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Renita Marcellin
Advocacy & Legislative Director
Americans for Financial Reform

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Thank you Chairman Barr and Ranking Member Foster for the opportunity to testify today. I am the Advocacy & Legislative Director of Americans for Financial Reform (AFR), an advocacy organization and coalition born out of the 2008 Global Financial Crisis (GFC) that continues to advocate for a fairer, more stable and equitable banking system.

To that end, we support the work of the Federal Reserve, OCC, and FDIC to move forward with rulemaking to implement the Basel III "Endgame" capital proposal coming out of the Basel Committee on Banking Supervision (BCBS),[1] with appropriate modifications to fit the scope and nature of the U.S. financial system. We also strongly support the work of the regulators to address climate-related financial risk, especially as the world grapples with the increasingly dire effects of climate change. Just as financial instability in one country can migrate to other parts of the globe, climate-related events and their effects on financial institutions similarly pose a global threat. Thus, it is only right that governments coordinate at every level to deal with the economic and societal threats posed by a warming planet. We appreciate the work of the Financial Stability Oversight Council (FSOC) and global standard-setting bodies to address macro-prudential risk, including climate-related risks, and continue to push for bolder and faster action necessary to contend with the dangers we face.

Brief Primer on What is Bank Capital

The 2008 GFC and the string of bank failures this spring reminded us once again of the steep economic and societal cost of not having resilient banks. Strong, high quality capital is essential to fortifying the banking system through economic cycles and periods of economic stress.

At this juncture, it is important to define what exactly capital is and what it is not. Capital equals equity: i.e. total assets minus total liabilities. Companies usually decide how to use this money, which can be used to reinvest in the company or pay dividends to shareholders. For non-financial companies, market forces and business strategy usually determine how companies use their equity.

However, given the unique role banks play in our economy, banks have special requirements on how much capital they need to retain to lower their likelihood of default. Banks are publicly-chartered entities that help supply the money, credit, and payment services the economy needs to thrive. Failure negatively affects more than just their shareholders. Furthermore, because they are so central to our economy, the government provides disproportional backing compared to non-financial companies, including the discount window and deposit insurance. Requiring higher capital levels helps ensure banks retain "skin in the game."

Contrary to the story peddled by banks and adopted by many in Congress and the media, capital is not money that is set aside or locked in a vault unable to be deployed to a bank's customers. Capital should

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[1] FRB, FDIC, OCC; Dept. of Treasury; "Regulatory Capital Rule: Large Banking Organizations and Banking Organizations With Significant Trading Activity" Posted in Federal Register Sept. 18 2023

not be confused with reserves. Instead, capital is simply the portion of a bank's funding that must be supplied by owners rather than creditors.

The Importance of Strong Bank Capital Requirements

The idea that more equity in a bank's funding structure will materially increase its cost of making loans is not sufficiently backed by data. In fact, many studies suggest that increased capital requirements actually promote lending. This is mostly because well-capitalized banks have a lower probability of default and therefore that is priced into their funding costs, leading these banks to have lower funding costs compared to their peers, as the Bank of International Settlements (BIS) noted in a 2016 study.[2]

Higher bank capital also allows banks to lend more during a downturn and can lead to a quicker economic recovery. In 2020, World Bank researchers found that bank "capital can help banks smooth the supply of credit during crisis years. In times of economic turmoil, banks with larger capital buffers are somewhat protected from cuts in lending."[3] In fact, countries with better capitalized banking systems in 2006, prior to the start of the financial crisis, experienced higher lending growth during and after the crisis, as noted by Professors Stephen Cecchetti and Kermit Schoenholtz.[4]

A December 2022 study that analyzed the impact of Basel III reforms, BCBS concluded that bank lending grew in aggregate after the Basel III reforms for banks above the initial median of a given regulatory ratio and banks below the initial median of that regulatory ratio."[5]

This all undercuts claims that higher capital requirements will hurt small business lending. In 2019, the Financial Stability Board found that Basel III rules had not hurt lending to small-medium enterprises in the Basel Committee jurisdictions.[6] In fact, what impacts small businesses adversely are often poor due diligence and underwriting processes at banks, according to a study by Moody Analytics.[7]

Furthermore, even if we accept that there is a level of capital requirements that would limit lending activity and thus hamper economic growth, capital levels in the U.S. banking system - and the capital levels required by the proposal under discussion here - fall under what most academics, regulators, and other independent experts suggest is an optimal level.

