I just want to contextualize the tax equity issue, though very important is such a very small part of the overall Basel III Endgame package. Even if were changed it would not materially weaken the overall impetus of ensuring that we have strongly capitalized banks.

Mr. CASTEN. Yes, no, I appreciate you saying that because I do think that this is not an issue that dramatically changes the intent of Basel III, but it does dramatically change because if I am understanding you right you all were not thinking about this back in 2014 timeframe.

We also did not have the Inflation Reduction Act, and I would love to live in a world where we actually, if we decide that it is worth spending taxpayer money on something, we do not only afford that opportunity to people who have tax liability and good tax accountants, and that is a long conversation about why we consistently use the tax code to engineer our society.

As long as that remains true, let us not pass the biggest climate bill in the history of any government anywhere that is meaningfully changing the deployment of clean energy in this country, is meaningfully putting us on a trajectory to leave a better planet than the one we inherited from our parents for our kids, and then cut it off at the knees. Even though this is a small piece of the Basel III rules, it is a big deal for the clean energy industry that is basically making decisions to invest right now based on whether or not they can monetize the tax credit that we passed last term.

I hope we can fix it. I have led several letters with my colleagues to push it. I hope that notice and comment period is factored in.

Thank you all for your time. I yield back.

Chairman BARR. It is always good when the gentleman from Illinois and I can find common ground.

With that I yield to my friend, the gentleman from Tennessee, Mr. Rose.

Mr. ROSE. Thank you, Chairman Barr, for holding this hearing, and thank you to our witnesses for taking time to be with us today.

The flawed Basel III proposal will have harmful impacts on consumers and small businesses. Simply put, the proposal's indiscriminate, one-size-fits-all approach undermines consumer lending and

will result in less access, increased cost, and reduced innovation for consumer credit and small business loans. The impacts of the proposed rule will be disproportionately borne by regional, mid-sized U.S. banks and their customers who are typically low-income consumers and those new to credit as well as small businesses that invest in the creation and growth of jobs in local communities. By statute, these institutions are supposed to have their regulatory requirements appropriately tailored to their business model and risk levels.

Mr. Guynn, due to inflation, the ability of working class Americans to finance essential purchases such as a house, car, or home improvements has become more costly and challenging. Would not the disproportionate and unfounded capital constraints created by the Basel proposal further restrict access to credit, increase consumer credit prices, and exacerbate inflationary impacts for working Americans?

Mr. GUYNN. It certainly will. I mean, that just follows from basic economic analysis, give that capital has an equivalent impact to a tax and; so, it will reduce the supply and increase the cost.

Now if the capital levels were lower you might say that cost is worth it because the benefits, in terms of increased resiliency, is worth it, but the agencies have not put forward any evidence to say that the massive increases in capital have not been sufficient. I think they need to do that before the proposal is finalized with a substantial increase in capital, as the proposal would do.

Mr. ROSE. Thank you, and I agree with your analysis.

Tennessee prides itself in being a destination for foreign direct investment in the United States. We are home to more than 1,000 foreign-based businesses that have chosen to invest more than \$47 billion in our economy in Tennessee, and create more than 160,000 jobs. These foreign-based companies like Nissan, Bridgestone, Aviagen, and many others rely on cross-border financing from global banks, including foreign banking organizations, or FBOs, operating in the United States to drive their expansion in Tennessee.

I fear that the prudential regulatory proposals, including Basel III Endgame and long-term debt rule, risk making the United States a less attractive market for global banks, which largely finance foreign direct investment. Mr. Baer, how would the Basel III Endgame and long-term debt proposals adversely impact global banks' financing of foreign direct investment in the United States?

Mr. BAER. Sure. I mean, foreign banks now generally operate in the United States under two business models, a few with an overlap. Some are effectively just regional banks—certainly all the large Canadian banks and some of the European banks—and they will suffer just as American regional banks do under the credit provisions, op risk, and all of that.

With regard to their market operations—and a lot of them operate either through subsidiaries or branches in the United States—they will certainly be seeing the extraordinarily high market risk charges that U.S. GSIBs, in particular, will be seeing.

I think we have already seen a scaling back of European operations in the United States, partly because of capital but also they are facing an extraordinarily stringent examination regulatory regime, where they are effectively having to duplicate their risk man-

agement in the United States versus abroad. Even though it is a consolidated risk management process, they are subject through what is known as the Credit Union Service Organization (CUSO) rules to a whole nother layer of examination, regulation, compliance burden in the United States, and generally do not get a lot of credit for that back home, on the capital front as well as others.

Mr. ROSE. Thank you. As the owner of a family farm, I know that the Basel III Endgame could have devastating ramifications for the agriculture industry. Mr. Bashur, what might we expect to see in the ag industry if Basel III Endgame is enacted?

Mr. BASHUR. I think liquidity would definitely dry up, both because a bank could operate as an intermediary or as a counterparty in those transactions. I think it is important for ag producers to be able to hedge interest rates or commodity prices. In particular corn and soybean will be affected, since I believe the majority of futures and swaps that are used are by those two industries.

Mr. ROSE. Thank you. I see my time is expiring, and I yield back, Mr. Chairman.

Chairman BARR. The gentleman yields. The gentleman from Texas, Mr. Green, is recognized.

Mr. GREEN. Thank you, Mr. Chairman. I thank the ranking member as well, and I thank the witnesses for appearing.

If you would, kindly indulge me. I would like to acquire some intelligence from each of you. I see that you are all very prominent personalities, well educated. First question to all of you, and if you would kindly extend a hand into the air if the answer is yes, I would greatly appreciate it.

Do you have women working in the business you are in? If you do, raise your hand, please.

[Show of hands.]

Mr. GREEN. Let the record reflect that all have raised their hands.

Are there women in your business who are capable, competent, and qualified enough to appear here today? If so, raise your hand, please. Thank you.

[Show of hands.]

Mr. GREEN. Is it fair to say that among you there is not one person who would identify as a woman? If this is true, raise your hand, please.

[Show of hands.]

Mr. GREEN. Thank you. Let the record reflect that once again we have an all-male panel. Let the record reflect that my visual observation indicates to me that these are all white males. If you have identified yourself as something other than a white male, perhaps on some survey, census report, would you kindly extend a hand into the air?

Let the record reflect that no hands have been extended into the air.

I still believe that women are capable, competent, and qualified enough to sit on these panels. My friend, the chair, and I have discussed this. There are some times when we seem to do better than others. This is one of those days when we are not doing well.

Let me move on to the questions at hand. Let us talk first about banks in this country. There are only 67, approximately 67 banks

in the country with more than \$1 billion in assets. In fact, of the 4,500 banks that will be impacted by this rule, that could be impacted by this rule, only 37 will be impacted.

Is this a true statement, Mr.—is it Kress?

Mr. KRESS. Correct, yes.

Mr. GREEN. Is this true?

Mr. KRESS. That is true.

Mr. GREEN. All of what I said?

Mr. KRESS. Correct.

Mr. GREEN. Is it true that banks that are well capitalized lend money?

Mr. KRESS. Absolutely.

Mr. GREEN. Is it true that they lend more when they are well capitalized than when they are less capitalized?

Mr. KRESS. That is correct.

Mr. GREEN. Is it true that what we are proposing, by way of a rule, Basel, is going to benefit banks in that they will be able to lend more?

Mr. KRESS. I am sure if you asked Mr. Baer he would say that it does not benefit banks. I think what is important to note is capital is a choice, right. It is choice about how we allocate the risk of bank failures and how we allocate the risk of financial crises. Strong capital rules force banks and bank shareholders and bank executives to internalize those costs. Weak capital rules externalize the costs of bank failure and bank crises on the rest of society. We know when those costs are externalized that they hit the most vulnerable among us. Black and Hispanic workers were hit hard. In 2008, Black and Hispanic families lost 45 percent of their household wealth, compared to 26 percent for White families. So bank capital is very much a social and racial justice issue.

Mr. GREEN. It is true that not one community bank will be impacted by this?

Mr. KRESS. That is correct.

Mr. GREEN. I ask because there is a lot of consternation emanating from my friends across the aisle. They seem to think that this will wipe out the community banks.

Mr. KRESS. This is 37 banks all with more than \$100 billion in assets.

Mr. GREEN. Would you repeat that, please?

Mr. KRESS. Thirty-seven banks, all with more than \$100 billion in assets.

Mr. GREEN. Let me close with this. I was here in 2008, when Secretary Paulson came before this committee, indicating that there was some troubled waters ahead. I was here when we voted on the \$700 billion bailout package. We bailed the banks out. We imposed rules to capitalize them well, but now we see that there is a need to do more.

I do not want to participate in another bailout. I am not prognosticating. I am not saying that this is a harbinger of things to come. What I am saying is it seems to me that rules that do not hurt banks, that cause them to be better capitalized, are not going to hurt those people who have their life savings in banks.

Mr. Kress, would you quickly respond in the last 5, 6 seconds?

Mr. KRESS. Over the past 15 years, we have seen repeated public backstops at the banking system. This is a practice of privatizing gains——

Chairman BARR. The gentleman's time has expired.

Mr. KRESS. Capital will——

Mr. GREEN. Thank you, Mr. Chairman.

Chairman BARR. The gentleman's time has expired. He can submit the remaining answer for the record.

The gentleman from Texas, Mr. Williams, is now recognized.

Mr. WILLIAMS of Texas. Thank you, Mr. Chairman, and thank you all for being here.

Over the last year our Nation's Federal banking agencies have been bombarding our financial system with excessive regulations and dangerous proposals like Basel III Endgame, long-term debt requirements, and climate risk management standards. It is alarming that our banking agencies are rolling out these types of proposal in a rushed fashion without considering how these combined regulations and requirements might impact innovation, limit access to capital, and threaten economic stability.

We have heard our Federal regulators make false claims that these harmful onslaughts of regulatory proposals have a meaningful cost analysis. However, from what I see, many of the rules proposed since March of last year are hundreds to thousands of pages long, but all of these proposals lack an adequate quantitative analysis to ensure that the cost of these new rules would not negatively impact financial institutions, businesses—and I am a small business owner in Texas—or the overall economy. There is no question that these burdensome rules will increase compliance costs to already struggling businesses.

Mr. Baer, did Federal banking regulators analyze and estimate interactive effects of the thousand-page Basel III Endgame proposal, long-term debt proposal, or the 1,500-page Community Reinvestment Act proposal?

Mr. BAER. Congressman, they made almost no effort to do that individually, and certainly no effort to do that collectively.

Actually, I am glad you mentioned the long-term debt. I mean, for regional banks, that is an extraordinary requirement. They are being subject to the same requirement as GSIBs, even though it is for an entirely different purpose. For GSIBs it is to facilitate a resolution where everything below stays open and operating. For regionals it is—which is somewhat understandable—to just have another layer of loss absorbency, but same requirement. For regional banks it will be more expensive for them to issue debt than large banks, the largest banks, which are constantly in the market. The market gives a liquidity premium, which the regional banks will not enjoy, so it will cost more.

Also I think the agencies, to your point on holistic review, simply did not understand the interplay between that rule and a liquidity rule called the Liquidity Coverage Ratio, which for reasons I can explain to you over a beer means that they are going to have to issue even more debt than projected.

That was, I think, a classic case of failing to understand the interplay of all these rules.

Mr. WILLIAMS of Texas. Thank you for that. One of the greatest concerns I have, along with many others, is that Basel III Endgame proposal will put American last and create disadvantages for American businesses and consumers and by making U.S. standards more stringent than what was recommended to other international countries. U.S. regulators are picking winners, they are picking losers in the global market, and forcing institutions that they regulate to end up being the losers.

Bad actors like China will surely not be placing their financial system under such standards, so we must not allow our banks to not be able to compete on a global scale.

Again, Mr. Baer, could you elaborate on the competitive disadvantages that U.S. banks, businesses, and consumers will face due to this proposal? I mean, what is wrong with being an American?

Mr. BAER. Yes, Congressman. Obviously it is going to vary. I think as I responded to the ranking member, business line by business line. I mean, obviously for credit cards, U.S. banks do not compete with banks in France or other places. The biggest impact would be in financial markets, in capital markets, where again, U.S. banks have done terrifically well.

I think, though, as you look at some of the risk weights here—and again, it is very technical—there are areas, particularly in dealing with a funds business, where U.S. banks could be looking at capital charges three, four times higher than overseas competitors, I think you would see migration there. I think the GSIB surcharges continues to be an issue for the very largest banks.

I think the bigger concern is not even competitiveness. It is just lack of capital markets liquidity. We have already seen inventory depth declining, even as the amount of bonds floating in the market has increased dramatically. So the ratio of market-making capacity to the need for market-making capacity is completely out of whack, and this would certainly worsen that.

Yes, at the margin certainly a competitiveness issue, but I think more an issue just about the resiliency of U.S. capital markets.

Mr. WILLIAMS of Texas. Regulations just choke small businesses. No question about it. I have limited time so I am going to ask you a quick question, Mr. Bashur. Can you elaborate on how the Basel III proposal will impact small businesses' ability to grow and thrive in the economy? As I said, I am a small business owner so I am interested in what you say.

