BANK POLICY INSTITUTE

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Before the U.S. House Financial Services Committee

"Prioritizing Main Street: Evaluating the Impact of Capital Proposals on Economic Growth and American Communities"

April 28, 2026

Chairman Hill, Ranking Member Waters, and Members of the Committee, thank you for the opportunity to discuss bank capital regulation.

My name is Greg Baer, and I am President and CEO of the Bank Policy Institute, a research and advocacy group whose members include 40 banks with more than $100 billion in U.S. assets. Our membership comprises the full range of banks covered by pending capital proposals from the federal banking agencies.

These proposals reflect a new and cogent approach to capital regulation. The agencies focus on risk, assess it honestly and asset-by-asset and show their work. They have conducted detailed economic analysis. The agencies also allow for public comment and therefore the potential for further improvements in the proposal. The result will be a capital regime that better reflects risk and allows bank capital to be allocated more efficiently, with substantial benefits for lending and market intermediation and thus for U.S. economic growth.

The proposals cover three separate but closely related risk-based requirements: general risk-based capital requirements that reflect international standards established by the Basel Committee; the Federal Reserve's stress capital charge; and the Federal Reserve's GSIB surcharge. The agencies have already reformed one leverage (non-risk-based) measure, the enhanced supplementary leverage ratio, and we hope that they will turn next to the other, the tier 1 leverage ratio. But the focus here is on risk-based measures.

Contemporaneous finalization of these three proposals would remove almost a decade of uncertainty about Basel implementation in the United States and lift a veil of secrecy from the Federal Reserve's stress test. Investors will be able to know what a bank's capital requirement is and project with confidence what it will be in the future — just like investors in any other type of company. For their part, banks will be able to engage in more thoughtful capital and business planning. As a result, banks' cost of capital will decrease, their ability to serve their customers efficiently will increase and the economy will benefit in an indirect but significant way.

We continue to study the Basel and GSIB surcharge proposals and are drafting comment letters for submission in June. Set forth in an appendix are some initial reactions, though other issues might emerge. Because the proposal is appropriately detailed and technical, comments on its contents will be

equally so. To give some examples, there are a variety of assets or exposures where the proposal overstates the risk in demonstrable ways: for example, a 10 percent credit conversion factor for unconditionally cancellable commitments; treating exposures to non-depository financial institutions (including bank holding companies) as corporate exposures rather than as bank exposures; and the risk weight for short-term exposures to banks that are key to providing intra-bank liquidity. More broadly, it will also be important to index key tailoring thresholds, with updates on an annual schedule. Finally, looking across the proposals, we are concerned that while overlaps between the Basel requirements and the Federal Reserve's stress test have been acknowledged (after having previously been denied or ignored), considerable work will be required to rationalize them in the final rules. Much of that work will fall to the Federal Reserve as it incorporates comments already submitted on its stress testing framework.

Capital Regulation Elements

Before diving into specifics, it is worth remembering the purpose of bank capital: serving as a cushion to absorb unexpected losses. Since 2020, U.S. banks have been required under accounting rules to maintain reserves against all expected losses for the life of each loan starting at the loan's origination, even if a loss is not probable. That loss reserve must be updated quarterly based on loan performance. Capital is an additional layer of loss absorbency on top of that reserve.

The Measure

A key question for bank regulation is: what is the appropriate measure of capital adequacy? The key ratio established by regulation is common equity tier 1 capital divided by risk-weighted assets. The former (the numerator in the ratio) is the most loss-absorbing form of capital and is not at issue in the current proposals; instead, the focus is on how to calculate the risk-weighted assets (the denominator).

The Calibration

As capital regulation has evolved, the consensus minimum ratio is: (1) 4.5 percent, calculated using a methodology developed the Basel Committee on Banking Supervision; plus (2) capital to absorb stress/tail events (calculated in the United States through the Federal Reserve's stress tests), with a minimum charge of 2.5 percent; plus (3) for systemically important banks, additional capital to further decrease the risk of failure (through the GSIB surcharge). Thus, the aggregate minimum of these requirements is a ratio of 7.0 percent, with some banks required to hold significantly more.

Smaller banks (except those subject to a community bank leverage ratio) must fund themselves with common equity tier 1 capital equal to 4.5 percent of risk-weighted assets plus a fixed 2.5 percent capital conversation buffer, with no GSIB surcharge.