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2 Leonardo Gambacorta and Hyun Song Shin, "Why bank capital matters for monetary policy", Bank for International Settlements Working Papers, April 2016

3 World Bank, "Bank Capital Regulation," Global Financial Development Report, Chapter 3 p. 85, 2019/2020

4 Stephen Cecchetti and Kermit Schoenholtz, "Higher capital requirements didn't slow the economy", moneyandbanking.com, December 15, 2014

5 Basel Committee on Banking Supervision. "Evaluation of the impact and efficacy of the Basel III Reforms", Banking for International Settlements, December 2022.

6 Arun, Avinash and Helene Page. "The Future of Small Lending," Moody's Analytics, November 2016.

7 *Id*

For example, Professor James Barth and Mercatus Center Senior Fellow Stephen Matteo Miller estimated that the optimal capital to risk-weighted assets ratio, that is where benefits equal costs, is around 25%.[8] Similarly, the Minneapolis Fed, as part of their proposal to end the "too-big-to-fail" problem, calculated the optimal level of capital to risk-weighted-assets to be 23.5%.[9]

However, the Kansas City Fed, which conducts a semi-annual review of bank capital levels, found that in December 2022 the weighted average Tier 1 Risk-Based Capital Ratio for G-SIBs was 14% and 11% for banks with more than $100 billion in assets that aren't G-SIBs. Using this metric, community and regional banks are currently holding more capital than large banks, 13.4% and 12.2% respectively.

This has to change and Basel III Endgame aims to do so. The proposal, when implemented, will increase capital requirements (common equity Tier 1) by 19% for the U.S. G-SIBS, which are only eight banks. For other banks with more than $100 billion in assets, capital requirements will increase by 6%. In aggregate, the proposal will increase capital requirements by 16% for all banks with more than $100 billion in assets, hence affecting fewer than 50 banks that operate in the U.S. The frantic arguments being levied at the proposals are all an attempt to keep the status-quo for less than one percent of U.S. banks that enjoy outsized political and economic power.

As Ms. Mayra Rodríguez Valladares recently said in her testimony before this committee, a capital ratio consists of a numerator and a denominator. Banks make these arguments as if capital is fixed and it can't be raised by issuing more equity. They can also increase the numerator by increasing their retained earnings and reducing share buybacks. To reduce the denominator, banks can reduce risks. For example, banks can reduce holdings of riskier assets such as poor credit quality loans, below investment grade bonds, securitizations, and derivatives that consume more capital. This is a feature, not a bug, of higher capital requirements. We want to disincentivize banks from employing strategies that maximize profits but put workers, jobs, and the greater economy at risk.

For these reasons and more that will be discussed below, Americans for Financial Reform strongly supports the work of the prudential regulators to raise capital requirements on our country's largest banks.

Why Basel Endgame is Needed

The Basel III Endgame bank capital rules proposed in July have been in the works since 2017. Today, the U.S. capital regime is substantially stronger than it was pre-2008 as a result of the first round of Basel III increases to the level and quality of capital. In this latest round, BCBS made significant steps towards remedying the overreliance of internal models by banks to determine their capital requirements. These internal models have led to inaccurate results, as they did during the 2008 crisis. The new proposal

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[8] James R. Barth and Stephen Matteo Miller; "Benefits and Costs of a Higher Bank Leverage Ratio" Journal of Financial Stability; Feb 2017.

[9] Fed Res. of Minneapolis. "The Minneapolis Plan to End Too Big to Fail." January 2017.

requires Category I-IV banks to calculate their risk weights using both the standardized approach and the new expanded risk-based (ERB) approach and determine their capital requirements using the greater of the two. The ERB Approach is itself a standardized approach as it provides clear rules on how to calculate market risk and unlike the standardized approach, it includes risk-weights for calculating operational risk.[10]

According to the Basel Committee on Banking Supervision, a key objective of the Basel III Endgame is to: "[R]educe excessive variability of risk-weighted assets (RWAs) … [and] help restore credibility in the calculation of RWAs by: (i) enhancing the robustness and risk sensitivity of the standardized approaches for credit risk and operational risk, which will facilitate the comparability of banks' capital ratios; (ii) constraining the use of internally-modeled approaches; and (iii) complementing the risk-weighted capital ratio with a finalized leverage ratio and a revised and robust capital floor."[11]

The shortcomings of the internal modeling features, known as the Advanced Approach have long been noted by many regulators.