Mr. BASHUR. I think it will be a detrimental impact on small business because of the retail exposure provision in this proposal. On top of that you have the operational risk provision in the proposal. I think that especially talking about community banks, I think community banks are actually affected in this because of the credit card interplay here, because a lot of them have to use larger issuers to issue their cards. I would just like to note that 82 percent of U.S. households have at least one credit card, so it is a large swath of Americans that will be affected.

Mr. WILLIAMS of Texas. My—

Chairman BARR. The gentleman yields. The gentlewoman from Ohio, Mrs. Beatty, is recognized.

Mrs. BEATTY. Thank you, Mr. Chairman, and again, thank you to all of our witnesses.

Professor Kress, I would like to start by taking about Basel III capital requirement proposal. Let me just say I agree with your written testimony acknowledging the importance of strong capital requirements to avoid financial crises and to protect our economy. Like many of us and others of my colleague have said, we remember the financial crisis of 2008, as an elected official, as a small business going through that. I also remember, in 2009, under a new President, President Barack Obama, that Congress passed almost an \$800 billion American Recovery and Reinvestment Act.

Capital is unquestionably our first line of defense, and I want to make sure that I am on the record saying that. I applaud the regulators' efforts to strengthen capital so that our financial system is safe and secure. We all know, whether it is small businesses or not, what happens when we go into a financial crisis.

At the same time, I want to also be a champion of access to capital, particularly for underserved and minority communities. We just heard what can happen to small businesses. We also know that, historically, minority and underserved businesses have experienced unequal access to loans and other banking services. I think we can do both at the same time; We can increase capital reserves at large financial institutions while also promoting credit accessibility for low- and moderate-income (LMI) communities and communities of color.

I would like to now turn to small business credit and affordability. Professor Kress, does the Basel III proposal decrease risk weights for all small businesses or just a subset?

Mr. KRESS. There is a different treatment in the credit risk framework, depending on whether the company is publicly traded. For non-publicly traded small businesses the risk weight is 100 percent, which is the same as the risk weight under the existing capital rules; so, the credit risk framework would not change for non-publicly traded businesses. It would drop to 65 percent, from 100 percent, for publicly traded businesses.

Mrs. BEATTY. What was the reasoning behind the different risk weights for these types of businesses, and what changes can we make in the final rule to achieve the same goal without disadvantaging small businesses?

Mr. KRESS. I will note that U.S. regulators are under statutory constraints. In section 939A of Dodd-Frank, Congress told the regulators that they cannot use credit ratings to set risk weights for businesses as is done internationally by most other countries. This attempt by regulators is an attempt to use a standardized, non-credit-ratings-based methodology to assess riskiness.

As with green energy tax credits and residential mortgages, this is an area where the regulators have received public comment. In another example of the public comment process working, they have indicated an openness to considering alternatives.

Mrs. BEATTY. Let me continue with this. Some claimed that Basel III Endgame proposal runs afoul of the Administrative Procedures Act. Can you set the record straight for us and explain the steps that regulators took prior to issuing the proposal to conduct

a thorough analysis and to meet all of the standards and requirements?

Mr. KRESS. Thank you for this question because I feel like I have been living in an alternate universe, hearing the descriptions of how this rule allegedly runs afoul of administrative law.

The quantitative impact analysis done in the Basel III Endgame proposal is more substantial than in any banking rule I have witnessed. The banking agencies have already conducted a QIS. That is why we know that the risk-weighted assets for market risk will increase, more than double the increase in lending-related risk-weighted assets. That is how we know that the capital requirements for the largest GSIBs will increase almost three times as much as the capital requirements for mid-sized banks.

The proposal has been put out for comment for 173 days already. Regulators have promised to do another quantitative impact study, release that study for public comment. This is way more than was done, for example, in the initial implementation of the Basel III rules, when I was at the Federal Reserve, and it is a quantum leap over what was done to comply with administrative law with the deregulatory rules established under the Trump Administration. If you look back at the tailoring rule, for example, there was no effort to quantify impacts on the economy, other than a conclusory statement that it would not materially impact—

Chairman BARR. The gentlewoman's time has expired.

Mr. KRESS. We know now that is false.

Mrs. BEATTY. Thank you so much. Thank you, Mr. Chairman.

Chairman BARR. The gentlewoman's time has expired.

The gentleman from Wisconsin, Mr. Fitzgerald, is now recognized.

Mr. FITZGERALD. Thank you, Mr. Chairman.

Before I get into the questions that I had, Professor Kress, you mentioned earlier that the Basel proposal would only apply to a small group of 37 banks. I just wanted to get, Mr. Baer, your comment on that number, and could you respond to that. Do you think that is accurate or close?

Mr. BAER. Sure, Congressman. It is correct but perhaps a trifle misleading is those banks hold, I think, approximately 85 percent of U.S. banking assets.

Mr. FITZGERALD. Got you. Thank you for verifying that.

I have been pleased to see that some of my colleagues on the other side, it sounds like some of them are seeing some at least significant issues or problems with the implementation of the proposal. However, rather than going back to kind of the initial, everything on the initial drawing board, some of my colleagues on the other side are pushing only for this narrow carveout from increased capital requirements for green energy tax credits from the Inflation Reduction Act.

Mr. Bashur, if such a carveout is granted to address only one of the many problems in the regulators' proposal, while much of it would still be intact, what message would that send, not just on the independence of the Federal Reserve but to families who may have more difficulty getting a mortgage or, as said before, small businesses who would see the reduction in an access to credit?

Mr. BASHUR. I think it would send a bad message because there are so many provisions in this proposal that contravene S. 2155 and apply uniform regulation over categories I through IV, one of them being the tax equity piece, but then again, with supplementary leverage ratio, accumulated other comprehensive income (AOCI) for available-for-sale (AFS) securities among others. I think that it has to be—and the fact that we do not have detailed cost-benefit analysis, economic analysis, I think it warrants reconsideration altogether.

Mr. FITZGERALD. Very good. Despite the unnecessarily drawn-out process that has kind of characterized bank mergers under this administration so far, yesterday Acting Comptroller Hsu announced changes to the merger process that would make the process slower and probably less transparent. This follows the Department of Justice's (DOJ's) plan to update guidelines on banking mergers to provide more robust scrutiny, and Vice Chair Barr's expressed desire to assess how the Federal Reserve platform performs analysis on bank mergers.

If you believe antitrust analysis should follow the rule of law and not the individual views of those who, at any particular point in time, had the relevant agencies, I am concerned any change in that analysis that would depart from long existing and widely accepted standards may not reflect actual changes in the competitive environment. Further, the capital proposal from the Fed and other financial regulators, on top of the other recent regulatory proposals is bound to lead to consolidation to overcome the compliance burden of this rulemaking.

To Mr. Guynn, if the Biden Administration insists on throwing up obstacles to bank mergers while sharply increasing the regulatory burden on banks, is it time for Congress to step in and ensure there is a transparent, defined timeline for approving or denying a merger?

Mr. GUYNN. Thank you very much, Congressman. It is interesting because I actually think that the administration's policy that disfavors bank mergers is at war with its policy on Basel III Endgame, because Basel III Endgame has the biggest economic impact on the regional banks, and that will actually give them a powerful economic incentive to become much larger. Otherwise, they become uncompetitive. If you then say, well, you cannot merge, there is a risk that they will become weaker and weaker financially, and that will cause a problem for the system. Basically, that will increase the risk of failure and force mergers into FDIC receivership.

I guess in answer to your question, I think it would actually be useful for Congress to propose a bill to reform and make more rational, more predictable, more transparent the bank merger approval process.

Mr. FITZGERALD. Thank you. I am going to try and sneak in one more question here real quick.

Small businesses are increasingly turning to credit cards as a key source of funding. Research shows 30 percent of small businesses have used credit cards as their primary source of funding, and another 22 percent relied on a loan or line of credit.

Mr. Baer, at a time when small businesses are facing tighter monetary policies, particularly when it comes to securing loans from traditional and non-traditional lenders, would revised bank capital standards under Basel Endgame further limit small business credit?

Mr. BAER. Absolutely, Congressman. I mean, first because they do not qualify for a favorable risk weight because they do not have listed securities, even though our research, which we published, and I would commend to you, shows that for a bank that rates a business investment grade internally, whether that company has listed securities or not, is entirely nonprobative of default and loss given default. There is no justification in the proposal for it, and we have demonstrated it is entirely spurious.

Chairman BARR. The gentleman's time has expired.

The gentlewoman from California, the ranking member of the committee, Ms. Waters, is recognized.

Ms. WATERS. Thank you so very much for this hearing that we are doing today.

I am a bit irritated here because it seems as if we have forgotten, in such a short period of time, what has happened in this country as it relates to this struggle to increase more capital in our largest bank. I would like to just raise a question here about what took place with our banks.

Last year we saw the second-, third-, and fourth-largest bank failures in the U.S. history. It started when Silicon Valley Bank sold its securities at a loss. Is that correct?

Mr. KRESS. Correct, Ranking Member.

Ms. WATERS. Investors and customers lost confidence in Silicon Valley Bank and pulled their money, resulting in the biggest bank run. Is that correct?

Mr. KRESS. Correct.

Ms. WATERS. We later saw that Silicon Valley Bank was exempt from certain bank capital requirements, pursuant to a Trump regulatory rollback, when they should have held 2 percent more capital for the security portfolio that they sold at a loss. Is that correct?

Mr. KRESS. That is correct, and I would note that regulatory rollback was done with no impact analysis.

Ms. WATERS. This Basel III Endgame rule could fix that problem. Is that correct?

Mr. KRESS. That is what it is proposed.

Ms. WATERS. In 2018, Trump signed 2155 into law to deregulate large regional banks, and Trump's regulators, that law was a blank check to roll back all kinds of requirements on banks like Silicon Valley Bank. Is that correct?

Mr. KRESS. Correct.

Ms. WATERS. They claimed this deregulation would not undermine financial stability, and Silicon Valley Bank proved that was a lie. Is that correct?

Mr. KRESS. Absolutely.

Ms. WATERS. Now we have all of our regulatory agencies working together—FDIC, OCC, the Federal Reserve—all saying this rule is very important, that because of Basel III Endgame that we should raise that capital so that we will not again witness what we witnessed with the failure of not only Silicon Valley Bank but with

Signature Bank and First Republic Bank, three of these banks that had a run on them. It all had to do with a lack of capital when the run took place, and they did not have the capital to make sure that they took care of their depositors. Is that right?

Mr. KRESS. Yes, ma'am.

Ms. WATERS. With the Federal banking regulators jointly issuing a proposal to strengthen capital requirements for the biggest banks, known as Basel III Endgame, should that not be what the Members of Congress are doing in order to avoid the catastrophe that took place with Silicon Valley Bank and Signature Bank and First Republic? Is that not what we should be doing?

This proposal will help prevent future financial crises like the 2008 financial crisis, when Lehman Brothers and other large financial institutions failed, costing the U.S. economy \$22 trillion and resulting in massive taxpayer bailout. We bailed them out, and we said we would never do that to our taxpayers again. The way to do that is to ensure that they have the capital that is needed to avoid what happened with Lehman and Silicon Valley Bank and Signature Bank and First Republic Bank. Is that correct?

Mr. KRESS. Yes, ma'am.

Ms. WATERS. The Dodd-Frank Act required the largest banks to hold more capital, but Trump-era deregulation reversed much of that, causing the failures of Silicon Valley Bank, Signature Bank, and First Republic Bank, three of the largest bank failures in U.S. history.

Capital is not locked away. Rather, it is safe funding that banks can redeploy, which is why better-capitalized banks lend more, not less, to consumers, in good times and bad. Is that correct?

How soon we forget. How soon we want to run away from 2155, when it became apparent what had happened when deregulation took place. Now we have others who wish to ignore what our regulators are saying and not go along with Basel III Endgame that says we must have 2 percent more capital. I do not understand it. Do you?

Mr. KRESS. No, madam.

Ms. WATERS. Thank you. I yield back.

Chairman BARR. The gentlewoman yields back.

The gentlewoman from California, Mrs. Kim, is now recognized.

Mrs. KIM. Thank you, Chairman. I want to thank our witnesses for being here today. Since our ranking member mentioned, the failure of the Silicon Valley Bank—and I am also from California—just to be clear, I would like to state for the record that SVB's failure was about liquidity, not capital, and I think it also had to do with the mismanagement of the banks and the failure of the regulators.

I want to start by coming back to the focus of our hearing and make a couple of observations.

One, I am deeply concerned that the Basel III Endgame and the other proposals will make credit more expensive for small businesses and it would reduce mortgage lending to low-to moderate-income households and put our banks at a competitive disadvantage abroad.

I am also concerned that the current proposal, as written, does not enjoy broad consensus from the Federal Reserve Board. It has

been reported that certain European countries want carveouts on their own Basel III Endgame proposals to protect their banks from the increased cost of higher capital requirements. In Asia, 3 of the top 10 companies in the world are giant-sized, state-owned Chinese banks that, to my knowledge, are not planning to implement the Basel framework any time soon.

A question to you, Mr. Baer. One of the Basel Committee on Bank Supervision's core mission is to harmonize regulatory standards to bring other international jurisdictions up to the U.S. regulatory standards. In your view, what will happen to the competitiveness of our banking industry if U.S. capital standards are not harmonized with other international jurisdictions?

