

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

¹² *Id.* at 11.

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

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

¹⁵ *Id.*

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

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

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

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

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

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

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

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

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

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

²³ See *id.*

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

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

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

1. Reducing Reliance on Internal Models

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

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

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

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

2. Enhancing the Market Risk Framework

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

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

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

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

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

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

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

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

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

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

IV. Criticisms of the Proposed Rule Are Unconvincing

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

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

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

³² 12 U.S.C. § 1823(c)(4)(G).

1. Effect on Nonbanks

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

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

2. International Competitiveness

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

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

³³ Cecchetti & Schoenholtz, *supra* note 14.

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

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

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

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

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

3. Legal Authority

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

³⁶ See, e.g., Robin Wigglesworth, *Europe is Having a Better Banking Crisis Than the US*, FIN. TIMES (Mar. 23, 2023), <https://www.ft.com/content/81e811d1-e45e-47f5-b70e-1a4638b43010>.

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

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

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

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

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

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

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

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

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

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

⁴³ 12 U.S.C. § 5365(a)(2).

⁴⁴ *Id.*