BANK POLICY INSTITUTE

Testimony of Greg Baer

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At the Hearing *Implementing Basel III: What's the Fed's Endgame?*

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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 represents banks with more than $100 billion in U.S. assets. As our membership comprises the full range of banks covered by the recent Basel proposal, we welcome the opportunity to testify today.

At the end of July, the federal banking agencies jointly proposed the Basel finalization rule that would result in very large increases in capital requirements for U.S. and foreign banks operating in this country. The Bank Policy Institute will be responding to that proposal in comprehensive detail after analyzing its contents and conferring with member banks to gauge its full impact. This testimony will not attempt to present a detailed response ahead of that formal comment letter, but it will instead highlight six of the proposal's major conceptual and procedural problems and offer a few illustrative examples of where it accordingly goes very badly wrong.

Congressional attention here is vitally important, as this proposed rule would affect every person and every business in the United States if implemented in its proposed form. Congressional attention is further warranted because the agencies' proposal would constitute a de facto repeal of regulatory tailoring legislation that Congress passed on a bipartisan basis in 2018 through the Economic Growth, Regulatory Relief, and Consumer Protection Act (S. 2155).

First, the proposal has no basis in real-world experience.

The nation's largest banks have proven themselves highly resilient since implementing a robust package of regulatory reforms following the Global Financial Crisis of 2008-09. The level of tier 1 common equity, 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.

Further evidence of the adequacy of current capital levels comes from the Federal Reserve's annual stress test. 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 bail-in debt — 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 resulting Great Recession. This result is consistent with every past outcome of this test. The proposed rule ignores the existence of this test and its consistent results.

To the contrary, at war with history and independent analysis, the proposed rule concludes instead that every bank holding greater than $100 billion in U.S. assets is undercapitalized and, in some cases, significantly undercapitalized—and would require 16 percent more capital, on average, and far more for some banks.

While the proposed rule does not cite the failure of Silicon Valley Bank as a basis for its policies, one might reasonably ask whether that experience suggests that more capital is needed. Silicon Valley Bank, First Republic and a few other smaller banks failed for two reasons: interest rate risk and depositor concentration risk. Those banks incurred large unrealized losses as a result of an unprecedented series of interest rate increases by the Federal Reserve following a historically long period of near zero rates and a failure by bank managers and examiners to anticipate the potential effect. The primary problem with SVB and the other failed banks was a *liquidity* problem, an extraordinary concentration of their depositor bases that bore no relation to the funding of America's larger banks.

Yet the proposed rule *has nothing to do with liquidity risk or interest rate risk*. It is about everything else: credit risk, market risk, operational risk, counterparty credit risk and risk on derivative instruments. SVB's borrowers repaid their loans; SVB did not trade securities; SVB did not suffer a cyberattack or other major operational problem; SVB's derivative counterparties did not default; SVB did not experience large mark-to-market losses on its derivative exposures. Ironically, SVB's assets were very much in keeping with the implied preference of the proposed rule: holding government or agency securities that carry a zero or low risk weight. The proposed rule would not have made SVB any safer. It would have required SVB to raise more equity to increase its capital by approximately 10 percent, which would have done it no good.[1] Indeed, if a year ago you had asked me to construct a hypothetical bank failure that in no way argued for higher capital requirements, I would have described a situation much like SVB. While to a hammer everything is a nail and to anti-bank activists any problem at any bank is an argument for higher capital requirements for the largest banks, SVB is anything but.

Second, the proposal is based on no conceptual standard and has no basis in data or analysis.

The essence of the proposal is to assign a risk weight to each bank asset and off-balance sheet exposure (for example, a loan commitment or derivative instrument). The sum of those risk weights (total risk-weighted assets) serves as the denominator in calculating the bank's risk-

[1] *See, e.g.* Steven Kelly, "The Fed gets ratioed, bank capital edition: Say it with us: More capital would not have prevented SVB's failure," Financial Times (August 31, 2023), https://www.ft.com/content/98589f4c-0e38-4785-b7b6-a80f1aefaaa9.

based capital ratio, and thereby determines how much capital (the numerator) must be held to meet specified minimum ratios.

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, either with respect to any individual risk or for all risks in total. The proposed rule provides no legal standard, no quantitative standard, and no qualitative standard, instead deferring to an agreement in Basel, itself lacking any such standard, as a minimum requirement for U.S. banks.

The proposal's approach to assigning risk weights stands in contrast to the agencies' existing capital rules. In particular, the current Advanced Approaches to credit risk—which as described below the proposal would eliminate—is calibrated using the so-called "Asymptotic Single Risk Factor" model.[2] This model sets capital requirements at a level sufficient to provide a buffer to protect a bank's debt holders against peak losses that exceed expected levels. These losses above expected levels are commonly termed "unexpected losses." The confidence level is set to 99.9 percent, meaning there is a once-in-a-thousand years probability of a loss that exceeds a bank's capital requirements. It is not clear whether the agencies believe this standard is no longer appropriate, as the proposal would eliminate it in favor of no standard at all.

Furthermore, the proposal contains no analysis of the absolute or relative risks of the underlying assets or exposures. The absence of historical analysis is incredible given that the agencies possess a massive database of historical loss experience. Regulatory data going back to 2001 provides loss experience in good and bad times. Credit rating agencies and other private sector firms maintain robust databases of loss experience from which risk weights could rationally be derived. The Fed's own FR Y-14 data collection, used to feed its stress tests, could be used to calibrate the various risk weights for credit risk and operational risk.

The agencies' decision to ignore historical data is significant because that data argues for significantly lower risk weights than the agencies have proposed. To provide just one example, public data reported by the largest banks indicates that the average risk weight for first-lien closed-end mortgages is 24 percent across all mortgages.[3] In contrast, based on no data, the proposed rule imposes risk weights between 40 and 90 percent depending on the loan-to-value of the mortgage—so, more than 1.5 to nearly four times what the agencies' own data would support.