Components

Regulatory requirements are designed to measure and capitalize three main risks: credit, market and operational. Thus, (somewhat counterintuitively with respect to the last), each of those risks is translated to risk-weighted assets and thereby counted in the denominator for purposes of calculating risk-based ratios.

One major flaw of both the Basel standard and the stress test is that each risk is assessed in a silo, and the associated risk-weighted assets are simply added up. Doing so effectively presumes – quite counterfactually – that losses in each category are perfectly correlated. This presumes, for example, that capital maintained for credit risk will never be available to cover a short-term operational loss, and that

operational risk capital will never be available to meet an expected credit loss. Thus, the collective charges imposed across these risks significantly overstate true capital needs.

Basel-Based Minimum Requirements

The key question for purposes of Basel-based minimum requirements is how to determine the risk of an asset — in regulatory parlance, what risk weight to assign it.[1] For credit risk, by common understanding, a reserve held at the Federal Reserve is considered to have no risk, and thus is assigned a zero risk weight, with no capital required against it.[2] On the other hand, a second lien mortgage would receive a 100 percent risk weight, reflecting its more significant risk, and so receive the full minimum capital charge of at least 7 percent, plus any stress test or GSIB add-on. Most other assets – first lien residential mortgages, credit card receivables, securities – fall somewhere in the middle.

The Basel Committee did much of this calibration work long ago. In developing its standardized approach to credit risk, the Basel Committee looked at historical loss experience and external credit ratings for different types of financial assets. Revisions to the Basel III capital framework adopted in 2017 generally retained those original risk weights, with minor adjustments.

Those risk weights in turn are the underlying basis for the U.S. banking agencies' recent proposal. The agencies are proposing two standardized approaches to credit risk: (1) the existing/legacy U.S. standardized approach; and (2) a new, expanded risk-based standardized approach that implements the 2017 Basel Accord.

The former would largely reflect the standardized approach already in place in the U.S. today, subject to some minor adjustments to improve the calibration and risk sensitivity of credit risk weights. The latter would generally reflect the revised Basel Committee approach, subject to some modifications intended to reflect unique features of the capital framework in the United States and the structure of our banking system.[3] The Expanded Risk-based Approach would apply to the very largest banks (i.e., Category I and II banks) and any bank that chooses to adopt it; the revised legacy standardized approach would apply to any remaining bank, unless it chooses to be governed by the community bank leverage ratio.[4]

In general, proposed credit risk weights under the legacy standardized approach are higher than the corresponding credit risk weights under the new expanded risk-based approach. However, banks calculating their risk-based requirements under the legacy standardized approach will not need to calculate and maintain capital for operational risk. Thus, it remains unclear how many banks will choose the expanded Risk-based Approach rather than the legacy standardized approach, trading off lower

[1] In the past, there was also debate about what should count as capital in the numerator of a capital ratio. At this point, however, there is consensus that common equity tier 1 capital is the key relevant measure, as it is the most narrowly defined and clearly loss-absorbing measure. It generally includes common stock, retained earnings and — for the largest banks — accumulated other comprehensive income (AOCI), subject to regulatory deductions and adjustments. Under both the Basel and U.S. capital frameworks, banks must also maintain relatively greater amounts of other, broader definitions of capital (tier 1 capital and total capital) relative to their risk-weighted assets. The current proposals would include a five-year transition period to phase in the recognition of most components of AOCI in CET1 capital for Category III and IV firms that do not currently do so.

[2] A leverage ratio does consider reserves, as well as Treasury securities, in its denominator.

[3] Notable examples include (1) elimination of the requirement for a company or fund rated by the bank as an investment-grade exposure to have listed securities in order to qualify for a lower 65 percent risk weight (a change also made by the UK and EU in their implementations); and (2) substitution in the operational risk framework of a single non-interest component in place of the separate Basel services and financial components, in part to allow for netting of applicable income and expenses, as well as the scaling — based on empirical data — of the income and expenses of the investment management business line in the business indicator calculation. The proposal notes that "[c]onsistent with previous rulemakings that implemented aspects of the Basel standards in the United States, the proposal may differ from the Basel standards in certain areas to reflect factors such as specific characteristics of U.S. markets, requirements under GAAP, practices of U.S. banking organizations, and U.S. legal requirements and policy objectives." 91 FR 14952, 14961.