In 2013, the Basel Committee released an analysis where it found that even banks of a similar profile were coming up with very different risk weights when measuring the credit and market risks of their assets, both loans and securities.[12]

As my colleague, Alexa Philo, noted in her testimony to this committee, the largest banks were not holding nearly enough capital in the lead up to the financial crisis to account for their real market risk, particularly for the severity of price declines and unprecedented volatility in a number of markets.[13] Stock indices lost over 50% of their value from the October 2007 peak to the March 2009 trough.[14] The International Monetary Fund noted that "It is well known that risk-weighted capital measures had no predictive power for the failure of the large banks in the (2008) financial crisis" and that typical models did not predict the extreme outcomes necessary for the estimation and allocation of capital.[15]

The proposal will also improve risk-based capital for market risk by better accounting for stress losses and increasing the requirements applied to less liquid trading positions. Additionally, the proposal will improve the standardized approach for operational risk by accounting for prior losses associated with a bank's operational risk exposure and force banks with over-the-counter derivatives on their balance sheet to better consider their counterparty's credit risk.

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[10] "U.S. Basel III Endgame Proposed Rule," Davis-Polk. September 14, 2023.
[11] Basel Committee on Banking Supervision,"Basel III: Finalising post-crisis reforms", Banking for International Settlements, December 2017.
[12] Basel Committee on Banking Supervision, "Regulatory Consistency Assessment Programme (RCAP) Analysis of risk-weighted assets for credit risk in the banking book", Banking for International Settlements, July 2013.
[13] Alexa Philo, "Hearing Entitled: Implementing Basel III: What's the Fed's Endgame?", Written Testimony before the House Financial Services Committee, Americans for Financial Reform, September 14th 2023.
[14] Kiran Manda, "Stock Market Volatility in the 2008 Crisis", Leonard N. Stern School of Business Glucksman Institute for Research in Securities Markets Faculty Advisor: Michael Brenner, April 1, 2010.
[15] Senior Supervisors Group, "Risk Management Lessons from the Global Banking Crisis of 2008", October 21, 2009.

Lastly, the proposal restores Basel III requirements for Category IV banking organizations. The 2023 mid-size bank crisis highlighted that banks in this asset range were insufficiently capitalized to withstand abrupt and unexpected stresses. The failure of SVB that triggered the 2023 crisis was caused by a liquidity run, but the loss of market confidence that precipitated the run was prompted by the sale of assets at a substantial loss that raised questions about the capital adequacy of the bank.[16] The banking agencies' rulemaking in 2019—going further to deregulate in addition to what was required by legislation—helped pave the way for 2023 failures by removing all Category IV firms from enhanced capital standards.

The bank capital reforms in the proposal are essential to prevent further large bank failures and financial system instability, as a result of undercapitalized banks pursuing outsized risk-taking. Lax standards have led to large-scale boom and bust financial cycles in recent history that have hurt all Americans and businesses and disproportionately reduced wealth and access to credit for communities of color, rural, and other underserved communities and small businesses.

U.S. Participation in International Bodies

The Large Bank Capital proposal is intended to align the U.S. with the standards adopted by the Basel Committee on Banking Supervision (BCBS). The Basel Committee on Banking Supervision was created by the central banks of the G-10 countries in 1974. Now it has 45 members (mainly central banks and other prudential or market regulatory bodies) representing 28 jurisdictions.[17] Compared to many countries, especially non-EU members, the U.S. has outsized representation on the Committee. Whereas all other countries represented have just their central bank and maybe one other regulator as a member, the U.S. has four members on the committee, the Fed, FDIC, OCC, and the Federal Reserve Bank of New York.[18] Additionally, the United States has the most G-SIBS out of any participating country in the BCBS and our G-SIBs are highly interconnected in the global financial system.[19]

It is erroneous to think that the U.S. has ceded its authority to a global body when international bodies have no legal authority in the U.S. U.S. regulators need to follow Administrative Procedures Act and have any Basel accord go through the standard notice and comment period before it can become binding in the U.S. Furthermore, U.S. regulators, as they did in this proposal, usually make significant tweaks to accords to adjust for our market. The U.S. has a strong incentive to participate in BCBS and other global standard-setting bodies because member countries usually limit foreign operations of non-member countries or member countries who are non-compliant.