Rather than publishing and analyzing existing data and seeking public input on it, the proposed rule takes as given and irrefutable the risk weights negotiated by staff of global central banks and regulatory agencies at Basel in 2017 and then, in many cases, imposes arbitrary up-

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[2] See, Basel Committee on Banking Supervision, "An Explanatory Note on the Basel II IRB Risk Weight Functions," July 2005, https://www.bis.org/bcbs/irbriskweight.pdf.

[3] See, "Regulatory Capital Reporting for Institutions Subject to the Advanced Capital Adequacy Framework—FFIEC 101," Schedule B "Summary Risk-Weighted Asset Information for Banks Approved to Use Advanced Internal Ratings-Based and Advanced Measurement Approaches for Regulatory Capital Purposes. The average is taken between 2Q14 and 2Q23 across all Category I and II firms.

charges to those risk weights, which the agencies for political marketing purposes generally term "gold plating" or "super equivalency." However, the risk weights devised in Basel were based on undisclosed analysis and considerable political horse trading among member countries. In particular, any analysis done was almost certainly not focused on loss experience in the United States as opposed to the other 26 countries represented at the Basel negotiating table, and it almost certainly did not reflect the effects of major changes to U.S. regulation between 2010 and 2017. The resulting agreement was not a treaty ratified by the U.S. Senate, and it was not the subject of any Congressional oversight. (It was not even formally approved by the Board of Governors of the Federal Reserve System or the Federal Deposit Insurance Corporation.) Nonetheless, the proposed rule improperly treats the Basel risk weights as a non-negotiable floor for large U.S. banks.[4]

The agencies also note that they are proposing to increase risk weights above Basel levels in order to preserve competitive equity between large banks subject to the proposal and small banks that might have a credit risk weight higher than the Basel standard. There are three problems with this position. First, it is not rooted in law. Second, it ignores a rather simple solution, which is to lower the risk weight for small banks to better reflect risk rather than inflating the risk weight for large banks to overstate it. Third, it takes no account of other capital charges that apply only to banks with more than $100 billion in assets, including the stress capital charge.

Finally, any implementation of the Basel agreement in the United States presents a crucial issue necessitating considerable analysis that was never considered in Basel: how its design and calibration should be adjusted in light of a Federal Reserve stress test designed to capture and (through a stress capital buffer) capitalize many of the same tail risks covered by the proposal. But there is no indication in the proposed rule that this has happened.[5] And, of course, the Basel agreement that forms the basis for the rule took no account of Federal Reserve stress testing. Indeed, when Basel reached agreement in 2017, the Federal Reserve had not yet even proposed that stress test losses be converted to an additional binding capital charge, and no other country has proposed such a charge, then or since.

The practical stakes here are large and far-reaching. For example, operational risk is double counted in the proposed rule and the Federal Reserve's stress capital charge. Unless

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[4] As noted in the dissent from FDIC Director McKernan, "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." Statement by Jonathan McKernan (July 27, 2023), https://www.fdic.gov/news/speeches/2023/spjul2723c.html.

[5] The proposed rule states only: "Because this proposal aims to better reflect the risk of banking organizations' exposures in the calculation of risk-weighted assets, without changing the targeted level of conservatism of the minimum capital requirements, the Board is not proposing associated changes to the targeted severity of the stress capital buffer requirement." Proposed Rule at 29. It is difficult to read the reference to "conservatism" to mean anything other than that the agencies have decided against recognizing the overlap in rules because doing so would lower the aggregate requirement. This statement thereby defines arbitrariness and caprice for purposes of the Administrative Procedure Act.

corrected, we estimate that 30 percent of bank capital would be held against operational risk, as opposed to credit, market and other risks. As discussed further below, that is neither credible nor desirable.

Third, the proposed rule would impose massive costs on the economy, which it minimizes or ignores.

A recent review of the academic literature by the Basel Committee on Banking Supervision found that a 1-percentage-point increase in capital requirements reduces annual GDP by up to 16 basis points, or about $42 billion of output lost per year in U.S. terms. Applying this measure of economic cost (nowhere mentioned in the proposed rule), and considering that the banks subject to the proposal account for nearly 80 percent of banking sector assets and that capital requirements are increasing by about 2 percentage points (i.e., from 12 percent to 14 percent), the proposed rule would *permanently* reduce annual U.S. GDP by more than $67 billion each year.

As Governor Waller put it in his dissent from the proposed rule:

> An increase in capital requirements forces banks to hold more capital against the services they provide to families and businesses, which is equivalent to imposing a tax on those services. Someone must bear the cost of that tax; the only question is who will bear it. One possibility is that banks will absorb the cost themselves. Another possibility is that banks will attempt to mitigate those profit reductions by passing the cost of higher capital requirements along to their customers. This will raise costs for American families and businesses, which could harm many of them and hinder economic growth. Banks may also simply stop providing more capital-intensive services, which could impede market functioning. It is possible some of those services could migrate outside of the banking system to less regulated entities that can provide them. But as we saw during the pandemic, a lot of problems can emerge from nonbanks that operate outside of our view. That is why I believe a safe but needlessly narrow *banking* system doesn't necessarily result in a safe *financial* system and vibrant economy.[6]

Certainly, nothing in the proposed rule provides any insight on this topic. Instead, the agencies merely assert, with no supporting analysis, "While this increase in requirements could lead to a modest reduction in bank lending, with possible implications for economic growth, the benefits of making the financial system more resilient to stresses that could otherwise impair growth are greater."[7]