[4] Generally chosen only by community banks, this option requires a bank simply to meet a 9 percent minimum leverage requirement.

credit risk weights against a new operational risk charge; that choice will depend on the risk profile of each bank. Importantly, and as noted above, the proposal only extends this choice to smaller banks; the largest banks (i.e., Category I and II firms) must calculate risk-based capital requirements under the Expanded Risk-based Approach, even where the legacy standardized approach would produce a lower requirement.[5]

The U.S. proposal departs from Basel implementation in other jurisdictions in one very significant way. Under the Basel framework, jurisdictions may allow banks to use internal models to establish their risk-weighted assets for credit risk, subject to a requirement that a bank's collective risk-weighted assets under that approach not be lower than 72.5 percent of its risk-weighted assets as calculated under the standardized framework. Most foreign jurisdictions, including the EU and UK, have taken advantage of this option to permit banks to use internal models to assign credit risk-weighted assets, but U.S. regulators have not. Instead, they have proposed eliminating the use of internal models for credit risk and operational risk entirely and simply defaulting to the two standardized approaches. U.S. banks would still be permitted limited use of internal models for market risk.

The Stress Test

For the more than 30 banks with more than $100 billion in U.S. assets, the Basel risk-based capital requirements are only the beginning. The Global Financial Crisis taught that banks need to be prepared for extreme tail events, and therefore the Federal Reserve established a stress test which is now used to produce a stress capital charge. The minimum stress capital buffer is 2.5 percent, but some banks receive significantly larger charges. The stress capital buffer is designed to ensure that a large bank can withstand a stress event worse than the Global Financial Crisis and remain sufficiently capitalized to meet its obligations and continue to lend and intermediate in markets.

The Current Approach

The stress test captures credit risk by modeling bank losses under a severe macroeconomic shock; operational risk by using a standardized estimate of loss; and market risk by modeling losses under a Global Market Shock and the presumed default of the bank's largest counterparty.

Credit Risk. For the most recent stress test, that meant assuming a macroeconomic scenario whereby:

- The unemployment rate rises rapidly by 5-6 percentage points, peaking around ~10 percent;
- Real GDP collapses roughly ~7–8 percent peak-to-trough;
- The stock market crashes ~50–55 percent;
- Home and commercial real estate prices collapse ~35–40 percent; and
- Market volatility spikes to crisis levels.

Operational Risk. While operational risks include fraud, computer system failures and process errors, the large losses that drive capital charges under the stress test derive from past losses from government fines and civil litigation. Given the idiosyncratic nature of such losses, designing a model to capture them

[5] Among other things, this approach ensures that the agencies' proposed capital framework complies with the intent of Section 171 of the Dodd-Frank Act (commonly known as the Collins Amendment) by ensuring that large banks are subject to risk-based capital standards that are at least as stringent as those applicable to smaller banks.

is inherently challenging. Under the recent proposal, the Fed would assume that a firm would incur the same size fines and incur the same litigation losses as in the years after the mortgage crisis.[6]

Market Risk. Under the stress tests, banks with large trading operations are also tested against a Global Market Shock component that stresses their trading and certain other fair-valued positions, and banks with substantial trading or custodial operations are also tested against the default of their largest counterparty.

Presumed Correlation. Furthermore, all of these shocks (i.e., macroeconomic, operational, trading and counterparty default) are assumed to occur more or less simultaneously — that is, to be strongly correlated. However, this assumption is plainly counterfactual and significantly increases projected losses under stress, and thus each bank's stress capital charge. For example, with respect to operational risk, the agencies have presented no historical evidence that the timing of recognizing operational risk losses in bank earnings, and therefore capital, correlates with the timing of recognizing losses relating to financial risks (credit, market, derivative counterparty default) otherwise capitalized by the proposal. Fines or judgments against banks for anti-money laundering and sanctions compliance, antitrust violations and consumer credit practices — which now make up the largest operational risk loss events — have little to zero correlation with credit and market loss events. Even in the case of the Global Financial Crisis, where the collapse in the value of mortgages and mortgage-backed securities led to both credit losses and enormous litigation losses, there was a material lag in the litigation and enforcement losses, as those judgments were generally recognized several years later.

Proposed Reform

The Federal Reserve has proposed significant changes to the stress test intended to bring it into compliance with the Administrative Procedure Act and make it a better gauge of how a bank would actually perform under stress. More specifically, the stress test proposal includes a set of guides used for calibrating macroeconomic variable paths over the hypothetical severe recessionary period and would allow for public comment on each year's scenario; it also discloses details about the models used to project losses under the scenario.