Mr. BAER. Yes, I mean, it is a great point, Congresswoman. Actually, at the time that the 2017 agreement on Basel was announced, they said they did not expect an increase in capital requirements. They published a quantitative index study showing it would not result in an increase in capital requirements. Around the world you see that basically being the trend. The Bank of England has implemented with a 3 percent increase in capital requirements, compared to, I think, the initial estimate from the U.S. regulators was 16 percent. I think when they are done with their QIS it is going to be closer to 20.

Clearly if the desire is consistency, we are failing utterly. We have a U.S.-only GSIB surcharge methodology, which is roughly double the global standard. We have a U.S.-only stress test and stress capital charge, which again largely duplicates the op risk and market risk charges in Basel. It just goes on and on, and it is noted, even for small businesses, although they do not directly compete, but just as a measure of rationality, both the U.K. and the EU have abandoned the securities listing requirement.

Mrs. KIM. Yes, so Mr. Baer, if the financial regulatory agencies move forward with the Basel III Endgame proposal, would you say that credit will be more expensive for our small businesses, manufacturers, and families when compared to other countries in the United States and Asia?

Mr. BAER. Absolutely, Congresswoman. I mean, the capital charge for a loan to a U.S. small business would be significantly higher than for small businesses—

Mrs. KIM. You know, our country is the envy of the world because we have more banks than anywhere in the world. In fact, more than 4,000 banks provide credit to most corners of our society.

A question to you, Mr. Guynn. In your testimony you state that under the proposals large regional banks will have strong economic incentive to consolidate to better compete against U.S.' GSIBs. Can you elaborate on how the proposals will push banks to consolidate, and can you also tell the committee how greater consolidation will impact credit for small businesses and households?

Mr. GYNN. Yes, Okay. The reason there is a disproportionate impact on the regional banks is they are subject to the increase in capital by the Basel III Endgame, and a rule that currently only applies to the GSIBs will now be extended to them, where they are now going to be subject to subordinated, long-term debt requirement.

Subordinated debt is just a different name for an additional capital requirement. When you add those two together basically they will now be subject to nearly two times the amount of capital that they are currently subject to. That will be very expensive for them. They are smaller than the GSIBs. They will feel a need to have larger scale to be able to spread those costs over a larger base. So they will have a powerful incentive to merge and consolidate.

Also I do think that, as a sort of separate issue on small businesses, I think the real issue for the small businesses is I think the regional banks will continue lending to small and medium-sized businesses, which they focus on, but the risk weights will now disincentivize that because they will say, well, I only am charged a capital equal to 65 percent of a loan that I make to a large business that is publicly listed, but I have to have 100 percent charge for a small business.

Chairman BARR. The gentlelady's time has expired.

The gentleman from New York, Mr. Meeks, is recognized.

Mr. MEEKS. Thank you, Mr. Chairman and Ranking Member Foster.

Let me just say, while I think many of us feel like we have had ample opportunity to discuss the Basel III Endgame implementation proposal in this committee, I really do appreciate having a forum to look at the proposal and rulemaking process to see what improvements could be made. Now that the comment period has ended for the Basel implementation proposal, I want to express how much I have valued being able to weigh in with the regulators about concerns that I and many of my colleagues have about unintended consequences of the proposal.

In my meetings with the regulators I have actually found a genuine willingness to discuss how the proposal could be improved to address the issues that have been raised. I also believe that they share in our broader goals of addressing historical disparities and access to home ownership, which is a primary function of mine of having access to home ownership, which helps close a wealth gap, particularly in communities of color, as well as in credit scores and credit. I believe in the important role that Community Development Financial Institutions (CDFIs) and Minority Depository Institutions (MDIs) play in our communities and our ecosystem, and I want to make sure that they are also taken care of and not become victims of something that was unintended. My hope is that they will take into account the wide variety of comments received in order to have a comprehensive view of the various changes that need to be made.

Now I have been here long enough—in fact, I was sitting in this committee during the 2008 financial crisis, and I witnessed the ensuing devastation that it caused in communities across this country, and I never want to see something like that happen ever again. I believe that the safety and soundness of our banking system is paramount, as evidenced as recently as just this past March. I never want there to be confusion that raising concerns about potential impacts means that I do not support and understand the regulators' intent. Their intent is to do the right thing, and we are trying to make sure, I am trying to make sure that the intent is met and we do not have any unintended consequences, which is the rea-

son why I thought it was very important for me and others to ask the questions that we ask.

I will ask Dr. Kress, in your testimony you acknowledge that high loan-to-value residential mortgages are an area where adjustments to the proposal may be appropriate, and data shows that LMI borrowers and LMI communities and black and Hispanic borrowers are disproportionately represented in the highest LTV categories.

Do you believe that, as written, the proposal will translate into higher costs for borrowers in the highest LTV categories, and could you identify the targeted changes you referenced in this area?

Mr. KRESS. Thank you, Congressman, and I am heartened to hear that you have productive conversations with the regulators. That is an example of the notice and comment process working as intended, having those productive conversations in contrast to the threats to sue, to block the rule that we are hearing from the banking sector.

As I noted earlier, the regulators laid out three possibilities for how to address residential mortgage risk weights in the proposal. I know that they have received comments on all of them, and they have indicated openness to perhaps changing their prioritization of those options. I am sure those are conversations they are having within the building, and I know that they share your goal of protecting the safety and soundness of the banking system while ensuring access to credit.

Mr. MEEKS. Thank you. In my little time, Mr. Baer, I wonder if you could speak to how those various regulatory proposals could interact with one another and what it could ultimately mean for the consumer.

Mr. BAER. Sure, Congressman. Clearly that is one of the concerns here is that even within the Basel proposal the overlay between operational risk and credit risk has not been considered. We have not even talked about securitization today, where there are punitive charges which will affect the ability to make mortgage, auto, credit card loans, including to low-and moderate-income people, and distribute that risk.

The charges here are roughly double the current, whereas around the world it is actually—

Chairman BARR. The gentleman's time has expired.

The gentleman from Florida, Mr. Donalds, is recognized.

Mr. DONALDS. Thank you, Chairman. Gentlemen, thanks for coming here today.

Mr. Guynn, Vice Chair Barr knows that the U.S. banking system became significantly more capitalized following the great financial crisis, which is true. With that he is trying to sell the idea that greater capitalization, that better capitalized U.S. banks experience lower funding costs are more profitable and have gained more market shares in global markets for financial products relative to their global competitors.

Are you aware of any study that has shown a casual connection between U.S. banks' capitalization and their global competitiveness?

Mr. GYNN. I am not aware of any such study at all, Congressman.

Mr. DONALDS. What is Vice Chairman Barr talking about?

Mr. GUYNN. I think he is speculating. He said he did a holistic review of capital requirements, but he is yet to release what the data and what the conclusions of that are. Maybe he will actually release those after he has the data from the banks, that I guess they are now looking at. I hope that they do because there does need to be a lot more justification for why capital needs to be raised.

As you know, and as was discussed earlier in this hearing, it is a tradeoff. You can have perfectly safe banks but no lending to the—and other banking services—or you can have unsafe banks and a lot of lending and other banking services. What we are trying to do is we are trying to hit the right balance, and the question is, we have been increasing capital now for a number of years. Are we at that right balance or do we need to have still more capital? It is not cost free, despite what some people say. In our view, until someone shows that the benefits of that increased capital is higher than the extra cost then I do not think that this proposal should go forward.

Mr. DONALDS. Let me ask you this question. I think it was raised earlier in this hearing that U.S. banks are still competitive compared to their international counterparts, even with the extended regulatory and capital requirements that we have enacted in the United States since 2008. A different way of looking at that, are U.S. banks more competitive to other ways of raising capital, i.e., private equity, venture cap funds, other private endeavors that actually do not have to deal with Basel requirements or have to deal with the burden of the regulatory system in the United States?

Mr. GUYNN. Yes, that is a very good question, and in fact, one of the consequences of this will be to continue the trend of having non-bank financial institutions have a greater and greater share of the credit provided in the U.S. economy. In 1980, that was about 30 percent. It is now close to 60 percent and as you increase—

Mr. DONALDS. Mr. Guynn, I do not want to cut you off, but we are in a congressional hearing. Sometimes we have to restate these things.

Mr. GUYNN [continuing]. Okay. No problem.

Mr. DONALDS. In 1980, private access to credit, meaning not through the banking system, was 30 percent. It is now 60 percent. I mean, Mr. Baer, do you agree with this assessment that the more we do this it is actually going to continue to shrink the regulated banking system in the United States because people are smart and they are just going to say, “Why am I doing business this way? I will just do it another way and get around the Federal Government.”

I will add before you answer that, Mr. Baer, my problem with the government overall is that the government has become omnipotent busybodies who think they know everything, and they do not. Silicon Valley Bank is a testament to that, Mr. Baer.

Mr. BAER. Sometimes I think of myself as an omnipotent busybody, but I will not take that personally.

No, I mean, certainly we have seen, in certain asset classes, an incredible rise in private equity, private debt, certainly non-bank

mortgage. Some would say, oh, that is a problem because they are not regulated like banks. I mean, that may be a problem.

I think the larger problem, and we have seen this, is that they are not durable lenders like banks. The reason we have banks is because they take in deposits, which are relatively stable funding. They have access to a discount window, which is emergency funding, and that lets them lend money cheaper, and it lets them lend money under stress.

The question is, regulation aside, what is going to happen under stress with these lenders when they do not have any real stable funding to do that? What I think we are going to see, and we have already seen in capital markets, is it is actually the government that steps in. We saw that in the Treasury market, which forever had been advertised as the most liquid market in the world, and we had the Fed intervene as the market-maker of last resort. A phrase that did not exist pretty long ago, in both 2019 and 2020, and began trading the bonds.

I think the draft from banks is a concern, initially because of cost and stability, but then also because of government.

Mr. DONALDS. Mr. Baer—real quick, Chairman. I know I have 15 seconds. Mr. Kress, thank you for being here. In your opening statement you essentially said that, and I am paraphrasing, that because of the fact that the U.S. Government has stepped into the position of bailing out banks it is also the position of the U.S. Government to make sure that banks are appropriately capitalized so we do not have to go into that business again. Is that correct?

Mr. KRESS. That is correct.

Mr. DONALDS. Mr. Chairman, if you indulge me? Will you indulge me real quick, Mr. Chairman?

Chairman BARR. We can have him submit the answer for the record.

Mr. DONALDS. I will just pose this question to the witness. The question is this. If that is the premise, then why we do not stop bailing out banks, and why we do not actually look at the regulatory system itself so banks are in a position—

Chairman BARR. The gentleman's time has expired.

Mr. DONALDS. I yield.

Chairman BARR. You can submit that for the record. The gentleman yields back.

We now go to the gentlewoman from Texas, Ms. De La Cruz.

Ms. DE LA CRUZ. Thank you. Thank you, Mr. Chairman, for holding this important hearing, and thank you to the witnesses for appearing before us today.

Mr. Baer, this question is for you. Many people in my district rely on regional banks. Have regulators provided an analysis on what Basel III's regional bank customer impact will be?

Mr. BAER. Yes, Congresswoman, that is one of the failings of the proposal. There is very little data analysis, very little cost-benefit analysis.

Ms. DE LA CRUZ. So, the answer is no.

Mr. BAER. No.

Ms. DE LA CRUZ. Now, Mr. Baer, have the regulators provided analysis of the impact that the effective repeal of S. 2155 will have on regional banks and the customers that rely on them?

Mr. BAER. No, Congresswoman.

Ms. DE LA CRUZ. Mr. Baer, have the regulators provided analysis for the impact on rural area, if regional banks are not able to lend because they do not want to cross the \$100 billion mark and become subject to Basel III?

Mr. BAER. Not that I am aware of.

Ms. DE LA CRUZ. Mr. Baer, in October I sent a letter with other members of this subcommittee to the regulators, and we highlighted the impact Basel III would have on our farmers and our ranchers. Have the regulators provided an analysis for what the impact will be to our farming and ranching community?

Mr. BAER. No, and I would add that is not just lending. Securities markets, a lot of farmers and ranchers want to hedge their risks. There are punitive capital charges around end users' use of derivatives products. There are any number of impacts on folks like that, that are not quantified.

Ms. DE LA CRUZ. What I have heard is no to every question that I have given, that there has been no analysis made, and it is clear comprehensive benefit analysis has not been done for Basel III Endgame.

Mr. Baer, could you share with me, how should the regulators move forward in light of this?

Mr. BAER. I am glad you asked. I mean, we talked earlier about it, and I think Mr. Kress mentioned that they did a quantitative impact study and they said how much it is going to go up. I think they were off a little bit. Even taking that, the question, though, is not how much did it go up. The question is why did it go up and is the benefit of it going up worth the cost of it going up?

They did a little bit on the first question, they are going to do a little bit more, but we have not begun to answer the second and third question. The second question is all around what are the relative risks to these assets. I would also just object to the notion that the banking industry is putting out disinformation and threatening to sue.

My institute has probably published two dozen academic-quality research notes on every aspect of this proposal, from market risk to credit risk to operational risk, published by Ph.D. economists, subject to comment by anybody who wants to comment. We have filed probably a total of 200 pages of comment letters on this proposal, with rigorous data, rigorous analysis. We have not heard any challenge from those who instead would prefer *ad hominem*s.

This is very serious business. It has real impacts for the U.S. economy, and the fact that there is no data analysis behind this is a real problem.