The proposed rule would not affect all lines of business equally, as its risk weights are more irrational in some areas than others. A core misconception about bank capital is that banks simply take risk weights as a given and raise the necessary capital. The agencies perpetuate this misunderstanding by referring to how banks will have time to build capital given a delayed

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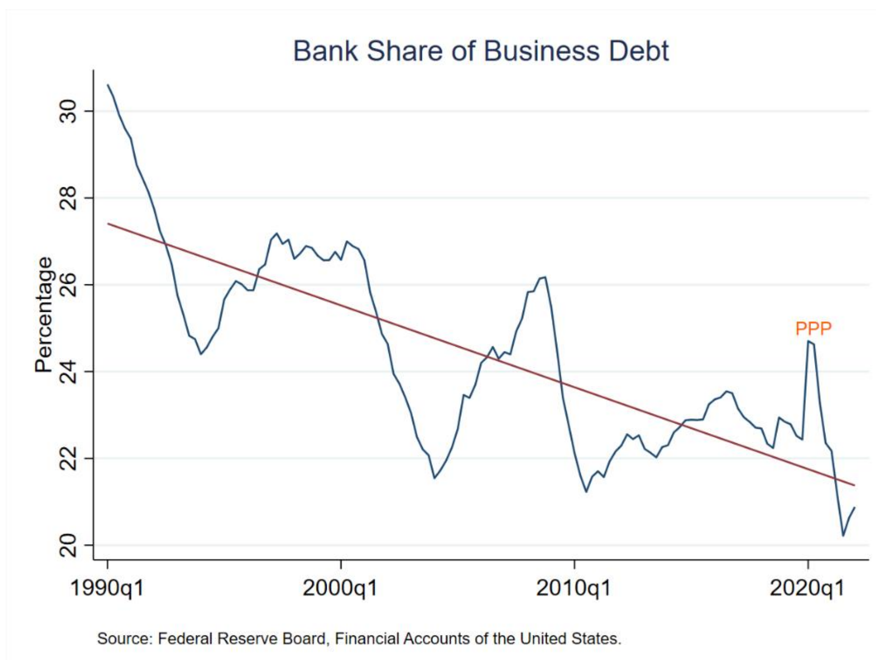
[6] Statement by Governor Christopher J. Waller (July 27, 2023), https://www.federalreserve.gov/newsevents/pressreleases/waller-statement-20230727.htm.

[7] Proposed Rule at 497.

effective date. Again, reality is distinctly otherwise. Banks generally respond to higher capital requirements not just by retaining earnings or halting share repurchases but by shedding the assets that produce the lowest return on regulatory capital. For those seeking affirmation that this approach is the case, simply listen to bank earnings calls and look at analyst reports. When bank CFOs and CEOs refer to "RWA optimization" or "balance sheet optimization" or "managing through it," as they increasingly do, what that means is eliminating previously profitable lines of business that are expected to suffer from unrealistically high risk weights. It means dropping lines of business that a bank would otherwise believe could earn it a market return.

Of course, this is a major reason why we have already seen a significant migration of certain assets out of the banking system in recent years. While the ability to hold deposits gives banks a natural funding advantage, that advantage is increasingly being eaten away by uneconomic capital requirements and the dead weight cost of massive and growing compliance costs driven by agency examination mandates. This effect is most true with respect to mortgage origination, commercial lending and securities market-making.

The chart below shows a decline in banks' share of business debt, as private capital markets—such as private equity, hedge funds, loan mutual funds, finance companies, and business development companies—have dramatically increased their market share.

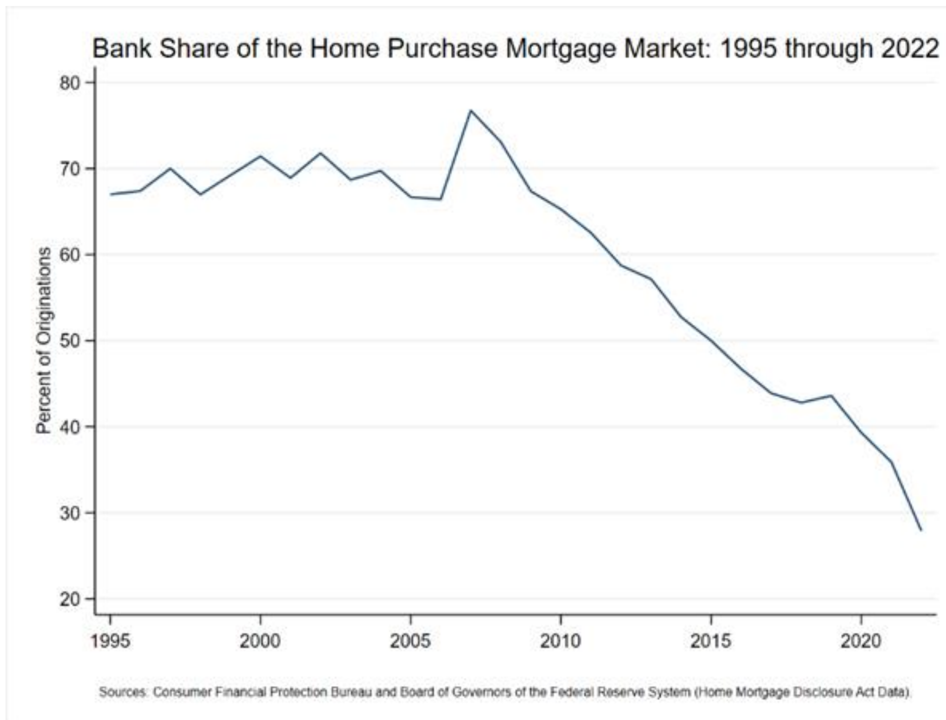


The proposed rule would accelerate this trend. As recently reported:

> The banking crisis in March along with the pending regulatory changes to bank capital requirements are adding even more rocket fuel to an asset class that's more than tripled in size since 2015.