Resolving Overlap

While the appendix provides some initial reactions to the Basel risk-based capital proposal on its own terms, many of the hardest questions arise with respect to overlap between that proposal's risk-based capital requirements and the stress capital charge produced by the Federal Reserve's stress test. Both impose separate capital charges for operational risk, derivative counterparty default risk, and market risk, and both attempt to calibrate those distinct capital charges to reflect losses under severe stress. There are thus many areas where the same risk would be capitalized twice.[7] Resolving this issue will be a difficult and important challenge for the Federal Reserve, and is a focus of our comment letters.

Ensuring Objectivity and Accountability

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[6]The proposed approach would allocate projected losses evenly across the nine-quarter stress horizon. For large legal losses, this assumption is difficult to reconcile with observed recognition dynamics. Legal matters leading to large losses typically unfold over multiple quarters, and accounting losses often occur years after the underlying trigger event or the onset of adverse conditions. Accordingly, assuming an even distribution of legal losses across the stress test horizon does not reflect their recognition in practice.

[7] *See* Greg Hopper, *How to Make the Global Market Shock Coherent* (May 5, 2025); Greg Hopper, *Rationalizing the Global Market Shock* (Oct. 17, 2023); Greg Hopper, *How Can the Global Market Shock More Effectively Complement the Fundamental Review of the Trading Book?* (May 30, 2023); Greg Hopper, *Why Is the FRTB Expected Shortfall Calculation Designed as It Is?* (May 23, 2023).

In addition, the proposed design of the Global Market Shock component does not include meaningful guardrails for the severity of the shocks in each year's scenario; the result is that Federal Reserve staff would appear to retain complete discretion to impose deeply improbable shocks, either alone or in combination, or to impose shocks that are historically unprecedented.[8] While public comment on Global Market Shock parameters would be permitted, there would be no standard against which to measure a given year's scenario. We thus have urged that the final rule include scenario design guardrails that would ensure that each stress test's Global Market Shock is designed to reflect severe but plausible shocks.

Measuring Correlation.

The proposal does nothing to measure or account for lack of correlation among credit, market, derivative counterparty default and operational risk, and thus continues to apply an "every risk everywhere all at once" approach that overstates capital needs.

The GSIB Surcharge

The GSIB surcharge is a common-sense concept that is difficult to operationalize. The concept is that, because the failure of a systemically important bank is more likely to pose risks to the broader financial system, each such bank should maintain somewhat more capital to make it even less likely to fail than non-systemically important banks. The tough question is how much more capital, and calculated on what basis?

The Basel Committee designed a methodology that measures each bank's systemic importance based on its market share across five different components: Size (total assets), Complexity (use of derivatives), Cross-jurisdictional activity (cross-border trading), Interconnectedness (trading with other financial institutions) and Substitutability (market share in custody, payments and underwriting). It also established a formula that translates each bank's measure of systemic importance (its GSIB "score") into a capital surcharge. So, as a bank's market share of total banking assets or derivatives trading or any of the other indicators increase, so too does its GSIB score and its GSIB surcharge.

In 2015, the Federal Reserve adopted this Basel methodology, which it labeled Method 1, but also adopted a second methodology that applies only to GSIBs in the United States, known as Method 2. Each U.S. GSIB is subject to the higher of the two, with the new, U.S.-only Method 2 generating a substantially higher charge. The weighted average surcharge for a U.S. GSIB is currently 1.7 percent under Method 1 but 3.2 percent under Method 2.

Method 2 differs from Method 1 in two important ways: (1) it substitutes reliance on short-term wholesale funding for substitutability as a component; and (2) it uses static coefficients for measuring each risk rather than market share measures that are updated each year. The Federal Reserve's 2015 rule calibrated Method 2's coefficients using 2012-13 data. Whatever the merits of these changes when first adopted, over time, each has proven problematic.

Short-term Wholesale Funding

While the five components were calibrated to each compose 20 percent of the GSIB score and thus the ultimate capital charge, the Fed estimates that short-term wholesale funding has grown to 30 percent of

[8] In some cases, use of an unprecedented shock may be appropriate based on market conditions. Use of such shocks, though, should be subject to some parameters and standards.

the score on average, and as high as 40 percent for some firms.[9] The current proposal appropriately recalibrates the contribution of short-term wholesale funding to 20 percent of the Method 2 score.

GDP Growth.