Ms. DE LA CRUZ. What I am hearing is that putting a rule forward where there has not been any kind of analysis, no cost-benefit analysis, when all we are hearing from communities, from securities communities to farming and ranching and rural communities like mine, south Texans will be affected if this rule goes into place, and the repercussion of it could be crippling local economies like mine that are rural and that are largely Hispanic.

Thank you so much, Mr. Baer. I yield back.

Chairman BARR. The gentlewoman yields back.

We now recognize the gentleman from Tennessee, Mr. Ogles, for 5 minutes.

Mr. OGLES. Thank you, Mr. Chairman, and thank you all for being here.

One of my colleagues posed a question, considering—as my colleague also pointed out—little data or analysis has been done. Should this proposal be withdrawn as it stands, Mr. Baer?

Mr. BAER. Yes, I think certainly parts of it, but then at that point maybe you do the whole thing. Yes, there are clearly aspects here where they are way off the mark and to the extent that they adjust when they see the new impacts, it is not just the banking industry that should have the right to comment on that.

I mean, one virtuous thing here—and think the Congresswoman was sort of hinting at this—is it is not the banking industry who is filing all these comment letters. It is civil rights groups, community groups, end users, and the buy side on capital markets, small business groups; so, folks are getting the message that this is not a banking issue. This is an American economic issue. I think if there are going to be major changes made to the proposal it is not just the banks that have the right to comment on that but everybody else.

Mr. OGLES. Mr. Bashur?

Mr. BASHUR. I think the lack of economic analysis and the fact that this is clearly an abuse of their discretionary authority warrants withdrawal of the rule in its entirety. I think they do not have unbridled authority, and I think that this rule is just an example of we just want to do what we want to do, without any consultation with Congress. My goal here is I want the elected representatives to make these determinations. I do not like the bureaucrats to be making what Code of Federal Regulations (CFRs) are effectively law. So I think that this needs to be coming from you all, ultimately.

Mr. OGLES. Yes, no, you make an important point there.

Mr. Bashur, on January 12 your organization, along with other industry organizations filed a comment letter on Basel III Endgame proposal. In the letter your organization noted there were significant violations of the Administrative Procedure Act as it relates to the proposal.

Can you touch on that because it kind of gets back to where should the authority lie? For example, I have the Stop Basel Endgame Act that essentially just pulls it back. I mean, when you look at a set of proposals that is trying to make us, quite frankly, more like Europe, when we have a different type of banking system that is much more resilient than the rigidity that you see in Europe, and a lack of free market influences that you see from Russia and China, both of which had input into the Basel Endgame, why would we want to comply with their ideas when we have an entirely different banking system, based off a different free market model, and make ourselves less competitive?

I will stop there and let you answer the question.

Mr. BASHUR. Yes, I may quibble with you a little bit there. I mean, I do think that there is virtue in having common standards across the nations with which we compete in banking and finance. Actually, I mean, one of the ironies here is if they had proposed

something more like what has been adopted as Basel in Europe and the U.K., I do not think there would be nearly as many concerns. It is all the add-ons. It is the additional charges for mortgage, small business.

Mr. OGLES. That is right. I will reclaim my time. That is the issue that I see here, is that it is not the same. Again, maybe over a cup of coffee we can quibble back and forth. I would argue that our banking system is much different than that of Europe's, and that there is more free market component.

Now the problem is when you look at the regulatory regime, when you look at the bank failures of New York and California, that was management failure. That was a regime that did not do its job. There should have been not just red flags but there should have been flares going off that these banks were in trouble. Again, this is a failure, so now you have this, not just reaction but over-reaction in the marketplace of putting more layers and more burdens.

Look, I come from southern middle Tennessee, so a lot of my district is rural and suburban. When I see more regulations being layered on top of banks and credit unions, that is affecting the access to capital, that someone who is suddenly eligible for a \$300,000 or \$350,000 mortgage, they are not qualified for that anymore. That small HVAC company that requires that line of credit to make payroll in the lean months, suddenly that is being lowered or not renewed.

So it is having an impact on my economies all because you have an administration that whether it is the CFPB, the Fed, you name it, any agency, they have gone too far, too fast, and they have done so without any quantitative analysis to back up their presumptions. You and I become the guinea pigs on their theories on how this is great for America. When I would say when you look at their failed policies, whether it is immigration, whether you look at the terrorists that are coming across this country—and I sure as heck do not trust them with the economy or the banking system—enough is enough, and it is time for Congress to take back its authority to truly control the purse and put this administration in its place.

With that, Mr. Chairman, I yield back.

Chairman BARR. The gentleman yields back.

We now recognize the gentleman from South Carolina, Mr. Timmons, for 5 minutes.

Mr. TIMMONS. Thank you, Mr. Chairman.

The Basel III Endgame proposal has generated the lion's share of attention throughout this administration's regulatory onslaught, but the Federal financial regulators have put forward many other proposals related to bank capital requirements, including proposals for long-term debt requirements.

In November, I, along with Chairman Barr and many other members of this committee, authored a letter expressing concerns with the long-term debt proposal and asked for a comment period extension. The extension was granted, but many of the underlying concerns still persist. Due to these underlying concerns, it is my belief that this proposal is far too prescriptive and should be withdrawn.

However, we must accept the reality of the situation and work to get the proposal to the best place possible for Americans. This includes doing away with the regulators' one-size-fits-none approach and prioritizing tailoring for banks based on their risk profiles and size.

Mr. Baer, how can Federal regulators tweak or, let us say, recalibrate the LTV proposal to reduce the potential for negative consequences on the banking sector?

Mr. BAER. Congressman, thank you for that question. I mean, I think on the long-term debt requirement that the solution there is actually relatively simple compared to Basel. It is simply to reduce the calibration. I mean, instead of 6 percent it should be a fraction of that.

Again, as I noted earlier, it is for a different purpose. For regional banks it is basically to add another layer of loss observancy because the regional bank has almost all of its assets in the bank and will be resolved by the FDIC. The reason for that requirement for the GSIBs is entirely different. There is a large broker-dealer. It is going to be resolved at the holding company level through a bankruptcy or a Title II, and there you need to recapitalize at the holdco and you need to keep the subsidiaries open and operating.

Again, the cost to the regionals are disproportionate. They do not have as greater of an access to liquidity as the large banks because they simply do not issue as much debt. If it were 6 they would have to probably issue 7, 8, 9 percent because they need to be in the market all the time.

As I noted earlier, and it is quite complex, it is not easy to just substitute a deposit from the holdco to the bank since there is a separate bank-level requirement, with more long-term debt because then the holding company has to go out and issue more.

I think without really realizing the repercussions they have imposed the requirement for regionals both at the holdco and the bank level, something not done for GSIBs, again because that is a holding company strategy. I think they thought that was a relatively simple matter, and in fact it is fantastically expensive to the regional banks.

Mr. TIMMONS. Sure. Thank you for that. Given the extremely prescriptive manner in which the proposal seeks to distribute the debt there is a real risk that the issuance of significant amounts of bank debt, without regard for macroeconomic or market conditions, in a compressed timeframe, will potentially result in decreased appetite for these assets. As such, the value of this debt could be severely negatively impacted.

Considering the short, 3-year compliance runway, what risks are presented when such an artificial amount of LTV floods the market, and how will banks have to react to mitigate that risk?

Mr. BAER. Yes, exactly. As noted, they are not volume issues so that would be more difficult. There is also a sort of a technical issue with the proposal that we hope will be corrected, where there is a \$400,000 minimum issuance requirement. The goal there was, well, let us make sure that this debt is not sold to mom-and-pop investors.

It turns out even in institutional markets the debt is usually significantly smaller increments than \$400,000—50, 100,000; so, say-

ing it has to be \$400,000 and more would not just prevent retail customers from buying it. It would prevent a lot of institutional customers from buying it. Of course, retail customers, mom and pop, widows and orphans, whatever you want to call it, they are not going to be buying long-term debt from a regional bank in \$50,000 increments; so, that needs to come down if it is going to be feasible for them to issue this debt.

Mr. TIMMONS. That was actually my next question. How do you think Federal regulators came to this number, \$400,000? It seems pulled out of thin air.

Mr. BAER. I do not know how they came to that. I know it is speaking to a lot of bankers and investment bankers that it is unworkable. I also think—I mean, I give them credit—maybe this is an example of, as Mr. Kress notes, of the comment process working. I do think that sanity will win out here.

Mr. TIMMONS. Thank you. Our banks are capitalized at the highest levels in our Nation's history. Time and time again regulators are touting the health of our banking systems. Yet they are trying to implement policies that will unnecessarily restrict access to capital and make life in President Biden's economy even more of a challenge.

Thank you to the witnesses for their expertise today. I yield the rest of my time. Thank you.

Chairman BARR. The gentleman yields back.

We now recognize the gentleman from South Carolina, Mr. Norman, for 5 minutes.

Mr. NORMAN. I am in the real estate business. I have been in housing for a long time. The Basel III, I guess the Endgame, the best way I can describe it, is going to negatively affect the housing market. Some of the rules that have been put in place, like the risk-based assignments of mortgages, disallowing banks to use private insurance to lower the risk for those who put less down payments into a home, is going to dramatically affect the banks.

How do you all see this? Mr. Baer, I will ask you.

Mr. BAER. I mean, again, it just comes down, for me, to what is the data and the evidence here. As I think I mentioned earlier in the hearing, if you think about mortgages the current risk rate is 50 percent. The advanced approach, which is the better measure, is 25 percent. Basel is effectively 25 percent, and we are looking here at 95 percent if it is on the balance sheet, and even more if it is sold to a GSE. That is really hard to understand.

This rule is so complex, and it is why it is so disappointing there was not a more analytical rule applied to it.

Commercial real estate actually does well under this proposal. People do not realize that. I think they actually do better than the current standardized, but you have to really take it asset by asset and ask yourself the hard questions about what is the loss experience and what is the appropriate charge for this? That is really the work that was not done here.

Mr. NORMAN. The analytical firepower is there. Why are they not using that? I mean, it does not take a rocket scientist to figure this out.

Mr. BAER. Yes, I mean, it is not just the analytical firepower but there is incredible amounts of data on this that the banking agen-

cies have through their own call reports but also exist in the private market. We have tapped operational risk loss data, which they did not use, which is freely available. They did not cite their own operational risk loss data; so, it is very difficult to understand.

I mean, I think some of this was simply, as I think we have discussed a few times, well, we will just take whatever we agreed to in Basel as a compromise with the rest of the world. Again, what is harder to understand is why all of that has now been added to with surcharges, and again, with no recognition that there is going on in the background a Fed stress test that nobody else in the world is running and, which is effectively double counting a lot of these risks.

Mr. NORMAN. So goes housing, so goes the economy and all these regulations, and everything else this administration is doing to trainwreck this country is astounding.

Does anybody else want to comment on this?

Mr. BASHUR. I would just say that with regard to the mortgage piece, ultimately what it comes down to is it is arbitrary. The new risk weight is arbitrary. I think that, again, that just plays into the fact that the economic analysis has not been properly done here. There has been no disclosure, there has been no communication, and we need to get to the bottom of it.

Mr. KRESS. Congressman, I would ask my fellow panelists to identify any banking rules in the past two decades that would meet their standards for the types of analysis that ought to be done here. The Basel III Endgame rule has already gone through one set of quantitative impact assessments. The agency has put it out in the proposed rule. That is far more than was done in Dodd-Frank 15 years ago, and that is quantum leaps more than what was done under the Trump Administration, while the Trump Administration was deregulating.

They are trying to establish a high standard that is not found anywhere in the law in an effort to protect bank share prices, share buybacks, and executive compensation.

Mr. NORMAN. Would you not admit this is a different time and this is a different era? I am in South Carolina. People are moving there but with the energy policies—just to give you an example—the energy policies, that is trainwrecking my industry, in South Carolina, with people coming there. What you are just saying makes no sense.

Mr. KRESS. I think two things have changed. One is a collective amnesia that Ranking Member Waters pointed out. We forget the consequences of financial crises. Two, we have seen a movement in the judiciary to put up new barriers to administrative rulemaking. The banking sector appears to be taking advantage of that, again to protect share prices and executive compensation.

Mr. NORMAN. It is not protecting the economy. It is not protecting the industry that is the bellwether for the economy and it is really a sad day that this is taking place. You can make all the, I guess, excuses, but the results will be what the results will be, and it will not be pleasant.

I yield back.

Chairman BARR. The gentleman yields back.

I would like to thank our witnesses for their testimony today. Without objection, all members will have 5 legislative days within which to submit additional written questions for the witnesses to the chair, which will be forwarded to the witnesses for their response. I ask our witnesses to please respond as promptly as you are able.

This hearing is adjourned.

[Whereupon, at 12:19 a.m., the subcommittee was adjourned.]

A P P E N D I X

January 31, 2024

Proposal: 1813 (AG64) Reg H, Q, LL & YY-Regulatory Capital Rule: Amendments to LBOs and Banking Organizations

Description:

Comment ID: 156789

From: Greater Beallwood Baptist Church, Adrian Chester

Proposal: 1813 (AG64) Reg H, Q, LL & YY-Regulatory Capital Rule: Amendments to LBOs and Banking Organizations

Subject: R-1813 Regulatory Capital Rule: Amendments Applicable to Large Banking Organizations and to Banking

Comments:

NONCONFIDENTIAL // EXTERNAL

As a board member of the Greater Columbus Urban League and member of the NAACP here in Georgia, I must bring to your attention my opposition to the proposal that would raise capital requirements for banks. Passing this proposal could have a devastating impact on Black families in Georgia and across the nation. The implications of such a decision are far-reaching and could exacerbate existing disparities that already plague our communities. I implore you to take these concerns seriously and reconsider the passing of this proposal.