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[16] Vice Chair of Supervision Michael Barr. "Review of the Federal Reserve's Supervision and Regulation of Silicon Valley Bank," FRB. April 2023. Pg 2.

[17] Bank of International Settlements. Bank Committee Membership

[18] *Id*

[19] Bank of International Settlements, "Global systemically important banks: assessment methodology and the additional loss absorbency requirement."; Financial Stability Board, "2022 List of Global Systemically Important Banks (G-SIBs)," Nov 2022.

It is also clear that the U.S. is seen as a leader and has significant sway on BCBC. Prior to the adoption of the Basel I accord, which called on banks in participating countries to hold at least 8 percent capital to RWA and hold capital against some off-balance-sheet exposures (OBS),[20] US bank supervisors in 1986 proposed returning to RWA standards that accounted for OBS exposures. In 1987, the US worked with the British to do just that, one year before the first accord was published. The inclusion of the Supplemental Leverage Risk Ratio in the third Basel accords was shaped to look more like the U.S.-styled cap on leverage which included more types of assets than most countries in the ratio's denominator, as noted by former Secretary of the Treasury Timothy Geithner.[21] Even former Treasury Secretary Steven Mnuchin, under President Trump, said in 2017 before this committee that much of Basel III was about bringing European capital standards closer to the United States.[22]

Globally-active American financial institutions interests can only be credibly advanced if U.S. authorities participate in global standard setting bodies, such as the BCBS. Moreover, participation allows U.S. financial authorities' to have a broader view of the global market and thus better manage cross-border spillover effects from foreign financial developments.

Reassessing Competitive Advantage

International standards are generally intended to prevent a "race-to-the-bottom," and they do not stop U.S. regulators from applying stronger safeguards when appropriate. With every iteration of Basel standards where countries increased their own standards and during consideration of many domestic reforms, both American and European banks have raised concerns surrounding global competitiveness. When Dodd-Frank was being considered, U.S. banks complained about being at a competitive disadvantage to their European counterparts, while European banks threatened to move business to the U.S.[23]

Regulators should seriously consider two important questions when considering how our competitive advantage is defined: 1) Should we judge competitive advantage as only a simple measure of our banks' revenue and return-on-equity (ROE)? 2) How do we ensure that our quest to become "competitive" does not lead to our banks becoming a source of instability in the global financial system as they were pre-2008.

To answer the first question, competitive advantage does not simply equal the ability of our financial institutions to grow revenue or use their debt to boost their ROE. This narrow thinking, as former FDIC Sheila Bair pointed out, is a fundamental conceptual error that has had grave consequences when used

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[20] John Walter "US Bank Capital Regulation: History and Changes since the Financial Crisis." Federal Reserve Bank of Richmond, Economic Quarterly. Pg. 11

[21] "The State of the International Financial System, Including International Regulatory Issues Relevant to the Implementation of the Dodd- Frank Act", Hearing before the House Financial Services Committee, pg 52, September 22 2010.

[22] "The Annual Testimony of the Secretary of the Treasury on the State of the International Financial System" Hearing before the House Financial Services Committee, pg. 55, July 27 2017.

[23] Haig Simonian, "UBS warns against excessive capital rules," Financial Times, April 2011.

to create regulation.[24] Increased leverage benefits shareholders in the good times, but increases the risks of bank insolvency, the costs of which are spread across the economy. A classic tale of privatized benefits and public costs. Only recently are communities across this country recovering from the tremendous societal losses as a result of the GFC, especially Black and Brown communities, who bore the highest costs. In the medium- and long-term, the financial services industry and country are less competitive if we sacrifice proper safety-and-soundness measures because doing so eventually leads to panics, credit crunches, and financial crises.