A drawback of relying on fixed coefficients is that GSIB Method 2 scores have inflated over time with growth of the U.S. economy; thus, even if a GSIB grew at the same rate as the economy and therefore were no more systemically important than before, its score would still rise. The Federal Reserve explicitly recognized this problem in adopting the final rule in 2015 and committed to correcting it:

> [T]he Board acknowledges that over time, a bank holding company's method 2 score may be affected by economic growth that does not represent an increase in systemic risk. To ensure changes in economic growth do not unduly affect firms' systemic risk scores, the Board will periodically review the coefficients and make adjustments as appropriate.[10]

The Federal Reserve's proposal would make an adjustment for GDP growth, but only since 2019. The proposal states that "whereas method 1 and method 2 scores evolved largely in parallel between the fourth quarter of 2016 and the fourth quarter of 2019, the two scores have diverged since then."[11] That rationale lacks any underlying principle or logic. The Federal Reserve did not in 2015 (or at any time since) say that it would review and recalibrate if Method 1 and Method 2 diverged; it said it would review and recalibrate for economic growth and other changes unrelated to systemic risk.[12] Nominal GDP has grown 83 percent since 2013, the year of data from which the rule was calibrated; the Fed should recalibrate for GDP growth since that time.

Overall Assessment

As noted, the greatest virtue of the current proposal is that it aims to calculate risk from the ground up, imposing the appropriate risk weight for each asset. That said, much popular and academic commentary fails to focus on that complex and analytical work but rather asks simply what it all adds up to on an aggregate basis — not whether each risk is being evaluated accurately.

So, in response, it is worth asking what evidence we have that current capital levels are in aggregate too high or too low. Fortunately, we have some ways to check.

Reality

We now have over 15 years of experience post enactment of Dodd-Frank in 2010 and adoption of post-crisis reforms. That considerable experience has shown that banks have more than enough capital. The past 15 years have included geopolitical turmoil, supply shocks, high inflation, recession, and capital market disruptions, yet large banks have remained not only solvent but well-capitalized, and have continued lending and intermediating apace.

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[9] Regulatory Capital Rule: Risk-Based Capital Surcharges for Global Systemically Important Bank Holding Companies; Systemic Risk Report (FR Y-15), 91 Fed. Reg. 14908 (March 27, 2026) at 14916.

[10] Regulatory Capital Rules: Implementation of Risk-Based Capital Surcharges for Global Systemically Important Bank Holding Companies, 80 Fed. 40902 (Aug. 14, 2015) at 49085.

[11] 91 Fed. Reg. 14908 at 14912.

[12] In a 2021 speech, Federal Reserve Vice Chair for Supervision Quarles noted that the Federal Reserve had an unfulfilled commitment to review and revisit the GSIB surcharge for changed economic conditions, not divergence of Method 1 and Method 2 results: "In setting the GSIB surcharge, the Board committed to periodically revisit the calibration of the surcharge to ensure that it remains appropriate in light of current conditions. We have not followed through on our commitment to revisit the surcharge calibration, and I believe that is something we should do." Randal K. Quarles, *Between the Hither and the Farther Shore: Thoughts on Unfinished Business*, Bd. of Governors of the Fed. Rsrv. Sys. (Dec. 2, 2021)

The greatest shock of this era was the onset of COVID-19. As its implications reverberated through the economy, and before the government provided any assistance, businesses drew heavily on their existing bank lines of credit to build precautionary cash buffers. Banks met this surge in demand, funding a massive increase in lending as commercial and industrial loans rose by nearly $500 billion in a matter of weeks. Bank capital ratios remained high, and markets remained confident.

The Annual Checkup

As noted, the Federal Reserve conducts an annual stress test. In addition to producing a capital charge, it also serves as an assessment of the resilience of the system. For the 22 banks that participated in the 2025 stress tests, the Fed projected nearly $550 billion in losses under severely adverse macroeconomic and financial market conditions, comparable to the losses seen during the Global Financial Crisis. And yet the results showed those banks could absorb double those losses and remain not just solvent but above all regulatory minimum requirements — so, able to lend as in steady state. That is a remarkably high level of capital — and a disadvantageously high level of capital, given that it comes at a real cost to economic growth.[13]

Some might object to reliance on the stress test because it relies on a single scenario, and there are some downsides to doing so in assessing a capital charge.[14] However, as a health checkup, the stress test is an excellent diagnostic. Commercial banks tend to lose money in the same basic ways: unemployment causes consumers to default on their loans; falling home prices produce mortgage defaults; GDP shrinkage causes corporate defaults. So, while the underlying cause of a recession or crisis might vary — a supply shock, a regional downturn, a virus — those events translate to the same loss drivers at banks (unemployment, falling home prices, GDP shrinkage), and the stress test gauges those. Also, importantly, while the stress test uses a hypothetical scenario, it projects losses using actual bank balance sheets.