> The growth of the private credit industry is changing the lending landscape in the U.S., disintermediating banks from the process, and even taking the rough edge off the Fed's monetary tightening efforts….
>
> The heavy hitters of the industry aren't hiding their excitement: On his firm's Q2 earnings call, Apollo Management's Marc Rowan hailed this era as a "great time" for private credit; Jon Gray of Blackstone called it a "golden moment."[8]

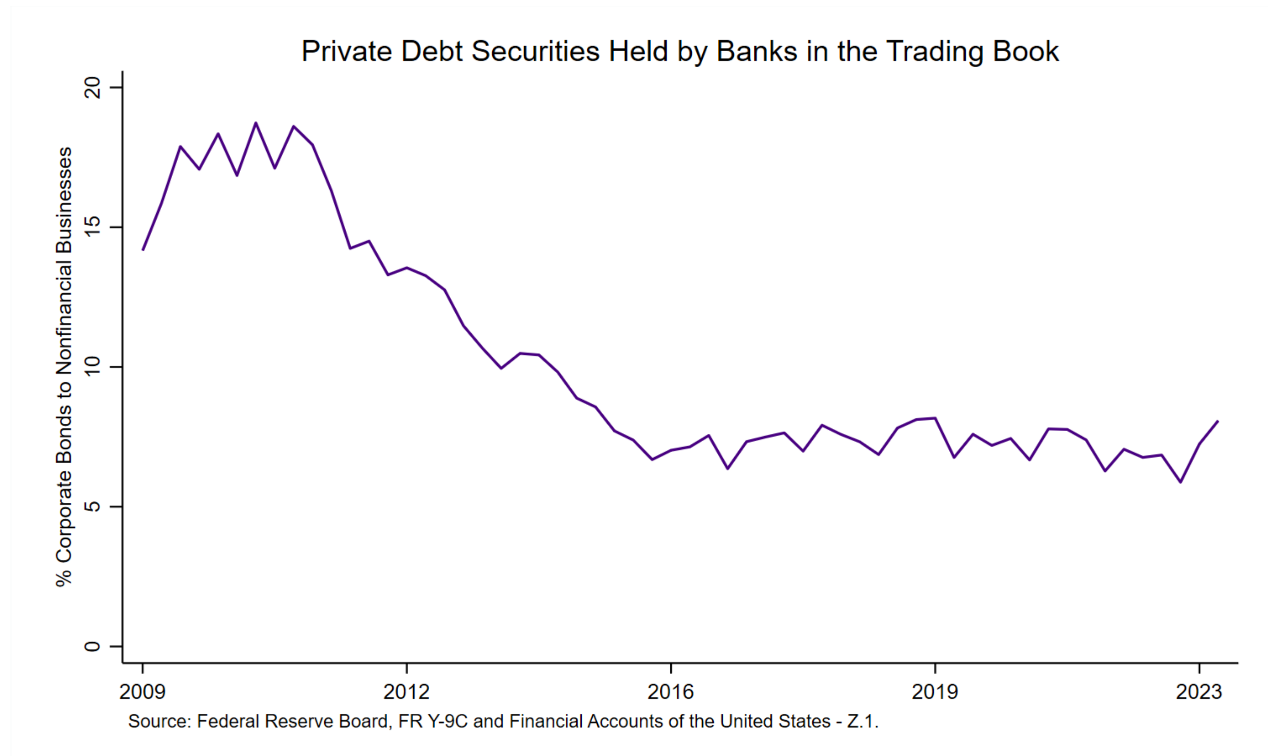
Similarly nonbank activity in the mortgage market has expanded considerably in the post-crisis period. Between 1995 and 2007, banks' market share was stable, hovering around 70 percent of all mortgage originations. According to the most recent data on mortgage loans, banks now account for only about 28 percent of all mortgage-loan originations for home purchases. With the proposed changes to mortgage risk weights and the "double count" of operational risk in the Fed stress tests overlayed on top of this, this trend will likely further accelerate.



Lastly, banks' holdings of debt securities for trading purposes have declined significantly over the past decade. Between 2011 and 2023, the share of private debt securities held on banks' trading books, relative to nonfinancial corporate bonds outstanding, has decreased from approximately 18 percent to 7 percent. Trading and market-making activities are essential for well-functioning capital markets. Large banks play a key role in corporate bond markets by holding large inventories of corporate bonds to conduct market-making activities, particularly for less liquid bonds. Several post-crisis regulations, including the Volcker Rule, the supplementary

[8] Kate Marino, *Post-SVB crisis, this debt market juggernaut is poised to grow even more*, Axios (August 14, 2023), https://www.axios.com/2023/08/14/private-credit-banking-svb.

leverage ratio, the GSIB surcharge, and the GMS component in U.S. stress tests, have led to a significant reduction in banks' inventories of corporate bonds, thereby leading to a decline in banks' market-making activities.



As noted below, the proposed rule would massively increase capital held against these assets, imposing a *coup de grace* on many types of principal-at-risk market-making in this country.

Fourth, the proposed rule would fundamentally alter the role of government in American finance.

If adopted, the proposed rule would complete a sea change in capital regulation: a move from the government ensuring safety and soundness of banks to the government allocating credit across the economy. The proposed rule's 1,000-plus pages assess and specify the risk of every loan made by a bank and every other type of product offered by a bank. Of course, because the Basel agreement was drafted as a one-time, one-size-fits all approach, it ignores unique features of borrowers and does nothing to accommodate nuance among products or differences in risk management among banks. Rather, it groups loans together broadly by type. But to be sure, your loan is in there somewhere. And to an unprecedented extent in the history of this country, the decision of whether you get that loan and how it will be priced would be taken out of the hands of loan officers at banks and vested in the formula-writers in Basel and the stress testers at the Federal Reserve. Everyone knows the story of the entrepreneur who had his or her loan turned down at several banks until one was willing to take the risk or saw the risk differently. With this proposal, that discretion will be the case less and less.