Regulators can seek to reward and attract high-risk banking activity by weakening banking regulation–as we did in the pre-crisis era–but in doing so we will expose the American public to the risk of future failures or bailouts or other massive government interventions that benefit the biggest banks.

Prior to the 2008 GFC, the United States enacted a series of deregulatory reforms that dangerously weakened our financial system, including lowering capital requirements, allowing the unchecked growth of the shadow banking system, and failing to regulate derivatives leading to securitization practices that masked risk. U.S. regulators also widely accepted the touted hedging benefits derivatives provided without considering how large interlinked exposures could magnify risk. This was done with the aim of, among other things, attracting and retaining financial activity within our borders. As a result, the United States became a source of instability in the global financial system, and we ultimately damaged our global competitive position.

Conversely, the opposite is true. A well capitalized banking system is critical to having a sustainable competitive advantage compared to our global counterparts.

This was exemplified after the financial crisis. American banks have fared much better than European banks after the financial crisis and one important reason for this is that U.S. regulators took decisive action regarding capital requirements in 2009 to address fears about the solvency of many major banks. The U.S. implemented its first version of a stress test in which the 19 largest banks were required to estimate their capital adequacy under adverse macroeconomic situations and if the needed capital was insufficient to weather the storm, they were forced to obtain financing from the Troubled Asset Relief Program (TARP) to get enough capital to meet all safety and soundness requirements even under an adverse economic scenario. In the first go-around, 11 out of 19 banks failed. This level of transparency shown by regulators and the TARP program, which was by no means perfect, had the combined effect of shoring up confidence in our banks and putting our banking system on the path back to resilience.

The U.S Significantly Lags Our Peers in Addressing Climate-Related Financial Risk

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[24]Sheila Bair, "Statement of Sheila C. Bair, Chairman Federal Deposit Insurance Corporation on Financial Regulatory Reform The International Context" Statement before the House Financial Services Committee, June 16 2011.

It is unfortunate that some of the voices calling for the U.S. to match the looser regulatory framework of other jurisdictions for the sake of maintaining a competitive advantage are asking for the U.S. to not match those jurisdictions in regards to addressing climate-related financial risk.

For many of the reasons discussed above, it is imperative that the U.S. takes more of a leadership role in addressing the systemic risks posed by climate change, which by nature is a global problem. US regulators must continue to work with their global peers to address this issue. Authorities in the United States, starting with President Biden and FSOC have issued their own initial recommendations on mitigating climate-related financial risk, but much more must be done to protect U.S. financial institutions and to understand macroprudential implications.

The Federal Reserve has started a year-long scenario analysis pilot program to analyze climate-related financial risks for just the six largest banks in the U.S.[25] The program will analyze the impact of a set of climate and energy-transition scenarios on specific bank portfolios and business strategies and review firms' analyses and engage with them to build capacity to manage climate-related financial risks. At the conclusion of the program, the Fed will publish detailed climate, economic, and financial variables that make up the climate scenario narratives at the beginning of the exercise and insights gained at an aggregate level, which would help identify potential risks and improve risk management practices to account for climate-related risks.

In addition, last month the Treasury Department published a set of "Principles for Net-Zero Financing and Investment," that will serve as a guide for financial institutions as they develop and implement net zero transition plans consistent with their public climate commitments, and help them manage their transition risks.[26]

Despite these recent efforts by regulators, climate supervision and regulation remains an area where the U.S. is painfully lagging behind its peers. While these are important first steps, the Fed must deeply improve future rounds of its scenario-analysis exercises to capture the full scale of macroprudential risk.[27] Furthermore other central banks and regulatory authorities have completed system-wide studies and worked with supervised firms on risk management and scenario-analysis exercises for years.[28]

In 2019, UK's Prudential Regulatory Authority (PRA) included climate change in its insurance stress testing for the first time.[29] In 2021, the Central Bank of Kenya (CBK) issued the Guidance on Climate-Related Risk Management to commercial banks and mortgage finance companies, enabling banks to integrate climate-related opportunities and risks in their governance structure, strategy, and