The Great Migration

Logic would suggest that a bank funded by low-cost deposits should generally have a significant competitive advantage in lending, and thus that deposit-funded forms of lending should generally remain at banks. Similarly, broker-dealer affiliates of banks, while not deposit-funded, should benefit from synergies with the lending franchise. Only considerable regulatory and compliance costs — most notably, capital requirements that far exceed economic and market reality — could overcome banks' structural advantages and drive that business away. Consider then:

- Nonbanks' share of U.S. mortgage originations rose from about 20 percent in 1990 to over 65 percent by 2020.[15] More recent government data show that this dominance has persisted and deepened in key segments. The U.S. Government Accountability Office reports that nonbanks' share of loans in agency mortgage-backed securities (MBS) increased from 51 percent in 2014 to 76 percent in 2024.[16] In 2024, nonbanks originated 71 percent of loans in Fannie Mae and Freddie Mac MBS and 87 percent of loans in Ginnie Mae MBS. At the same time, the overall system remains

[13] The Basel Committee on Banking Supervision (2010) estimated the impact on lending spreads and on GDP at different levels of capital requirements. The study found that, at any initial level of capital requirements, each percentage point increase in capital requirements raised loan rates 13 basis points and permanently reduced the level (not the growth) of GDP by 9 basis points. See Basel Committee on Banking Supervision, *An Assessment of the Long-Term Economic Impact of Stronger Capital and Liquidity Requirements* (August 2010). For related discussion, see also Bill Nelson and Francisco Covas, *What is the Optimal Level of Bank Capital?* (January 2019).

[14] *See* Greg Baer, *Stress Test Dummies: A Fundamental Problem with CCAR (and How to Fix It)* (July 16, 2018); Francisco Covas, *Capital Requirements in Supervisory Stress Tests and their Adverse Impact on Small Business Lending* (August 2017).

[15] *See* Jordan Panfoldo, Chris Acker, and Phillip An, *Interest Rates and Nonbank Market Share in the U.S. Mortgage Market*, Federal Reserve Bank of Kansas City, *Economic Review*, 110(1) (February 2025).

[16] *See* U.S. Government Accountability Office, Nonbank Mortgage Companies: Ginnie Mae and FHFA Could Enhance Financial Monitoring (February 2026).

overwhelmingly centered on the government-backed secondary market, with roughly 60–70 percent of new mortgage originations ultimately securitized by Fannie Mae, Freddie Mac, and Ginnie Mae.[17] In parallel, mortgage servicing has shifted from banks to nonbanks, with their share growing from 27 percent of agency-backed mortgages in 2014 to 66 percent in 2024. In 2024, nonbanks serviced 59 percent of loans in Fannie Mae and Freddie Mac MBS and 83 percent of loans in Ginnie Mae MBS.[18]

- Trading firms such as Jane Street, Hudson River Trading and Citadel Securities have reshaped financial markets. Jane Street reported $39.6 billion in trading revenue last year, more than any bank-affiliated broker-dealer. Citadel is the largest U.S. equity market maker. None of these firms is subjected to bank-like capital requirements or undergoes a stress test.
- The explosive growth of private credit has been well documented, and private credit is now roughly the size of the bank syndicated loan market. While multiple factors have led to that rise, it is clear that capital charges disadvantage banks as lenders to leveraged companies, and make it more economic to lend to private credit funds and other nonbank financial institutions.

Instinct/Gut Check

Post-crisis performance has been observed by experts. By 2019, Chair Powell and Vice Chair Quarles had seen enough to announce that capital levels were, in their consistent phrasing, "about right." Since 2019, however, common equity tier 1 capital requirements at GSIBs have risen by 8 percent, and for all large banks (over $100 billion in assets) by 6 percent.

By the Federal Reserve's estimate, the cumulative impact of the three current risk-based proposals would be a reduction of 4.8 percent for Category I and II firms and 5.2 percent for Category III and IV firms.

Thus, if the current proposals were adopted as proposed, capital levels would still be significantly above "about right."