Of course, it's easy to say that current capital requirements suffer from the same problem — indeed that any capital requirement suffers from the same problem, and, to some extent, that observation is fair. But two things have changed here.

First, and most importantly, the proposed rule lacks calibration. Historically, risk-based capital requirements have been set high enough to protect against insolvency and loss to the Deposit Insurance Fund. They have been calibrated based on historical loss experience. They have served as a floor, ensuring that banks do not significantly underestimate risks and therefore hold insufficient capital against them, but leaving room for a healthy, competitive market in which banks can compete on their ability to manage risk and therefore offer a wide range of choices to customers.

Recent history since the adoption of the Federal Reserve stress test is different, and the proposed rule would amplify this trend. The proposed rule is calibrated extremely high relative to any possible real-world or economic measure of actual capital needs. As a result, when it is combined with other capital charges, banks will be less able to look at the given capital charge for a particular asset or exposure and decide that their own risk assessment merits taking it on. An unrealistically high capital charge will often trump economics and prudent risk management.

Second, the proposed rule abandons altogether the use of bank models in assessing credit risk by eliminating what is referred to (quite accurately) as the Advanced Approaches under current U.S. regulation and the Internal Ratings-Based Approach outside this country. This step is extraordinary because the core purpose of the 2017 Basel agreement was in fact to *retain* the use of bank models, subject to certain new parameters. The European Union and the United Kingdom already have announced that they will retain their use of bank models and, in fact, there is no country in the world on track to do what U.S. regulators are proposing to do. Remarkably, at a time when data analytics let us be ever smarter in assessing risk, this proposal would take us in the opposite direction.

In response, one could observe that the Advanced Approaches are currently being used by only nine U.S. banks holding 55 percent of bank assets, and generally have not been the binding constraint; therefore, elimination of their use would have no effect on the thousands of banks holding the other 45 percent of bank assets and only a limited effect on the remaining nine. But what will be lost is a note of reality amidst the theory of bank capital assessment. Bank models are incontrovertibly more accurate than standardized government models, for a host of reasons, and the results of those models give the agencies real data and analysis to think about.[9] But, if the proposed rule is finalized, there would be less basis for dissent or cause for hesitation.

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[9] First, banks invest heavily in their own models, as they use them for financial forecasting for internal planning, securities reporting purposes, and for their own risk management. Therefore, banks have a strong incentive to get their models right. Second, at a substantive level, bank models include more comprehensive and granular data than standardized models. Industry experience has shown that to develop meaningful revenue projections, it is essential to model different revenue streams at a highly granular level. Third, and most importantly, because bank models are used not only for stress testing but also for other, real-world purposes, they are subject to backtesting. Fourth, federal bank examiners, as well as each bank's own compliance and audit departments, oversee that backtesting process.

The primary justification offered by the agencies for elimination of bank models is "unwarranted volatility" among banks. First, note as an evidentiary matter that the only sources cited for this allegation are two dated Basel studies based on data almost exclusively from non-U.S. banks. As noted above, the agencies hold or could easily access incredibly rich data by which to evaluate the extent of variability but they have chosen not to do so. The agencies have also ignored other, more recent work that indicates that variability is minimal.[10] Furthermore, the U.S. agencies constantly review and backtest bank models, yet have never seen cause to bring an enforcement action based on understatement of risk by a bank doing business in the United States.

But the larger point is that, as the focus on "unwarranted" variability appears to acknowledge, some variability is in fact warranted, and highly desirable. Indeed, this *warranted* variability is a vital component of our banking system. In reality, banks can legitimately have different views of the risk of an asset. There is no perfect risk assessment at the time a loan is made, much less a perfect risk assessment that a simple standardized model drafted in Basel Switzerland in 2017 can identify. One bank might specialize in a certain type of consumer lending that allows it to consider risk factors that another bank (and any standardized measure) could not; another bank that employs a large workout team might decide to take a greater risk of default on a commercial loan, knowing that its loss given default will be lower than most; a third bank might see how a relatively risky loan to an existing company could bring it a customer's broader business, with earnings that offset the risk; a fourth bank might have a deep personal history with a small business borrower and therefore have a greater reason to trust in repayment. All of this nuance is lost in the proposed rule. For the Basel standardized models, these factors simply don't compute. Warranted variability must be sacrificed on the alleged yet unproven altar of unwarranted variability.[11] Again, this approach conflicts with that of the EU and UK.

Thus, the strong impression from the proposal is that bank credit models are being ignored as a current data source and eliminated as a future basis for capital regulation not because they are inaccurate, but rather because they consistently demonstrate that a lower requirement than the agencies prefer is appropriate. In a variation of "the best way to improve morale is to fire all the unhappy people," it would appear that the agencies are proposing to ignore and eliminate results from more accurate bank models because they produce a result they disfavor. The only remaining granular analysis of a bank's risk across the capital framework will now rest solely at the Federal Reserve, which uses secret models to produce the analysis through its annual stress test and resulting stress capital charge in a process that is deliberately insulated from public view, accountability or challenge.

The essence of competition in banking is a competition in the management of risk, but that risk management is becoming more and more the province of federal regulators and examiners.

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[10] See, Covas, Francisco and Stepankova, Barbora, "Consistency in Risk Weights for Corporate Exposures Under the Standardized Approach," Bank Policy Institute (January 10, 2022), https://bpi.com/consistency-in-risk-weights-for-corporate-exposures-under-the-standardized-approach/.