The Black community, like many marginalized communities, has historically faced systemic barriers to financial stability and upward mobility. Raising capital requirements on banks would have a disproportionate impact on these communities for several reasons, including limited access to credit and reduced lending to Black-owned businesses. Raising capital requirements on banks would make it even harder for Black families to access affordable credit for homeownership, entrepreneurship, and education.

I must also point out that our banks are already held to higher capital requirements than European banks making this proposed increase unnecessary. Federal Reserve Chair Jay Powell has even stated that our current capital levels are at "multi-decade highs," further demonstrating that not only would this proposal be harmful to our families, it is completely unwarranted.

It is our collective responsibility to ensure that the decisions made by federal leaders promote inclusivity, fairness, and prosperity for all Americans, regardless of their race or background. I trust that you will take these concerns into account and make choices that reflect these values. In light of these concerns, I strongly urge the FDIC to consider the broader ramifications of the proposed increase in capital requirements on the Black community and vulnerable populations in Georgia.

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Prestige Property Brokers

Proposal: 1813 (AG64) Reg H, Q, LL & YY-Regulatory Capital Rule: Amendments to LBOs and Banking Organizations

Description:

Comment ID: 156785

From: Renitta Sweet

Proposal: 1813 (AG64) Reg H, Q, LL & YY-Regulatory Capital Rule: Amendments to LBOs and Banking Organizations

Subject: R-1813 Regulatory Capital Rule: Amendments Applicable to Large Banking Organizations and to Banking

Comments:

NONCONFIDENTIAL // EXTERNAL

Good evening,

As the former President of the Urban League of the River Valley and the current Communications Chair of the Urban League of Greater Atlanta Young Professionals I am deeply committed to black economic empowerment and social justice. As a leader in the Urban League I have worked tirelessly to ensure young black professionals understand the resources available to them as potential first time home buyers and small business owners. At the Urban League we understand that education, employment, and advocacy are critical tools in the fight for the advancement of the black community. As part of the stated mission of the Urban League we are tasked with promoting economic empowerment through program areas that include education and job training, housing and community development, workforce development, entrepreneurship, health and quality of life. Considering my years of service to the Urban League and our stated mission of promoting economic empowerment in the black community I have no choice but to voice my concerns about the proposal that would require increase in capital requirements for certain banks.

The proposed increase in capital requirements has the potential to limit access to credit for many Black families, which could further exacerbate existing economic disparities. Historically, Black communities have faced significant obstacles in obtaining loans and credit. The Urban Institute recently released a paper which stated this proposal "would disproportionately disadvantage low- and moderate-income (LMI) borrowers and communities, as well as Black and Hispanic borrowers," which would leave many already struggling families further behind.

I'm concerned that the Biden administration's work to promote economic equality could be setback in a way that is outlined by the Urban Institute. I believe that with thoughtful planning and consideration of the unintended consequences of policies, we can design policies that encourage responsible lending practices without disproportionately burdening minority families. Please strongly consider opposing this proposal because it does not adequately address the economic impact it would have on Black families.

Best regards,
Renitta Sweet

Proposal: 1813 (AG64) Reg H, Q, LL & YY-Regulatory Capital Rule: Amendments to LBOs and Banking Organizations

Description:

Comment ID: 156790

From: Tonza Thomas

Proposal: 1813 (AG64) Reg H, Q, LL & YY-Regulatory Capital Rule: Amendments to LBOs and Banking Organizations

Subject: R-1813 Regulatory Capital Rule: Amendments Applicable to Large Banking Organizations and to Banking

Comments:

NONCONFIDENTIAL // EXTERNAL

I am writing to express my deep concerns regarding the proposed increase in capital requirements for banks, and I believe it is crucial to shed light on the potential detrimental impact that this policy change could have on African-Americans in Georgia and across the country.

As the Executive Director of the Georgia State Conference of the NAACP, I know the economic challenges and disparities that Black communities continue to face. Our mission has always been to advocate for racial and social justice, particularly in the context of economic empowerment and financial inclusion.

I know that an increase in capital requirements could exacerbate the existing economic disparities faced by African-Americans. Historically, Black individuals and communities have faced discrimination in banking and lending practices. Higher capital requirements may lead banks to be more risk-averse, making it even harder for Black Americans to access credit, obtain mortgages, or secure loans for businesses and education. Additionally, Black-owned businesses often rely on loans and lines of credit to keep their doors open and plan for expansion. Increased capital requirements could restrict the availability of these critical resources, hindering the growth and success of Black entrepreneurs.

Many of our businesses and communities are still grappling with the aftermath of the pandemic and I praise the Biden administration's work to provide them with support, while the Federal Reserve continues to battle inflation; however, if this proposal is passed, then any progress made is at risk.

I urge you to carefully consider the potential consequences of increasing capital requirements and to implement policies that ensure equitable access to financial services for all Americans. It is vital that regulatory decisions align with our commitment to racial and economic justice.

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Peace and Empower,
Tonza S. Thomas

Proposal: 1813 (AG64) Reg H, Q, LL & YY-Regulatory Capital Rule: Amendments to LBOs and Banking Organizations

Description:

Comment ID: 156797

From: Demetrius McBride

Proposal: 1813 (AG64) Reg H, Q, LL & YY-Regulatory Capital Rule: Amendments to LBOs and Banking Organizations

Subject: R-1813 Regulatory Capital Rule: Amendments Applicable to Large Banking Organizations and to Banking

Comments:

NONCONFIDENTIAL // EXTERNAL

As the Advocacy Chairperson of the Urban League of the River Valley Young Professionals and a longtime member of the Urban League, I have spent the greater part of my years as a young professional fighting for economic prosperity and social justice for black Americans. The Urban League works to increase educational and employment opportunities for African Americans and I personally have overseen programming aimed at educating black entrepreneurs and educating black young professionals about the benefits of first time home ownership. Part of the mission of the Urban League is to enable and empower African-Americans and others in underserved communities to achieve their highest human potential and secure economic self-reliance, parity, power and civil rights. Given my work on this mission and my deep understanding of the issues facing the black community, I had no choice but to make my concerns known about the proposed increase in capital requirements for banks.

Home ownership is widely known to be the best way for all Americans, but particularly black Americans to build wealth, but unfortunately economic and social inequities make the dream of owning a home difficult for black Americans. Sadly, discriminatory housing policies have led to far too many Black Americans being excluded from achieving the American dream of owning a home, building equity, and increasing their wealth and the wealth of their families for generations to come. Because of this, the wealth gap has widened, and over the years this lack of equity has spilled over into all areas of the American economy, making life harder for black Americans. These rule changes could also be costly for predominantly Black municipalities, such as the city I live in, because of the potential limitations in securing funding for community development and important infrastructure projects that would hopefully lessen economic disparities.

It is critical to the success of our country that all Americans have equal access to owning their first home and receiving loans to start and fund small businesses. We have made great strides in this regard over the last few years of the Biden administration so I ask that we not take a step back by potentially decreasing access to funding for the Americans who most need it.

Proposal: 1813 (AG64) Reg H, Q, LL & YY-Regulatory Capital Rule: Amendments to LBOs and Banking Organizations

Description:

Comment ID: 156134

From: The Courier Eco Latino Newspaper, Wane A. Hailes

Proposal: 1813 (AG64) Reg H, Q, LL & YY-Regulatory Capital Rule: Amendments to LBOs and Banking Organizations

Subject: R-1813 Regulatory Capital Rule: Amendments Applicable to Large Banking Organizations and to Banking

Comments:

Wane Hailes

At the NAACP, we work hard to promote the political, educational, social and economic equality of rights of all people. Part of that job is standing up against policies that would be detrimental to our community. It has been brought to my attention that an increase in capital requirements would disproportionately affect the African American community in Georgia and across the country.

Higher capital requirements would lead to banks being more cautious in lending and passing off costs to borrowers. As a result, individuals and businesses, especially in underserved communities, would find it harder and more costly to access credit. This could hinder entrepreneurial endeavors, homeownership, and other financial opportunities. The Urban Institute has made clear that this proposal would "disproportionately disadvantage low- and moderate-income (LMI) borrowers and communities, as well as Black and Hispanic borrowers." For communities that are already at a disadvantage, this proposal would be especially detrimental.

I must also mention that an increase in capital requirements is unmerited. Federal leaders have stated that our banks are well-capitalized and ready to help us weather any economic crisis should it come down to that. Federal Reserve Chair Jay Powell stated that our capital levels are currently at "multi-decade highs."

We cannot ignore the damage that this proposal would do to our communities if it is implemented. I respectfully ask that you reconsider an increase in capital requirement to protect our most vulnerable communities.

Wane A. Hailes, President/Publisher
The Courier Eco Latino Newspaper
P.O. Box 5747
Columbus, Georgia 31906
706.225.0106 Office
706.358.9202 Cell

Proposal: 1813 (AG64) Reg H, Q, LL & YY-Regulatory Capital Rule: Amendments to LBOs and Banking Organizations

Description:

Comment ID: 156196

From: Dar'shun Kendrick

Proposal: 1813 (AG64) Reg H, Q, LL & YY-Regulatory Capital Rule: Amendments to LBOs and Banking Organizations

Subject: R-1813 Regulatory Capital Rule: Amendments Applicable to Large Banking Organizations and to Banking

Comments:

My name is Dar'shun Kendrick, and I am writing to express my concern about the proposed increase in capital requirements for banks. I have the honor of representing Georgia's 95th District in the State House of Representatives, and I currently serve as a ranking democrat on the Small Business Development Committee. Because of this, I understand how these regulations could impact small businesses and individuals in my community.

The proposed increase in capital requirements could severely harm small businesses, infrastructure projects, and community investment. Small business owners like myself, and those I represent in the Georgia legislature as well as a business attorney, who often rely on loans for growth and improvements, may struggle to access necessary capital if loan costs rise due to higher bank capital requirements. This, in turn, could discourage investment in local communities. The broader risk implications extend beyond individual businesses, affecting the economic ecosystem of communities by limiting job opportunities, reducing income, and diminishing overall economic activity.

Moreover, the proposed increase in capital requirements poses an even graver threat to the progress of minority-owned small businesses, as it compounds existing challenges in accessing much-needed capital. The Federal Reserve's 2022 Report on Firms Owned by People of Color[<https://www.federalreserve.org/publications/2022-report-on-firms-owned-by-people-of-color>] corroborates these alarming disparities, finding that Black and Hispanic-owned businesses face higher credit risk labels, lower approval rates for sought financing, and an increased likelihood of being entirely shut out of funding. Regulatory changes must address these systemic challenges to ensure equal access to financial resources for aspiring entrepreneurs in all communities.

Over the last few years, the Biden Administration has worked to strengthen our small businesses post-pandemic, but passing the proposed capital requirements could undermine any progress made. I urge you to reconsider this regulation given its potential impact on small businesses and our overall economy.

Ms. Dar'shun Kendrick, JD/MBA/Investment Advisor Representative
Corporate/Securities Attorney, Business Coach, Public Speaker
Published Author, Investor & Georgia State Representative (2011- present). Doggy mom and the best auntie EVER.

"Fear is the tool of a man-made devil."- Napoleon Hill, Outwitting the Devil

December 11, 2023

Subject: Capital Requirements

To: Federal Reserved R-1813RIV 7100-AG64

Being the mayor of a small town like Toombsboro is both challenging and deeply rewarding. My commitment to advocating for my constituents goes beyond the local sphere; it involves amplifying the voices of rural communities in a broader way. In the spirit of that, I am writing to you to express my firm opposition to the proposed increase in capital requirements for banks.

The imposition of higher capital requirements on these banks could result in increased costs, reducing banks' willingness to lend and leading to higher interest rates for small businesses and individuals in rural areas. This potential financial constraint poses a significant threat to the growth and prosperity of Toombsboro by making it more challenging for us to attract new businesses and retain existing ones. It is also important to note that communities of color would be disproportionately impacted by this new rule. Minority communities already face a number of challenges when it comes to securing loans for education, housing and businesses. Passing this proposal would exacerbate those conditions, causing further harm to disenfranchised groups and widening the racial wealth gap.

Additionally, our banking system has been fortified by federal regulators, who after the 2008 crisis, have worked to ensure that the system is protected. Federal Reserve Chair Jay Powell has even stated that our banks are at "multi-decade highs" in the capital. On top of that, our banks are already held to higher capital requirements than banks in the European Union. All of this points to how unnecessary this proposal truly is.

This new rule threatens to impose an unaffordable cost on small towns like mine. I strongly urge you to reconsider the implementation of heightened capital requirements given the negative impact it could have on our communities.