The Lesson of SVB

Some have argued that the failure of Silicon Valley Bank argues for higher minimum capital levels. This argument is very difficult to understand, and it is worth noting that the federal banking agencies did not make it in either their 2023 proposed rule or the current one. That makes sense because SVB's collapse was driven by a concentrated and unstable deposit base and significant interest rate risk from long-duration government securities.[19] It was exacerbated by extraordinary failures of crisis management and resolution strategy at the FDIC.

Thus, with respect to the task at hand, if the question is, "Does SVB teach us anything about the correct risk weights for Treasury securities, commercial paper, consumer loans, derivatives or any other asset?" the answer is "No." SVB did not lose money on its portfolio of Treasury and agency mortgage-backed securities because the Treasury and agencies defaulted on those bonds and caused credit losses; it did not incur trading losses from market volatility in those securities; SVB did not make consumer loans; it had no securities business. Rather, it lost money because the market value of its government securities

[17] See Urban Institute Housing Finance Policy Center, *Housing Finance at a Glance: A Monthly Chartbook* (March 2026).
[18] See Financial Stability Oversight Council, *Report on Nonbank Mortgage Servicing* at 19 (May 2024).
[19] The story was very similar at Signature and First Republic. The former catered to crypto clients and had a highly unstable deposit base; First Republic was a victim of rising interest rates given its large portfolio of lower yielding mortgage loans.

went down as interest rates rose. Saying that SVB argues for higher capital for loans or securities trading is like arguing that the sinking of the Titanic argues for lower highway speed limits.

There *are* lessons to be learned from the failure of SVB. Fortunately, the federal banking agencies have undertaken appropriate responses to that episode: (1) phasing out the so-called AOCI filter that prevented unrealized losses on securities from showing through to regulatory capital; (2) revisiting liquidity rules that encouraged the holding of the securities that brought SVB down and discouraged being prepared to use the discount window or standing repo facility;[20] and (3) reforming the FDIC's recovery and resolution function.[21]

Evidence v. Theory: Academic Models

In contrast to the practical evidence described above, which indicates that both current capital levels and those under the proposal are more than adequate, some popular and academic commentary has focused instead so-called "optimal capital" research that uses academic models to identify an ideal level of systemwide capital. Even if one accepted that approach as appropriate, current bank capital levels fall at the higher end of the range of optimal capital found in the academic literature (6 percent to 14.5 percent, with a midpoint of 10.3 percent).[22] But there are important reasons to be highly skeptical of such research.

First, these academic models attempt to estimate the optimal aggregate capital level for the banking system as a whole. But even if it were accurately defined for the whole system, optimal aggregate capital tells us nothing about the appropriate capital for any particular bank. Banks' assets, activities and business profiles vary widely, and an inquiry focused on only on systemwide levels ignores completely the core and complex regulatory task of risk weighting assets. Second, while academic models weigh lost economic growth from higher capital against diminished chance of systemic crisis triggered by bank failures, they do not consider whether transferring that risk to nonbanks affects the calculus. As a result, there are a range of very real potential costs of higher capital to financial stability that these models simply ignore. And, of course, these types of models must necessarily make a range of other simplifying and subjective assumptions to make the analysis of economic growth and systemic risk tradeoffs tractable. Finally, most such studies are dated and/or are heavily influenced by pre-crisis loss data; as a result, they effectively ignore a host of significant post-crisis reforms that meaningfully reduce risk, including liquidity requirements, central clearing and improved risk management practices.[23]

An analogy would be an academic who came up with a model to identify the ideal level of health care spending for any country, balancing lives saved against costs, without any examination of the actual operations of the health care or insurance industries in the United States. Or an academic model to determine the ideal level of defense spending for any country, not considering the current geopolitical threats or budget constraints of the United States.

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[20] Scott Bessent, Secretary of the Treasury, *Remarks: A Reset on Liquidity Regulation* (Mar. 3, 2026); Michelle W. Bowman, Vice Chair for Supervision, Bd. of Governors of the Fed. Reserve Sys., *Liquidity Resiliency, Financial Stability, and the Role of the Federal Reserve* (Mar. 3, 2026).
[21] Travis Hill, Acting Chairman, Fed. Deposit Ins. Corp., *Resolution Readiness and Lessons Learned from Recent Large Bank Failures* (October 15, 2025).
[22] *See* Francisco Covas and Bill Nelson, U.S. Bank Capital Levels: Aligning with or Exceeding Midpoint Estimates of Optimal (September 2023).
[23] Indeed, when the Bank of England recently updated its estimate of optimal capital to account for such changes, it lowered the estimate by a percentage point. Bank of England Financial Policy Committee, "Financial Stability in Focus: The FPC's Assessment of Bank Capital Requirements" (December 2025), p. 4.