[11] In a bit of irony, despite the removal of bank models from the capital framework, in the same proposal the agencies suggest that banks maintain these models as "internal models can provide valuable information to a banking organization's internal stress testing, capital planning, and risk management functions. Large banking organizations should employ internal modeling capabilities as appropriate for the complexity of their activities."

Furthermore, as their preferences are imposed across the industry, bank balance sheets will likely become more and more homogenous, creating financial stability risk.

Fifth, the proposed rule effectively repeals a regulatory tailoring statute enacted on a bipartisan basis in 2018.

The proposed rule represents de facto agency repeal of the Economic Growth, Regulatory Relief and Consumer Protection Act enacted by Congress in 2018. Through the proposed Basel rule and others, the agencies are proposing to reverse the decision by Congress to tailor regulatory requirements by bank size and complexity. Under prior leadership—back to my days at the Federal Reserve and Treasury Department—federal banking agencies dissatisfied with a federal statute would ask Congress to revisit and revise it; through this rule, the agencies have decided simply to ignore and thereby nullify it.

The consequences for our economy would be significant. As our research has shown, mid-size and regional banks play a vital role in local communities. Data show that these banks—defined as those whose asset size falls between community banks and the four universal banks—account for more than half of small business loans originated in many of the 50 largest metropolitan areas.[12] Their role is particularly significant for cities other than the largest ones: for the 26th to 50th largest cities, regional banks provide more than 50 percent of the loans in all but three such cities. In aggregate, nearly 60 percent of the U.S. population resides in metro areas where the combined share of small business loans originated by mid-size and regional banks exceeds 50 percent. If these banks withdraw from or reprice in these markets, it will leave a mark.

Nonetheless, the proposed rule would change the calculation of the numerator for Category III and IV institutions, subjecting those banks to the same treatment for Accumulated Other Comprehensive Income (AOCI), capital deductions and rules for minority interest as the largest banks. All banks would be required to calculate their risk-weighted assets under the same two standards—the Standardized Approach and Expanded Risk-Based Capital Approach (a new standardized approach based on the Basel standard). All banks would also be subject to the proposed rule to utilize the Standardized Approach for Counterparty Credit Risk and Derivative Contracts. In addition, the proposed rule would remove an existing materiality threshold from the market risk capital rule and instead apply it to all banks with at least $100 billion in assets, regardless of their levels of trading assets. There would be large costs associated with adopting the governance and data processes required by the proposed market risk rule, which would be totally disproportionate for regional banks with negligible trading books. Lastly, the proposal would require Category IV institutions to be subject to the countercyclical capital buffer and a supplementary leverage ratio that were not previously applicable to them.

Applying the Basel-based approach to calculating RWAs on all institutions above $100 billion is particularly problematic because the Basel standard was never designed to be applicable to mid-size and regional banks. In particular, the Standardized Approach to Operational Risk produces

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[12] Calem, Paul; Covas, Francisco; Gross, Benjamin, "Bridging the Gap: How Larger and Mid-sized Banks Power Small Businesses," Bank Policy Institute (July 21, 2023), https://bpi.com/bridging-the-gap-how-large-and-mid-sized-banks-power-small-businesses/.

outlier results when applied to some smaller banks within that cohort, which were not considered by the Basel Committee when it finalized the international standard in 2017.

Sixth, the proposed rule represents a fundamental repudiation of the Basel agreement it purports to implement.

The agencies frequently refer to this proposal as the implementation of the Basel agreement reached in 2017. It is, in fact, largely a repudiation of that agreement.

At the press conference announcing the 2017 Basel agreement, Mario Draghi (then-ECB President and Chair of the Group of Governors and Heads of Supervision) stated, "The focus of the exercise was not to increase capital. As a matter of fact, the GHOS [the governors of the central banks and heads of supervision at the agencies represented at Basel] 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." That view is supported by the quantitative impact study released by the Basel Committee when it finalized the 2017 agreement, which concluded that the changes agreed to would, in the aggregate, actually reduce the risk-based capital requirements of the largest banks. At the time the agreement was announced, Secretary Mnuchin stated that it would "help level the playing field for U.S. firms and businesses operating internationally."[13] A projected capital increase of 16 percent for banks operating in the United States is impossible to square with the agreement reached in 2017.

If the proposed rule were adopted, banks operating in the United States would be the only major banks in the world being assessed solely based on a standardized approach, would be the only banks in the world experiencing an explicit stress capital charge on top of that standardized approach, and would be the only banks in the world facing a variety of capital add-ons above the Basel-agreed risk weights.

Case Studies

Four examples from the proposed rule give some sense of its fatal flaws and illustrate how a process without a governing standard and based on no analysis can produce bad outcomes.

Loans to high-quality small and mid-sized businesses.

The standardized approach in the Basel agreement generally imposes a 100 percent risk weight on corporate loans, but provides a more favorable risk weight of 65 percent for loans to businesses rated investment grade by a bank's internal credit rating system, as long as the borrower has issued securities listed on a national exchange.

This securities listing requirement has no evidentiary or analytical basis, and the one study of the requirement has shown that the listing requirement is non-probative of the risk of default.[14] Perhaps for that reason, both the EU and the UK have eliminated this requirement.

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[13] *See Global Regulators Agree on Rules to Prevent Financial Crises*, New York Times, (Dec. 7, 2017).
[14] *See* Covas and Stepankova, *supra* note 10.

The imposition of an unsupported and illogical securities listing requirement only serves to exacerbate the proposed corporate risk weights' most fundamental problem, which is that they are inaccurate measures of risk. Based on data submitted to the agencies by the largest banks, the appropriate risk weight of a loan to a corporate entity is 38 percent. Thus, while a decade of actual loss experience suggests a 38 percent risk weigh is appropriate, the proposal presents a false choice between 65 and 100 percent, based on a Basel standard which, in turn, is based on no identified data or analysis.