Sincerely,

Joyce Denson

Mayor Joyce Denson
Town of Toombsboro

Proposal: 1813 (AG64) Reg H, Q, LL & YY-Regulatory Capital Rule: Amendments to LBOs and Banking Organizations

Description:

Comment ID: 156587

From: Georgia House of Representatives, Kim Schofield

Proposal: 1813 (AG64) Reg H, Q, LL & YY-Regulatory Capital Rule: Amendments to LBOs and Banking Organizations

Subject: R-1813 Regulatory Capital Rule: Amendments Applicable to Large Banking Organizations and to Banking

Comments:

To Whom It May Concern:

In my capacity as a member of Georgia's House of Representatives, I am dedicated to safeguarding the well-being of my constituents and addressing key issues affecting District 63. My service on the Small Business Development Committee has afforded me valuable insights into the potential repercussions of the current proposal to mandate increased capital requirements for banks. I am writing to express my strong opposition to this measure, as it poses a genuine threat to the accessibility of capital that is essential to small businesses in our community.

As a small business owner, I can personally attest to the numerous challenges that come with starting and scaling a business. If the new capital rules are implemented, banks would face pressure to charge higher interest rates and limit lending opportunities, especially to those borrowers who are considered high risk. This potential restriction in credit access could impact the day-to-day operations of small and new businesses by affecting their ability to make payroll, contribute to the local economy, and execute expansion plans.

The Board must also take into account how minority-owned small businesses would be disproportionately impacted by these changes. Research has shown that persistent gaps in access to financial capital has hindered Black entrepreneurship and ultimately contributed to large racial wealth disparities. For example, the Federal Reserve's 2022 Report on Firms Owned by People of Color; <https://www.fedsmbusiness.org/survey/2022/2022-report-on-firms-owned-by-people-of-color>; revealed that Black and Hispanic-owned businesses are more likely to be labeled a high credit risk. The report also found that firms owned by people of color were less likely than white-owned firms to be approved for loans, lines of credit, and cash advances. Increasing the capital requirements for banks would exacerbate these existing issues and contribute to a legacy of discriminatory lending practices in the United States.

The adoption of this proposal threatens to undo the significant progress achieved by the Biden Administration and the Federal Reserve in promoting economic development in historically marginalized communities. I hope the Board will give due consideration to these concerns and advance policies that reaffirm their commitment to fostering opportunities for all Americans.

Rep. Kim Schofield D-63 (Atlanta, East Point, College Park, Hapeville and Union City)

o:404-656-0298

e: kim.schofield@house.ga.gov

Admin: marjorie.woods@house.ga.gov

Proposal: 1813 (AG64) Reg H, Q, LL & YY-Regulatory Capital Rule: Amendments to LBOs and Banking Organizations

Description:

Comment ID: 156572

From: Wendy Davis

Proposal: 1813 (AG64) Reg H, Q, LL & YY-Regulatory Capital Rule: Amendments to LBOs and Banking Organizations

Subject: R-1813 Regulatory Capital Rule: Amendments Applicable to Large Banking Organizations and to Banking

Comments:

Federal Reserve Leaders,

Through my work as former Rome City Commissioner and as a member of the Georgia Steering Committee of Rural Voices USA, I have always advocated for equity in all aspects of policy-making, especially when it comes to economic equity. Today, I am writing to voice my disapproval of increasing capital requirements on banks, given the strain it would place on underserved communities.

Rural communities often face unique challenges in accessing financial services, and the unintended consequences of this proposal would disproportionately affect them. Higher capital requirements could lead banks to become less willing to lend to individuals and businesses in rural areas. As rural communities often struggle with limited access to credit, such a policy could further exacerbate this problem, hindering economic growth and development. Additionally, small businesses play a pivotal role as the life force of countless rural communities. I am concerned that higher capital requirements may discourage banks from extending loans to these enterprises, stifling entrepreneurship and job creation in rural areas.

This proposal would exacerbate the existing disparities in access to financial resources, hinder economic growth and curb the progress that the Federal Reserve has made to battle inflation. While financial stability is important, I believe that any regulatory changes in the financial sector must carefully consider their impact on rural communities to ensure that the pursuit of equity remains at the forefront of policy decisions.

Thank you for taking the time to hear my concerns,
Wendy Davis
Two-term Rome City Commissioner

Statement for the Record
 On Behalf of the
Institute of International Bankers
 Before the
Committee on Financial Services
Subcommittee on Financial Institutions and Monetary Policy
U.S. House of Representatives
January 31, 2024

Chairman Barr, Ranking Member Foster and distinguished members of the committee, the Institute of International Bankers (IIB) appreciates the opportunity to submit a statement for the record for the hearing titled “Rules Without Analysis: Federal Banking Proposals Under the Biden Administration.”

We appreciate the committee’s attention to and examination of recent proposals by the federal banking agencies that are not supported by adequate data or analysis. Especially concerning to the IIB is the punitive treatment of the U.S. operations of internationally headquartered banks in the capital proposals.

In comment letters submitted to the federal banking agencies on January 16, 2024, the IIB urged the agencies to amend the Basel III Endgame and GSIB Surcharge proposals to maintain a level playing field for the U.S. operations of international banks, consistent with the principle of “national treatment” established in the International Banking Act of 1978.

“Of particular concern to IIB is that the Proposals take little account of the clear Congressional mandates to respect the principles of national treatment and equality of competitive opportunity and to take into account comparable home country regulation,” the IIB explained in its letter on Basel III Endgame. “National treatment and equality of competitive opportunity require treating international banks no less favorably than similarly situated U.S. banking organizations and creating a level playing field between international banks in the United States and domestic firms of a similar size and business model.”

The agencies’ own estimated effect of the Basel III Endgame proposal on Category III and IV internationally headquartered banks, however, is closer to its impact on U.S. GSIBs than the effect on Category III and IV domestic firms. The proposal estimates a 19% increase in capital requirements for domestic banking organizations in Categories I and II; a 14% increase for internationally headquartered banks in Categories III and IV; and just a 6% increase for domestic banking organizations in Categories III and IV. This is despite internationally headquartered Category III and IV banks already having higher capital ratios, smaller sizes overall, reduced risk profiles as part of global banking organizations, and smaller, less risky trading activities.

Of particular concern for internationally headquartered banks—and the main driver of the disproportionate increase in capital—is the operational risk component of the Basel III

Endgame proposal. The proposed operational risk elements applicable to internationally headquartered banks are not commensurate with their business models or the risks they pose. While ideally the operational risk component would be applied only at the consolidated level, the IIB suggested in its comment letter several modifications to the calculation of operational risk to avoid a disproportionate impact on internationally headquartered banks. These modifications include setting the internal loss multiplier (ILM) at 1—or allow flexibility to use an ILM less than 1 if the parent can under home country rules—and exclusion from the Business Indicator Component of income from inter-affiliate services and other transfer pricing requirements concerning services provided to unconsolidated affiliates.

Among the IIB's other specific recommendations for the Basel III Endgame proposal are the following:

- The agencies should not make the proposed changes to the numerator calculations for all Category II-IV institutions—except for the AOCl change. Internationally headquartered banks are negatively and disproportionately affected by the proposed changes for Category II, III and IV institutions, which include (a) the removal of the AOCl opt-out, reversing the change made in the 2019 tailoring rule, and (b) a number of deductions from capital that mirror those currently required of Category I and II firms, including for mortgage servicing assets and temporary difference deferred tax assets. The agencies estimate that internationally headquartered banks in Category III will face a 13.2% increase in their CET1 requirements and 9.7% increase in leverage capital requirements as compared to 4.6% and 3.8%, respectively, for domestic firms in Category III.
- Internationally headquartered banks and their subsidiaries should not be subject to the increased complexity and administrative burden of additional required RWA calculations in the United States for no clear purpose and no commensurate benefit. Under the proposal, internationally headquartered banks would be required to move from one U.S. regulatory capital calculation (the U.S. standardized approach) to three U.S. regulatory capital calculations (the U.S. standardized approach, the ERBA, and a second standardized market risk calculation to establish an “output floor” for market risk). These U.S. calculations are on top of an international bank's measuring its U.S. operations' contribution to a home country version of the standardized approach for home country output floor compliance purposes and home country implementation of modeled approaches. This would result in IHCs becoming subject to at least five different calculations. The serious burden this would create may lead some to reduce their U.S. operations or exit certain business lines to reduce compliance costs.

In a joint trade association letter, the IIB also urged the banking agencies to correct a serious flaw in the GSIB Surcharge proposal, which purports to move nine internationally headquartered banks up categories without analysis or explanation. While the IIB believes that the re-tiering may be the result of a calculation error, the IIB finds it concerning that the

agencies found this outcome acceptable, especially given the lack of data supporting this decision.

“If this re-tiering of international banks is the Federal Reserve’s intended result, then this outcome signals a severe miscalibration of the GSIB Surcharge Proposal and the CJA [cross-jurisdictional activity] risk-based indicator, and a specific targeting of international banks for more stringent regulation without any policy rationale,” the comment letter reads. “If this result were intended, then the cause of the re-tiering would need to be repropounded, as the Federal Reserve would need to substantiate this result with much more than it has provided in the Proposal. IIB, BPI and our members believe, however, that there is one significant error in the Proposal and in the related Form FR Y-15 revisions that is likely the cause of this projected change in tiering of international banks.”

In addition, the associations urged the agencies to eliminate derivatives from the CJA indicator in the final rule. Consistent with the broader lack of analysis, the changes to derivatives—an important risk management tool for international banks—were included without any rationale and only four years after the changes in the 2019 Final Tiering Rule.

“Extra care is required when creating standards that may discourage the use of derivatives for risk management purposes,” the comment letter reads. “Derivatives, particularly those used by international banks’ U.S. operations, facilitate enterprise-wide risk management on a cross-border basis, and discouraging derivatives activity would create impediments to efficient risk management. In general, supervision and regulation of enterprise-wide risk management tools should be the primary responsibility of home country regulators.”

We hope policymakers will address the IIB’s serious concerns with the recent capital proposals because internationally headquartered banks are an integral part of the competitive landscape of the U.S. financial system. For example, IIB members hold more than \$4 trillion in assets across the United States, employ approximately 200,000 people in the United States, represent more than half of U.S. primary dealers (55%), and make more than 40 percent of all commercial and industrial loans in the United States. Further, these institutions are often the primary facilitator of foreign direct investment in the United States.

The IIB appreciates the work of the Committee and its commitment to ongoing oversight of the federal banking agencies. We urge the Committee to redouble its focus on ensuring congressional mandates, such as the principle of “national treatment,” are acknowledged and respected in the regulations promulgated by the federal banking agencies. We look forward to working with Congress as these efforts continue.

Congress of the United States
Washington, DC 20515

November 14, 2023

The Honorable Michael S. Barr
 Vice Chairman for Supervision
 Board of Governor of the Federal Reserve System
 20th Street and Constitution Avenue, NW
 Washington, DC 20551

The Honorable Martin Gruenberg
 Chairman
 Federal Deposit Insurance Corporation
 550 17th Street, NW
 Washington, DC 20429

The Honorable Rohit Chopra
 Director
 Consumer Financial Protection Bureau
 1700 G Street, NW
 Washington, DC, 20552

The Honorable Michale Hsu
 Acting Comptroller of the Currency
 The OCC
 400 7th Street, SW
 Washington, DC 20219

Dear Vice Chair Barr, Chairman Gruenberg, and Acting Director Hsu, Director Chopra,

We are writing to express our concerns over pending rulemakings governing products and services offered to customers of financial services firms. Over the last three years, the prudential banking regulators (the Board of Governors of the Federal Reserve, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation), along with the Consumer Financial Protection Bureau, (collectively “Agencies”) have pursued rulemaking activity with far-reaching unintended consequences with no end in sight¹. It is critical that these proposals and actions are not seen in a vacuum and the full scope of their total impact on financial institutions be assessed. It is vital that we mitigate any harm to consumers’ access to credit and negative effects on our financial markets.

The collective impact of the Biden’s Administration’s financial regulatory rulemaking is staggering. The recently released Basel III rule is more than 1,000 pages long. Furthermore, nowhere in these proposals do the Agencies provide any indication that they have considered the aggregate effect of these various proposals on the ability of financial institutions to serve their customers and to support economic growth.

In February, the Bureau proposed a rule on a banks’ ability to offer products and services in the communities they serve, including low-and-moderate income (“LMI”) areas. There is no evidence that the Agencies have weighed the possible effect of substantially lowering the safe harbor for credit card late fees. Additionally, the Agencies must assess the impact of any late fee rule on banks’ new Community Reinvestment Act (“CRA”) obligations, as well as the combined effect of increased capital requirements on small businesses’ access to capital included in the Basel III Endgame proposal released by the Federal Reserve.

¹ <https://www.americanbanker.com/news/banks-flying-blind-without-cumulative-data-on-regulatory-proposals>

Additionally, the Basel proposal will profoundly affect banks' business strategies, including how they structure and operate their CRA programs. For example, the proposed capital rules would reduce incentives to engage in mortgage lending, which is central to the CRA programs of many banks.² Under the capital proposal, regulators would apply risk weights that could negatively impact mortgage loans. Many banks offer low down payment mortgages as a means of meeting the credit needs of LMI families. If history repeats itself, the new capital rules could push mortgage lending away from traditional sources, similar to what happened after the Dodd-Frank Act was signed into law.

Lastly, the Basel proposal would increase both cost and access to capital for small businesses and the consumers they serve. Coupled with continued rising interest rates and a tighter lending environment, small businesses will continue to see their access to capital squeezed. Raising capital requirements for banks across the country and changing the risk weights for these small businesses will not only deter lending to Main Street but could stifle new lending.