Conclusion

Thank you again for the opportunity to discuss these important issues. I look forward to your questions.

Appendix: Capital Issues

In our recent and forthcoming comment letters on each of the capital proposals, we have or will be identifying a series of changes to the proposals to better gauge risk and do so in a way that does not impose undue reporting burdens. While many of those comments are highly technical, set forth here are a few of the more significant issues.

Basel

- *Overlaps.* As noted, a major issue involves overlap between the Basel and stress test proposals, which the agencies have helpfully acknowledged. For example:
    - Credit valuation adjustment risk arises if a bank is in the money on a derivative transaction and the counterparty's credit quality deteriorates. This risk draws capital charges under both the Basel proposal and the Federal Reserve's Global Market Shock component of the stress test.
    - Similarly, the market risk component of the Basel proposal utilizes an expected shortfall methodology to capture extreme losses from tail events, largely mirroring the approach of the Global Market Shock. In some cases, the combined capital requirement can exceed a firm's actual economic exposure — that is, the most it could lose on a trade. The Federal Reserve should establish and disclose guardrails for the selection and adjustments to the GMS scenarios, consistent with comments made in the ABA and BPI Feb. 20, 2026 letter in response to the Federal Reserve's October 2025 stress testing transparency and accountability proposal.[24] These guardrails are especially important given that the agencies have proposed to resolve the overlap between the proposed market risk capital requirement and the stress tests through an evaluation of the aggregate calibration.
    - There are significant overlaps with operational risk, as both approaches effectively require banks to capitalize large enforcement actions and litigation losses.
- *Commitments*. While described as clarification, the proposed rule would change the definition of "commitment" and thereby impose a new 10 percent capital charge on a potentially wider range of undrawn and unconditionally cancellable commitments than would be subject to the charge under the current definition. In a break from the general practice of the proposal, there is no data or analysis provided to support such a change. Unlike credit cards or home equity lines, where the borrower can draw at any time for any reason, other lines potentially scoped in (the new scope is unclear) require approval by the bank before they can be drawn upon.
- *Risk exposures to banks and broker-dealers*. The proposal would adopt a tiered risk weighting system for exposure to banks and broker-dealers. The tiering regime is overly complex and could be simplified while still preserving risk sensitivity.
- *Private mortgage insurance*. The proposal gives no recognition to private mortgage insurance when risk-weighting a residential mortgage loan. While there was a sad history with mortgage insurers in the Global Financial Crisis, and some limits are appropriate, zero credit is not the right answer.
- *Operational risk.* Particularly as operational risk is being added to the standardized approach for the first time, issues here are magnified in importance. The proposal helpfully adopts an approach that nets fee-based revenues and expenses, there are areas for improvement, mostly with respect to data collection. These are in addition to the much larger issue of eliminating overlap with the stress test.

[24] *See* ABA, BPI, FSF, SIFMA, ISDA, U.S. Chamber of Commerce, Letter re Notice of Proposed Rulemaking regarding Enhanced Transparency and Public Accountability of the Supervisory Stress Test Models and Scenarios; Modifications to the Capital Planning and Stress Capital Buffer Requirement Rule, Enhanced Prudential Standards Rule, and Regulation LL (Docket No. R-1873; RIN 7100-AH05) (Feb. 20, 2026).

- *Securitization*. There are numerous highly technical issues raised with respect to securitization exposures.

GSIB Surcharge

- As described above, the coefficients were calibrated in the 2015 final rule based on year-end 2012 or 2013 average aggregate global indicator amounts for each indicator. Given that cumulative U.S. GDP grew approximately 19 percent from year-end 2012 to year-end 2019 in real terms and approximately 32 percent in nominal terms, failing to account for that economic growth has led to materially over-calibrated GSIB surcharges under the current proposal. The final rule should adjust Method 2 coefficients based on nominal GDP growth from year end 2012-2013, rather than from year-end 2019.
- The proposed change to daily or monthly averaging is unnecessary, as any concerns regarding the accurate measurement of systemic risk would be adequately addressed by the proposed move to averaging indicators with monthly or quarterly values and by narrowing the score band ranges to make the Method 2 scores more sensitive.