This arbitrary action would have real consequences for the U.S. economy. Small and mid-sized businesses generally do not list securities on the NYSE or NASDAQ. The difference between the pricing of a loan at a 38 percent risk weight versus a 65 percent risk weight versus a 100 percent risk weight is sizeable. The businesses that are the core of U.S. economic growth would pay that price through higher interest rates paid either to banks or to the private debt and capital markets that continue to feast on the regulatory arbitrage opportunity presented by uneconomic capital charges imposed on banks. Looking at an average corporate loan amount of $15 million, the difference between a 100 percent risk weight under the US approach versus a 38 percent risk weight under other jurisdictions would lead to over $120,000 in higher yearly interest expenses for a U.S. company as compared to a similar company in the EU or UK.[15]

Operational Risk

Operational risk is defined as the risk of loss resulting from inadequate or failed internal processes, people and systems, or from external events. Cyber risk is universally considered the largest operational risk facing banks. *Here is an important question to ask in evaluating the proposal's approach to operational risk: has any large U.S. bank ever failed for operational risk?* Has any such bank ever suffered a material loss as a result of a cyber -attack, an IT failure, any other true operational risk event? The proposed rule cites not a single case.

Nonetheless, the proposed rule converts operational risk into a capital charge by creating phantom bank assets — not loans or securities but "assets" that represent solely the theoretical risk of operational risk losses and which exist only to produce a capital charge. These phantom assets would be massive. Between existing capital rules and the Federal Reserve stress test, U.S. banks must already capitalize more than $1.5 *trillion* in phantom operational risk assets. Under the proposed rule, the former would rise an additional $2 trillion, resulting in a total of $3.5 trillion in phantom assets. *Those $3.5 trillion in phantom assets would in turn require banks operating in the United States to fund their balance sheets with approximately $350 billion in capital—significantly raising those banks costs of lending to businesses or individuals or providing liquidity in capital markets.*

This capital charge becomes all the more unjustified when one realizes that the past losses that the agencies likely are relying upon to justify a large charge for operational risk are derived

[15] The example assumes a 60 percent increase in capital requirements, which translates into a 78 basis point increase in the loan spread. Given that the bank has a common equity Tier 1 ratio of 13 percent and a 10 percent cost of equity, the calculation is 0.6 x 0.13 x 0.10 = 78 bps. This is equivalent to an approximately $117,000 higher annual expense on a $15 million loan.

largely from fines and penalties imposed by those same agencies, as well as piling-on penalties imposed by the Justice Department and settlements obtained in resulting class action litigation. That currently includes an ongoing frenzy of fines against banks for failing to monitor texting on their employees' personal phones. The fine imposed generally appears to have been set for large banks at $200 million, regardless of the merits of the case, and over $2.5 billion has been paid thus far. Fines for anti-money laundering compliance issues—not, to be clear, actual money laundering—have also been in the billions of dollars in recent years. In effect, the agencies are requiring banks to capitalize the costs of the ever-increasing penalties they impose, ensuring that those penalties are paid not just by bank shareholders one time but by all bank customers all the time.

But there is a more fundamental problem with the proposal. Future fines are unlikely to be highly correlated with market risk, counterparty risk or the other risks being capitalized by the proposal. The agencies are no more or less likely to fine a bank for failure to monitor its employees' personal phones during a credit crisis versus a market crisis. Thus, a bank fined for some perceived misdeed will in most cases be able to pay that fine out of earnings but even in extreme cases will be able to use some of its otherwise-required capital to pay the fine and rebuild its capital over time through earnings. Indeed, this was *exactly* the logic when the agencies noted that "the existing risk-based capital rules were designed to cover all risks, and therefore implicitly cover operational risk."[16] After all, unless these risks are perfectly correlated (which they clearly are not), a dollar of capital can guard against multiple risks, just as a single airbag can guard against a variety of collisions. The agencies have done nothing to explain this reversal in policy.

And lest we forget, the Federal Reserve's stress test already includes a charge for operational risk — $188 billion in aggregate losses for operational risk events are included in the current stress capital charge.

Market Risk

The proposal reserves its largest capital increases for market risk. Capital held against these risks has already increased substantially since the Global Financial Crisis, but the proposal's Fundamental Review of the Trading Book (FRTB) will provide an estimated massive increase of 70%. In contrast to the treatment of credit risks, for market risks the FRTB in principle allows the use of internal models; in practice, however, the FRTB effectively repeals internal model usage for a substantial portion of assets. The FRTB imposes extremely stringent tests that assets must pass to be included in the internal models methodology. Failure of these tests forces the assets into a punitive stress test or the draconian standardized treatment. These tests have significant flaws, however, and can fail for unjustified reasons. Moreover, the tests themselves, as well as the FRTB methodology in general, are rife with parameter choices that are stated ex cathedra, without any justification or explanation. The 70% increase in capital is not the result of increased bank risk but is rather caused by the FRTB tests forcing assets that are now covered by internal models into stress tests or standardized models, which use unjustified parameter choices to substantially overestimate market risks.

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[16] *See Risk-Based Capital Standards: Advanced Capital Adequacy Framework*, pp 312-13, https://www.federalreserve.gov/generalinfo/basel2/draftnpr/npr/Draft_Basel_II_NPR.pdf.

This impact does not include an annual increase to the global systemically important bank (GSIB) surcharge that has occurred since its adoption in 2016. That surcharge purports to measure systemic risk generally, but its components in essence represent a targeted tax on market-making—both the holding of trading inventory and the use of derivatives to hedge risk. At the time the Federal Reserve adopted the GSIB surcharge, it was already calibrated at double the international level. Meanwhile, although the Federal Reserve committed at the time to periodically adjust the surcharge to account for GDP growth, it has never done so. (Because the European and UK versions are based on market share rather than fixed components, they need not do so.) The result is that a large tax on market -making continues to increase each year, and the Federal Reserve has offered no justification for reneging on its prior commitment to rationalize the charge.