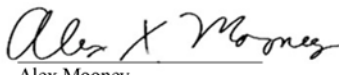
These are just a few of the many instances where the current slate of regulators has failed to grasp the implications one rule has across the banking ecosystem. Given the enormity of the impact that these proposals could have on the availability of credit to consumers, it is imperative that the Agencies immediately pause all rulemakings until the collective impact of these policy shifts can be assessed. We ask that you immediately engage in a multi-agency, comprehensive cost-benefit analysis to better understand the interaction of all these proposals and their potential aggregate impact on consumers. Only then, should the Agencies reopen any proposals, or reissue for comment any final rules.

Addressing these concerns is essential to ensure that every consumer has access to needed financial products and services, especially given the economic challenges facing hard working Americans. We appreciate your attention to this important matter.

Sincerely,


 Bill Huizenga
 Member of Congress


 Daniel Meuser
 Member of Congress


 Alex Mooney
 Member of Congress

²<https://nhc.org/wp-content/uploads/2023/07/Housing-Groups-Letter-re-Bank-Capital-7.25.23.pdf>; see also Laurie Under the Current CRA Rules, Banks Earn Most of Their CRA Credit through Community Development and Single-Family Mortgage Lending | Urban Institute.

Questions for the Record
Baer

Representative Bill Huizenga:

Thank you, Chairman Barr, for holding this hearing and for allowing me to waive on this morning.

Over the last three years, the prudential banking regulators, along with the CFPB (the Agencies) have pursued rulemaking activity with far-reaching unintended consequences with no end in sight.

To put it mildly, this Administration's financial regulatory rulemaking is staggering.

Furthermore, nowhere in these proposals do the Agencies provide any indication that they have considered the aggregate effect of these various proposals on the ability of financial institutions to serve their customers and to support economic growth.

We see this with the current SEC Chair... Chair Gensler has created layers upon layers of regulation, without a thought about how each one would interact with one another.

And in many instances, the courts have rightfully said that they went too far, that they didn't follow the necessary steps under the Administrative Procedure Act or effectively consider a cost-benefit analysis.

It is critical that these proposals and actions are not seen in a vacuum and the full scope of their total impact on financial institutions be assessed. It is vital that we mitigate any harm to consumers' access to credit and negative effects on our financial markets.

Whether it is a CFPB proposal that would limit a banks' ability to offer products and services in the communities they serve, including low-and-moderate income areas or the Basel III proposal, that will impact the 80 plus banks headquartered in my home state of Michigan and the over 300 billion dollars in deposits they hold... the current slate of regulators have failed to grasp the implications one rule has across the banking ecosystem.

Mr. Chairman, I'd like to enter into the record a letter that was sent to the Fed, FDIC, CFPB, and OCC from myself, Congressmen Mooney, and Meuser on this topic?

Greg Baer

Mr. Baer, do you believe that it is imperative that the Agencies (the ones I just mentioned) immediately pause all rulemaking until the collective impact of these policy shifts can be assessed?

Do you believe in a multi-agency, comprehensive cost-benefit analysis to better understand the interaction of all these proposals and their aggregate impact on consumers?

Questions for the Record
Baer

Representative Scott Fitzgerald:

The Basel III Endgame Proposal includes many provisions, one of which is the securitization framework. As you know, securitization is an important source of funding for U.S. consumer and business lending, with over \$1.5 trillion of asset-backed securities issued in 2023 alone.

Are you concerned about how the increased regulatory capital requirements within the securitization framework will affect securitization markets and the cost and availability of credit?

Representative Brad Sherman:

Within our current capital rule framework exists what is known as the p-factor, which determines the “securitization surcharge,” or the additional capital required for a pool of assets when held in securitized form. The Basel III Endgame proposed rulemaking doubles this securitization surcharge. Can you discuss what increasing the p-factor will do to the securitization market and overall access to credit?

Ranking Member Maxine Waters

Mr. Greg Baer

1. Which of the following options best describes your self-identified race? (you may choose more than one)
 - a. White or Caucasian
 - b. Black or African American
 - c. Hispanic/Latinx
 - d. Asian
 - e. Middle Eastern/North African
 - f. Choose not to answer
 - g. Prefer to self-describe (please specify)
2. Which of the following options best describes your gender identity?
 - a. Woman
 - b. Man
 - c. Non-binary
 - d. Transgender Man
 - e. Transgender Woman
 - f. Choose not to answer
 - g. Prefer to self-describe (please specify)

March 15, 2024

The Honorable Patrick McHenry
Chair, House Financial Services Committee
2129 Rayburn House Office Building
Washington, DC 20515

Dear Chairman McHenry,

Attached are my responses to the Questions for the Record submitted following the hearing held by the House Financial Services Subcommittee on Financial Institutions and Monetary Policy held on January 31, 2024 titled "Rules Without Analysis: Federal Banking Proposals Under the Biden Administration."

Huizenga Question #1

- Yes. Many of these rulemakings, including the Basel III endgame and the long-term debt proposals, suffer from insufficient individual cost benefit analysis. For instance, the agencies need to conduct a more in-depth analysis to quantify the costs and benefits of the Basel proposal, such as the approach conducted by the Bank of England. In a nutshell, the Bank of England's approach is to model the banks' responses to the changes in regulation, assess how changes in bank behavior affect the cost of financial services provided by banks, and determine how those changes affect the stability of the banking sector.

In addition, the agencies also fail to consider the effect that these various proposals will have with each other, especially as they are all being proposed at the same time. For that reason and others, I believe that the collective impact of all these various regulatory initiatives should be studied and considered before moving forward with action that could hamper and restrict the flow of capital throughout our economy via the banking system.

This collective consideration seemed to be the goal originally of the "holistic review" on capital that Vice Chair for Supervision Michael Barr has mentioned multiple times leading up to the various rules' proposals. However, as he confirmed in testimony before Congress, no document reflecting the conclusions of such review actually exists. Given the absence of any public release evidencing such comprehensive review, regulators should pause and consider both how these regulatory actions interact with each other but also better understand how they will affect the provision of credit throughout the economy.

For further reading on the insufficient or inaccurate cost benefit analysis of these rulemakings, please consider <https://bpi.com/the-trillion-dollar-omission-in-vice-chair-barrs-cost-analysis/> and <https://bpi.com/the-long-term-debt-proposal-and-bank-profitability/>

Huizenga Question #2

- Yes. Having multiple agencies participate in a cost-benefit analysis to understand how these rulemakings together impact consumers is critical, as various rulemakings from multiple agencies ultimately consider these items separately in a vacuum. For instance, the CFPB's credit card late fee rule as well as the Fed's Reg II proposal will limit access for credit card and checking account financial products for low and moderate-income households at the same time that the Federal Reserve's Basel III endgame proposal will make high LTV mortgages more expensive and difficult to obtain for this same group.

The Bank Policy Institute, American Bankers Association and Consumer Bankers Association recently [submitted a letter](#) to U.S. Treasury in response to a request for information on financial inclusion raising concerns that many recent regulatory proposals would harm financial inclusion and access to low cost financial products, including the Basel endgame capital rules, changes to Reg II, the CFPB's credit card late fees cap and updates to the Community Reinvestment Act, among others.

Fitzgerald Question #1

- Securitization is an important source of funding for U.S. consumer and business lending, including corporate loans, commercial and residential mortgage loans, credit cards, and auto loans. Banks play an important role in the securitization market, which helps them manage their own credit risks and extend additional credit throughout the U.S. economy while requiring lower interest rates on loans for their own customers. Unfortunately, the Basel III proposal goes far beyond the securitization framework proposed in other jurisdictions, such as the EU and UK, and would increase the capital requirements for securitizations by about 35 percent for the largest banks. This is particularly inappropriate for securitizations that meet criteria indicating they pose less complex credit risk concerns. In some cases, the combination of the new risk weights for securitization exposures and the stress tests would result in capital requirements that exceed the value of the underlying asset itself. Overall, the proposed changes to the securitization framework would reduce banks' capacity to hold these exposures and ability to make markets and therefore negatively affect cost and availability of this important source of funding for consumers and businesses.

Sherman Question #1

- As you mention, increasing the securitization surcharge (or p factor) would further increase the capital required for a pool of assets that are held in securitized form. Doubling the securitization surcharge, which is what Basel III endgame proposes to do, would make these securitization exposures even more costly and much less risk-sensitive than the current framework, and unfortunately the proposal contains no explanation or analysis for this proposed increase. As a result, the capital charges banks could face from participating in securitizations could cause them to retreat from this market and reduce their securitization exposures, which is an important source of funding for U.S. consumer and business loans with \$1.5 trillion securities issued in 2023 alone.

Waters Question #1

- a. White or Caucasian

Waters Question #2

- b. Man

Sincerely,

Greg Baer
CEO and President
Bank Policy Institute

Bryan Bashur Responses to Questions for the Record

**Subcommittee on Financial Institutions and Monetary Policy of the House Committee on
Financial Services**

“Rules Without Analysis: Federal Banking Proposals Under the Biden Administration”

January 31, 2024

Representative Brad Sherman:

Within our current capital rule framework exists what is known as the p-factor, which determines the “securitization surcharge,” or the additional capital required for a pool of assets when held in securitized form. The Basel III Endgame proposed rulemaking doubles this securitization surcharge. Can you discuss what increasing the p-factor will do to the securitization market and overall access to credit?

Answer: The higher p-factor will reduce liquidity in the securitization market. The higher capital charge will disincentivize banks from adding exposure to securitizations. This could drastically reduce liquidity in the secondary market for auto loans, mortgages, student loans, and credit cards. Without a robust secondary market, banks will be less likely to originate these common consumer loans. As a result, access to credit would decline. The p-factor was doubled in an arbitrary manner without any substantive explanation or thorough cost-benefit analysis. Moreover, the increase in the p-factor fails to take into consideration the varying riskiness of different types of underlying collateral. So, the p-factor treats credit card debt and commercial paper as equally risky.

Representative Scott Fitzgerald:

The Basel III Endgame Proposal includes many provisions, one of which is the securitization framework. As you know, securitization is an important source of funding for U.S. consumer and business lending, with over \$1.5 trillion of asset-backed securities issued in 2023 alone.

Are you concerned about how the increased regulatory capital requirements within the securitization framework will affect securitization markets and the cost and availability of credit?

Answer: Yes, I am concerned that the increased capital requirements for securitizations will reduce liquidity in the secondary market for popular consumer products, such as auto loans, mortgages, credit cards, and student loans. A less liquid secondary market will deter banks from wanting to originate these loans. Ultimately, this would reduce the amount and volume of these consumer loans throughout the U.S. The proposed rule arbitrarily doubles the p-factor for securitizations. This penalizes all types of securitizations, regardless of the underlying risk of the collateral. Additionally, banks would have to consider what the operational risk charges might be for any securitization exposures. This could further deter a bank from wanting to expose their operations to securitizations. Ultimately, credit access will decline.

Ranking Member Maxine Waters

Mr. Bryan Bashur

1. Which of the following options best describes your self-identified race? (you may choose more than one)
 1. White or Caucasian
 2. Black or African American
 3. Hispanic/Latinx
 4. Asian
 5. Middle Eastern/North African
 6. Choose not to answer
 7. Prefer to self-describe (please specify)

Answer: White or Caucasian

2. Which of the following options best describes your gender identity?
 1. Woman
 2. Man
 3. Non-binary
 4. Transgender Man
 5. Transgender Woman
 6. Choose not to answer
 7. Prefer to self-describe (please specify)

Answer: Man

Responses of Jeremy C. Kress
Assistant Professor of Business Law
University of Michigan Stephen M. Ross School of Business
Before the U.S. House of Representatives Committee on Financial Services
Subcommittee on Financial Institutions and Monetary Policy
“Rules Without Analysis: Federal Banking Proposals Under the Biden Administration”
Hearing Date: January 31, 2024
Written Response Date: March 29, 2024

Chairman Andy Barr

1. You stated in your testimony that the so-called Basel III Endgame proposal would only increase the cost of lending by 3 basis points, citing an estimate by the Federal Reserve’s Vice Chair for Supervision, Michael Barr. Since the Vice Chair announced that number, research has shown that it excludes the impact of lending on over \$1 trillion in operational risk assets that are newly created under the proposal. Do you stand by the 3-basis point estimate and, if so, why?

[Clarification sent on March 29, 2024]: While it appears that you did not explicitly cite the 3-basis-point increase in the cost of lending, I believe that you did state: “The pending Basel III Endgame rules will foster, not threaten, credit availability as most of the proposed capital increase is associated with large banks’ trading and fee-generating businesses, not their lending activities, and the risk weights for many categories of traditional loans will actually decrease under the proposal.” Can you please clarify what impact you think the proposed rule would have on lending? Furthermore, can you please respond to the assertion that for certain lending such as credit card lending this increase could be rather substantial and would impact consumers ability to access certain types of lending.

Response: As I stated in my testimony, strong capital requirements like those in the Basel III Endgame proposal promote long-term credit availability. Better capitalized banks lend more during economic and financial stress, precisely when households and businesses need credit the most.¹ As recent U.S. experience demonstrates, strong bank capital levels are consistent with sustained credit creation and economic expansion. Indeed, the Dodd-Frank Act and initial Basel III capital rule were enacted during what became the longest U.S. expansion on record.