[25] KPMG, "Climate Risk: FRB pilot scenario analysis" October 2022.
[26] U.S. Dept. of Treasury, "Principles for Net-Zero Financing & Investment" September 2023.
[27] Avery Ellfeldt, "Explaining the Fed's climate test," E&E News, February 9, 2023.
[28] European Central Bank, "Banks must sharpen their focus on climate risk, ECB supervisory stress test shows," July 2022.
[29] Bank of England, "Insurance Stress Test 2019", Bank of England, June 18 2019.

risk management frameworks. Further, it will guide these institutions in disclosing climate-related information to their stakeholders. The principles are binding, with banks "required to comply."[30]

In 2022, the Bank of England (BOE) published the results of its 2021 macro-financial system climate stress test with one of the explicit purposes of the test being to aid in the transition to net zero and to analyze climate-related risk on capital requirements.[31] Almost three years ago this month (November 2020), the European Central Bank published very detailed (approximately 50 pages) climate supervisory expectations for banks in the Eurozone. The U.S. is actually finally expected to take this step today.[32]

Earlier this month, the European Banking Authority published a report that recommends enhancement to capital standards to address environmental and social risks.[33] US authorities have taken no such steps, although they should be considering all available tools. Given all of this, it is hard to conclude that the U.S. is ceding its authority to global regulators when we are woefully behind the curve, even as the US faces unprecedented property insurance disruptions due in large part to climate-exacerbated disasters.[34]

Furthermore, the U.S. is particularly vulnerable to climate-related financial risk because of the statutory provision that prohibits U.S. regulators from relying on external credit ratings in bank capital requirements–a deviation from internationally accepted capital standards. As Professor Jeremy Kress notes in his study on this issue, this deviation can fuel companies graded by credit-rating agencies as "dirty" to borrow more from U.S. banks, as they do not have to compensate for downgrade by maintaining a bigger capital cushion. This dynamic has the strong possibility of further intensifying the U.S. banking system's exposure to climate risks.[35]

Conclusion

A global financial regulatory floor should be a central policy objective of the United States. Real progress towards this goal has been made through the Basel accords and our participation in BCBS. However, the measure of effectiveness should not be whether we managed to meet the global minimum standard. A robust financial regulatory system should ensure that the financial system is a contributor to sustained, equitable growth in our real economy.

Banks without the necessary capital reserves to weather economic storms put their depositors, customers, and communities in jeopardy, even more so for megabanks, whose failure threatens our entire country's economic stability. More well-capitalized banks are more able to provide credit to customers and communities. The proposals will make it harder for bank executives to pursue riskier

[30] Supra 27, pg 8
[31] Bank of England "Results of the 2021 Climate Biennial Exploratory Scenario (CBES)" Bank of England, May 24 2022.
[32] FDIC. Sunshine Act Meeting. October 17, 2023.
[33] European Banking Authority. "The EBA recommends enhancements to the Pillar 1 framework to capture environmental and social risks," October 12, 2023.
[34] Aimee Picchi, "Homes in parts of the U.S. are "essentially uninsurable" due to rising climate change risks." CBSNews, September 2023.
[35] Jeremy Kress,"Banking's Climate Conundrum," American Business Law Journal 679, April 2022.

short-term financial gains and mobilize capital for their own benefit by paying excessive dividends and buybacks to shareholders.

To that end, the U.S. regulatory regime needs to finalize the proposed updates to capital standards and increase the pace at which it is including climate-related financial risk into our regulatory and supervisory framework. The effects of climate change are here. In July, the committee heard from Sarah Benatar, the Treasurer of Coconino County, who described numerous weather-related events including wildland fires, flooding events, record snowfalls, and record heat levels her county experienced which led to people being displaced from their homes. As the county Treasurer that invests and protects public funds, she illustrated why it's important for her to consider environmental risk when choosing how to invest retirees' savings and the county's funds.

U.S. legislators and regulators need to adequately create a framework for financial companies, commercial companies, investors, and workers to consider the financial risks associated with climate change so these risks pose minimal economic and social costs. Good public policy requires policymakers to not only assess the costs for financial institutions to implement higher capital and climate-related standards, but to place the interests of the taxpayers, workers, and the broader economy above those of these companies' shareholders. This will advance economic justice and help the economy work better for everyone.