Meanwhile, for more than a decade, market-making has been consistently profitable, while central clearing and margin requirements have decreased counterparty risk. For the largest banks, trading income has provided helpful diversification to commercial bank income. Large banks made more than $40 billion in trading revenues in the tumultuous first half of 2020 as they performed the core function of market-making — posting bids to those looking to sell and offers to those wishing to buy. They have benefited from volatility in capital markets, and from diversification of risk. Indeed, the consistent market concern has not been that banks have insufficient capital for market risk but rather that existing capital requirements are so high that they have drained liquidity from capital markets. In a classic case of shooting the wounded, the proposed rule would further drain liquidity and likely enshrine the government, in the form of the Federal Reserve, as a necessary participant in capital markets whenever there is significant stress. For decades, Federal Reserve and Treasury officials have boasted about how deep and liquid capital markets are a major asset for our economic growth. That boasting will need to cease if a 70 percent capital increase is imposed.

Even a few years ago, the notion that the Federal Reserve would regularly function as a "market-maker of last resort" was considered anathema (and lacking legal basis). Through the use of special purpose vehicles, the Federal Reserve now apparently believes that its power to transact in private markets is effectively limitless and not just limited to monetary policy purposes. The Federal Reserve intervened to support the Treasury market — long touted as the most liquid securities market in the world — in 2019 and 2020, and this year's Jackson Hole conference featured a commissioned presentation on how the Federal Reserve should be a permanent and regular market-maker for that market. If the proposed rule drains liquidity from corporate bond markets, it would be no surprise if future presentations envisioned a role for the Federal Reserve there as well.

Mortgages

The proposed rule also errs in increasing the risk weights of mortgage loans significantly above those included in the Basel 2017 agreement (and being adopted abroad). The 2017 Basel agreement recognized that the preexisting standardized risk weight for mortgages, which lacks a sound empirical basis, already penalized most mortgages retained on the balance sheet of banks, and it therefore replaced the existing, uniform 50 percent risk weight for all mortgages with a

more risk-sensitive calibration. The proposal put forth by the U.S. banking agencies would instead assume that many mortgage loans are much riskier than is implied by the Basel standards, and by doing so would raise the cost of mortgage credit for many borrowers well above 50 percent. This would further constrain housing affordability, already a major national concern. We are still analyzing whether the impact on lower income and minority borrowers would be disproportionate to risk.

The addition of an operational risk capital charge on top of the credit risk capital charge for mortgage loans would further raise the overall capital requirements applicable to these loans, particularly for mortgages that correspond with special government-sponsored enterprise (GSE) programs targeting new homeowners or underserved borrowers (such as VA loans). Often times, these mortgages have higher loan-to-value (LTV) ratios of 80 to 85 percent, which would receive a punitive 60 percent risk weight under the proposal. This is higher than both the current U.S. standardized risk weight of 50 percent and much higher than the Basel agreement risk weight for these loans that is being adopted by the rest of the world, which is 40 percent. The operational risk charge in the U.S. proposal adds another 5 percentage points on average to U.S. mortgages.

Meanwhile, in the real world, over the past ten years, the average risk weight for mortgage loans based on banks' own loss experience has been 24 percent. Similarly (and citing yet another data source ignored by the proposed rule) the Federal Housing Finance Agency (FHFA) estimates an appropriate risk weight of 37 percent for mortgages held by Fannie Mae and Freddie Mac.[17] (The lower risk weight for bank mortgages is unsurprising given that banks hold a significant amount of jumbo mortgages (those above the dollar value that the GSEs are permitted to purchase), which tend to have a lower probability of default.)

As dismal as this sounds for mortgage loans on bank balance sheets, the impact of the proposal could be even worse for mortgages sold to the GSEs. The operational risk charge includes a "multiplier" on fee income, such as mortgage banking income, when loans are sold by banks to GSEs. Since these mortgages are often sold within 30 to 60 days of origination, these sales escalate the bank's risk-weighted assets, as banks will not only incur higher operational risk capital from the interest income on the mortgages but also from the fees generated from selling the mortgages to the GSEs.

Lastly, the proposal is not only punitive relative to the risk posed by banks' mortgage lending but imposes a form of double counting of risk. This is because the Federal Reserve's stress test imposes a stress capital charge on all mortgages accounting for losses associated with operational risk events. Hence, banks will be charged twice on the revenue side of selling a mortgage. Moreover, if a bank services the GSE mortgage, an additional operational risk charge will be imposed on mortgage serving income in the form of a multiplier of fee income on top of the already excessively high 250 percent risk-weight.

Conclusion

[17] *See Enterprise Regulatory Capital Framework*, https://www.fhfa.gov/SupervisionRegulation/Rules/RuleDocuments/Enterprise%20Capital%20Final%20Rule%20for%20Website.pdf.

Ultimately, this proposal is about power —the power to allocate credit across the economy. In unprecedented ways, it would shift that power from the private sector in the form of the nation's banking system increasingly to unelected, unaccountable and insular government agencies and supranational bodies. Furthermore, it would do so based on no data or analysis, in the face of decades of real-world experience, and in ways that dramatically misstate—and in every case, overstate—the actual risks of banking. And the consequences of this fatally flawed approach would be very real: deserving businesses and individuals would pay more for credit than they should; U.S. capital markets would be more illiquid than they need to be; and financial intermediation would shift not only to non-banks—with higher costs and financial stability risks—but over time to the government. The proposed rule should be withdrawn and reconsidered.