As I also noted in my testimony, most of the capital increase in the Basel III Endgame proposal is associated with large banks’ trading and fee-generating businesses, not their lending activities. The agencies’ impact analysis shows that the proposed increase in risk-weighted assets associated with trading activity is more than double the proposed increase

¹ See, e.g., Tamer Kapan & Camelia Minoiu, *Balance Sheet Strength and Bank Lending: Evidence From the Global Financial Crisis*, 92 J. BANKING & FIN. 35, 35 (2018) (“Banks that held more tangible common equity, either in absolute terms or in excess of the regulatory standard, reduced lending less than other banks with similar exposure to shocks.”).

associated with lending.² To the extent that the largest banks optimize their balance sheets to reduce the proposal's capital impact, those adjustments could result in a relatively greater focus on lending. As Bank Policy Institute CEO Greg Baer stated, "Clearly, under the proposal, the best thing you could do is be a bank that all it does is make loans."³

With respect to credit card lending, the Basel III Endgame proposal would reduce the credit risk-weights applicable to certain retail exposures, such as credit cards.⁴ Thus, the marginal risk-weighted assets (including the interest income-related part of operational risk-weighted assets) attributable to retail exposures such as credit cards would decline under the proposal, according to the agencies' estimates.⁵

2. You state in your testimony that over the past 15 years, policymakers have "repeatedly" provided public backstops to banks. Could you identify those repeated instances, and how higher capital would have prevented that from happening?

Response: As I stated in my testimony, over the past 15 years, policymakers have repeatedly provided public backstops to banks, either directly or indirectly, through Federal Reserve lending facilities, fiscal support measures, and equity injections. For example, during the 2008 crisis, the U.S. Treasury Department made \$245 billion in equity investments in banks and other financial institutions under the Troubled Asset Relief Program (TARP).⁶ Concurrently, the Federal Reserve created numerous emergency lending facilities that propped up banks and financial markets. The Federal Reserve revived many of these facilities a decade later, at the outset of the Covid-19 pandemic. Also in 2020, Congress established fiscal support programs, including the Paycheck Protection Program, that shielded banks from as much as \$300 billion in loan losses that otherwise would have depleted their capital.⁷ Just a few years later, the Federal Reserve created the Bank Term Funding Program (BTFP) in 2023 to backstop the banking system following the failures of Silicon Valley Bank and Signature Bank.⁸

Had policymakers required banks to fund themselves with more equity, many of these public backstops would not have been necessary. For example, one study concluded that if capital requirements had been just 3 percent higher in the lead-up to the 2008 crisis, the TARP

² Regulatory Capital Rule: Large Banking Organizations and Banking Organizations with Significant Trading Activity, 88 Fed. Reg. 64028, 64169-70 (proposed Sept. 18, 2023) [hereinafter Proposed Rule].

³ *Capital Wrap: A Roundup From Capitol Account's Basel Endgame Event*, CAPITOL ACCOUNT (Oct. 27, 2023), <https://www.capitolaccountdc.com/p/capital-wrap-a-roundup-from-capitol>.

⁴ See Proposed Rule, *supra* note 2, at 64051-53.

⁵ See *id.* at 64170.

⁶ See Paul Kiel & Dan Nguyen, *Bailout Tracker*, PROPUBLICA, <https://projects.propublica.org/bailout/>.

⁷ Ron J. Feldman & Jason Schmidt, *Government Fiscal Support Protected Banks from Huge Losses During the COVID-19 Crisis*, FED. RES. BANK OF MINNEAPOLIS (May 26, 2021), <https://www.minneapolisfed.org/article/2021/government-fiscal-support-protected-banks-from-huge-losses-during-the-covid-19-crisis>.

⁸ The BTFP not only helped protect banks from a system-wide run, it also created a lucrative arbitrage opportunity for banks that took advantage of its below-market interest rates. See Steve Goldstein, *Fed Is Shutting Down \$161 Billion Facility That Banks Had Arbitraged*, MARKETWATCH (Jan. 25, 2024), <https://www.marketwatch.com/story/fed-shutting-funding-program-ends-an-increasingly-popular-arbitrage-for-banks-30f0d455>.

capital injections could have been avoided.⁹ Likewise, if banks had been required to recognize losses on investment securities in their capital, the Federal Reserve's backstop in 2023 may not have been required.

Moreover, as I noted in my testimony, stronger capital requirements help counter the poor incentives that these rescues have fostered. The repeated public backstops over the past 15 years have created an expectation that the federal government will step in to bail out banks the next time a crisis hits. This expectation, in turn, exacerbates moral hazard, excessive risk-taking, and implicit "too-big-to-fail" subsidies. Strong capital requirements are therefore needed to ensure that large banks maintain capital cushions commensurate with their risk-taking, rather than relying on public backstops.

3. In response to a question during the hearing, you agreed that in light of the bipartisan Economic Growth, Regulatory Relief and Consumer Protection Act (S. 2155), Silicon Valley Bank held 2 percent less capital than it otherwise would have. What is your basis for this estimate? Why do you believe that an additional 2 percent of capital would have made a difference for the bank facing a bank run, and thus that S. 2155 was a proximate cause of its failure?

Response: In the absence of S.2155 and the Federal Reserve Board's "tailoring" rules, Silicon Valley Bank (SVB) would have been subject to the advanced approaches capital framework, including the requirement to recognize unrealized gains and losses on available-for-sale (AFS) securities in its common equity tier 1 capital.

In its retrospective review of the supervision and regulation of SVB, the Federal Reserve Board determined that recognizing unrealized gains and losses on AFS securities would have reduced SVB's capital by \$1.9 billion and would have resulted in a reduction in its common equity tier 1 capital ratio from 12.1 percent to 10.4 percent as of year-end 2022.¹⁰

Although it is not possible to say definitively that this additional capital would have prevented SVB's collapse, an additional \$1.9 billion of capital would have required SVB shareholders to internalize more of the costs of its failure, rather than externalizing those costs on the Deposit Insurance Fund.

4. In response to a question during the hearing, you agreed that under the so-called Basel III Endgame proposal, capital requirements would rise by 2 percent. Could you please provide documentation of the basis for your agreement?

[Clarification sent on March 29, 2024]: This is referencing the exchange at approximately the 2:19:45 mark when you appeared to agree with Ranking Member Waters premise that,

⁹ See David Aikman, Jonathan Bridges, Anil Kashyap & Caspar Siebert, *Would Macroprudential Regulation Have Prevented the Last Crisis?*, 33 J. ECON. PERSPS. 107, 117 (2019) ("Had a countercyclical capital buffer of 3 percent been built-up in the run-up to the crisis, it would have, in effect, brought the capital raising that ultimately proved necessary forward in time, substituting public provision of capital for private sector resources.").

¹⁰ Bd. of Governors of the Fed. Rsr. Sys., REVIEW OF THE FEDERAL RESERVE'S SUPERVISION AND REGULATION OF SILICON VALLEY BANK 89 (2023), <https://www.federalreserve.gov/publications/files/svb-review-20230428.pdf>.

“And now we have others who wish to ignore what our regulators are saying and not go along with Basel III Endgame that says we must have 2 percent more capital. I don’t understand it. Do You?” To which you responded “No, ma’am.” Just to clarify, do you believe that the Basel III Endgame proposal will require that banks must have 2 percent more capital, or do you believe that to be an inaccurate estimate?

Response: In responding to Ranking Member Waters’ question, I understood her to be referring to the additional 2 percent of common equity tier 1 (CET1) capital that SVB would have needed in order to maintain the same CET1 ratio if it had been required to recognize unrealized gains and losses on AFS securities. (See my response to Question #3.) I concurred with Ranking Member Waters’ assessment because the Basel III Endgame proposal would require Category III and IV banks like SVB to recognize unrealized gains and losses on AFS securities in their CET1 capital.¹¹

5. Your testimony states that banking agencies are not subject to any cost-benefit analysis requirement. What legal standard do you believe is applicable to the federal banking agencies in imposing a capital standard? Is your view that banking agencies are subject to no standard and therefore are exempt from the requirements of the Administrative Procedure Act and any judicial review of their decisions, and that Congress has effectively delegated standard-less and unreviewable authority to them to establish whatever standards they choose?

Response: As I stated in my testimony, the federal banking agencies are subject to the Administrative Procedure Act (APA), which requires that they engage in “reasoned decision making.”¹² To satisfy this standard, the agencies must “examine the relevant data and articulate a satisfactory explanation for [their] action including a ‘rational connection between the facts found and the choice made.’”¹³ However, the APA does not require the agencies to perform a quantitative cost-benefit analysis.¹⁴ Further, as independent agencies, the banking agencies are not subject to Executive Orders that require quantitative cost-benefit analysis. This exclusion makes sense: quantifying the benefits of a banking crisis averted is a nearly impossible task.¹⁵ In sum, while the banking agencies are subject to the APA’s procedural requirements, they are not required to perform a quantitative cost-benefit analysis.

6. In response to a question during the hearing, you responded that when Secretary Yellen stated that the banking system was well capitalized, she was referring only to a legal definition of 10% of risk-weighted assets and did not mean to convey any meaning beyond that. Reviewing her past statements, what is your basis for that assertion?

¹¹ See Proposed Rule, *supra* note 2, at 64036.

¹² *Motor Vehicle Mfrs. Ass’n of U.S., Inc. v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 52 (1983).

¹³ *Id.* at 43 (quoting *Burlington Truck Lines v. United States*, 371 U.S. 156, 168 (1962)).

¹⁴ See *Vill. Of Barrington v. Surface Transp. Bd.*, 636 F.3d 650, 670-71 (D.C. Cir. 2011); see also *Am. Textile Mfrs. Inst., Inc. v. Donovan*, 452 U.S. 490, 510 (1981) (“When Congress has intended that an agency engage in cost-benefit analysis, it has clearly indicated such intent on the face of the statute.”).

¹⁵ See John C. Coates IV, *Cost-Benefit Analysis of Financial Regulation: Case Studies and Implications*, 124 *YALE L.J.* 882, 906-69 (2015); Jeffrey N. Gordon, *The Empty Call for Benefit-Cost Analysis in Financial Regulation*, 43 *J. LEGAL STUD.* S351, S373-75 (2014).

Response: I do not know Secretary Yellen's intent when she made her past statements. As I stated at the hearing, it is true that the U.S. banking system is well capitalized, in that bank holding companies in the aggregate maintain total risk-based capital above 10 percent and tier 1 risk-based capital above 6 percent.¹⁶ However, the fact that banking organizations generally satisfy this legal definition does not mean that this capital threshold, which was established in 1997, is optimal for the types of activities and level of risk-taking in which financial conglomerates now engage, almost three decades later.¹⁷

Representative Brad Sherman:

Within our current capital rule framework exists what is known as the p-factor, which determines the "securitization surcharge," or the additional capital required for a pool of assets when held in securitized form. The Basel III Endgame proposed rulemaking doubles this securitization surcharge. Can you discuss what increasing the p-factor will do to the securitization market and overall access to credit?

Response: The p-factor is one of many inputs involved in calculating the risk-weight for a securitization exposure under the banking agencies' capital rules. The Basel III Endgame proposal would relax several of the inputs in the securitization framework. For example, the proposal would reduce the risk-weights for many assets that underlie securitizations, which would be reflected in lower values of the K_G variable in the securitization framework. In addition, the proposal would reduce the risk-weight floor for many securitization exposures. The proposed changes to K_G and the risk-weight floor would generally depress capital requirements for securitization exposures. Thus, the agencies did not propose to calibrate the p-factor in isolation. Rather, the proposed increase in the p-factor would help ensure that the other changes to the securitization framework do not inappropriately reduce capital requirements for securitization exposures that can pose risks to banking organizations and the broader financial system, as the 2008 financial crisis vividly demonstrated.

Representative Scott Fitzgerald:

The Basel III Endgame Proposal includes many provisions, one of which is the securitization framework. As you know, securitization is an important source of funding for U.S. consumer and business lending, with over \$1.5 trillion of asset-backed securities issued in 2023 alone. Are you concerned about how the increased regulatory capital requirements within the securitization framework will affect securitization markets and the cost and availability of credit?

Response: The securitization market can help promote funding for consumer and business lending. As the 2008 financial crisis demonstrated, though, securitization can also pose risks to banks and the broader financial system. When establishing

¹⁶ 12 C.F.R. § 225.2(r)(1).

¹⁷ See Bank Holding Companies and Change in Bank Control (Regulation Y), 62 Fed. Reg. 9290 (Feb. 28, 1997).

risk-weights for securitization exposures, the banking agencies balance the dual objectives of (1) promoting credit availability, and (2) ensuring that banks maintain sufficient capital to withstand potential losses on such exposures.

Ranking Member Maxine Waters:

Professor Jeremy Kress

1. Which of the following options best describes your self-identified race? (you may choose more than one)
 - a. **White or Caucasian**
 - b. Black or African American
 - c. Hispanic/Latinx
 - d. Asian
 - e. Middle Eastern/North African
 - f. Choose not to answer
 - g. Prefer to self-describe (please specify)
2. Which of the following options best describes your gender identity?
 - a. Woman
 - b. **Man**
 - c. Non-binary
 - d. Transgender Man
 - e. Transgender Woman
 - f. Choose not to answer
 - g. Prefer to self-describe (please specify)

