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Subcommittee on Financial Institutions and Monetary Policy

"Rules Without Analysis: Federal Banking Proposals Under the Biden Administration"

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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),

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[2] https://www.congress.gov/bill/115th-congress/senate-bill/2155.
[3] https://clsbluesky.law.columbia.edu/2023/08/01/cleary-gottlieb-discusses-proposed-capital-requirement-increases-for-banks/.
[4] https://www.fdic.gov/news/speeches/2023/spjul2723b.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.

<u>Burdens of the Proposal</u>

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]

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[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

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[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?srnd=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:

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[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

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[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.

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[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. UK[45] and EU[46] 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

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[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 assets[54] 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/bill/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 is 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 scores[64] 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-91eaf804.
[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 lead 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=qf25y3k5sy5k6kl.
[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-eff3-44c4-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 attaint 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:

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[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:

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[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.ft.com/content/5612cba3-1580-4003-a0ac-6623cbe28ee6.
[99] https://www.federalreserve.gov/publications/files/svb-review-20230428.pdf.

- SVB was already subject[100] 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

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[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=vuture&utm_medium=email&utm_campaign=2023-10-18%20silicon%20valley%20bank%20failure%20%e2%80%93%20a%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.
[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

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[113] https://www.mayerbrown.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.

<u>Economic Analysis</u>

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 period[124] 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

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[120] *Michigan v. Envtl. 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.

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[128] 88 FR 64169, n. 465
[129] https://punchbowl.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.

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

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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.

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[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/e3c3d1f3-0ebc-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 insurance[158] 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

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[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 LTD[164] 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

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[160] 88 FR 64527
[161] https://www.mayerbrown.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.

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[181] https://twitter.com/RepTimmons/status/1727418546941026718.
[182] 88 FR 64551
[183] https://www.chicagobooth.edu/review/did-fed-contribute-svbs-collapse.