WRITTEN TESTIMONY OF

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RIGHT-SIZING THE U.S. BANK CAPITAL FRAMEWORK: A RETURN TO TAILORING, ECONOMIC GROWTH, AND COMPETITIVENESS

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Chairman Barr, Ranking Member Foster and the members of the Subcommittee, I appreciate the opportunity to testify today on right-sizing the U.S. Bank Capital Framework. My testimony is given in my personal capacity and not on behalf of Mayer Brown LLP or any of its clients.

I commend the Subcommittee for holding this hearing as Congress has an important responsibility to oversee the implementation of U.S. capital requirements. Capital requirements are at the core of bank regulation due to their impact on the stability and efficiency of the banking system and the overall economy. It is therefore critical that they are appropriately calibrated.

While the banking regulators are ultimately responsible for setting capital requirements, it is Congress's constitutional responsibility to both establish the statutory mandates that dictate how the banking regulators must calibrate capital requirements and then oversee their implementation. It is vital that Congress play this important role because of the consequential public policy choices inherent in setting capital requirements. Setting capital requirements is not a mere technical exercise. It involves making public policy decisions that impact every American.

On the one hand, capital requirements help ensure that banks can pay their obligations to their depositors and thereby protect the savings of American households and businesses. By off-setting potential moral hazard risk arising from the existence of deposit insurance, capital requirements also reduce financial losses to the federal deposit insurance system when banks fail. Further, from a macroeconomic perspective, properly calibrated capital requirements can strengthen the resilience of the U.S. economy by enhancing banks' ability to absorb losses arising from economic shocks (such as recessions, bank failures or even, as we saw in 2020, pandemics).

Yet, capital requirements are not cost free. Improperly calibrated capital requirements can reduce access to credit and increase borrowing costs for Americans for everything from car and home purchases to educational loans and daily credit card transactions. Because capital requirements impact the allocation of credit throughout the economy, improperly calibrated capital requirements also can diminish economic growth by diverting resources to less productive sectors of the economy. In the short run, this means Americans have a higher cost of living. In the long run, it means Americans build wealth at a slower rate and their living standards are diminished.

Improperly calibrated capital requirements also reduce the resilience of the banking system and the economy overall. Economic growth and a dynamic financial system are the front-line defense against systemic risk. Healthy banks can better absorb losses and avoid, or at least minimize, the impact of shocks on their capital levels. In effect, economic growth can provide an additional buffer ahead of bank capital. Similarly, when American businesses are growing and American households have stronger finances, they are less vulnerable to spillover effects of economic shocks, including unemployment and business and individual bankruptcies.

Due to the major policy implications inherent in calibrating capital requirements, Congress has enacted statutory mandates to govern capital requirements, starting with the National Bank Act, which established the national banking system in the 1860s. Over the last few decades, Congress has enacted a series of new mandates to further prescribe how the banking regulators must set capital requirements. It has mandated not only risk-based and leverage requirements, but also enhanced and minimum capital requirements for larger banking organizations.[1] It has further mandated that these enhanced capital requirements be tailored based on the risk-profile of banking organizations and specified separate capital requirements for small and community banks and custody banks.[2] Additionally, Congress has mandated that large banking organizations be subject to both company and supervisory-run stress tests to assess whether their capital levels are sufficient to withstand a major economic shock.[3] Further, Congress has established specific capital requirements to govern troubled banks under the Prompt Corrective Action framework.[4]

The banking regulators have implemented these statutory capital requirements into a highly-complex and technical series of regulations often based on text initially produced by the Basel Committee on Banking Supervision ("Basel Committee"). However, the banking regulators have in recent years substantially deviated from proposals agreed to by the Basel Committee when implementing them into U.S. regulations. These deviations have created regulatory disparities between the U.S. and the rest of the world.

Currently, U.S. banking regulators are preparing to issue their proposal for implementing the Basel III Endgame capital requirements. This proposal will be the final piece of the reforms put forth by the Basel Committee to strengthen global capital standards in the wake of the 2008 Global Financial Crisis. In 2023, the U.S. banking regulators issued a proposal that purported to implement the Basel III Endgame, but which again contained numerous, substantial and unexplained deviations from the Basel Committee's agreed-upon text. After receiving comments on the proposal, however, the banking regulators ultimately withdrew the proposal due to, in part, bipartisan concerns from Congress and the public about its potential impact on the availability and cost of credit to American households and businesses and on the American economy overall.

As this Subcommittee prepares to review a new Basel III Endgame proposal, I offer several considerations to guide your assessment.

1. <u>Data-Driven Process</u>. Capital requirements should be set based on the best available data and research. Congress has already mandated the framework for capital requirements. The task now is for the banking regulators to implement those statutory mandates. The data should drive this decision-making, so that capital requirements correspond to the risks presented by particular assets. Such a data-driven process will increase the chances that the proposal results in appropriate and durable capital requirements.

   During the notice and comment period for their proposal, the banking regulators also should welcome additional data from the public to further inform their decision-making. We have a remarkable financial system that has evolved to support the sophisticated financing needs of the $30 trillion U.S. economy. The U.S. has more than 4,000 banks

[1] 12 U.S.C. §§ 3907, 5365, 5371.
[2] 12 U.S.C. §§ 5365, 5371.
[3] 12 U.S.C. § 5365.
[4] 12 U.S.C. § 1831o.

that vary greatly by size, business models, geographic markets and customers. This diversity is a strength of the U.S. economy because it enables the banking system to provide customized services that address the specific needs of business sectors, entrepreneurs, and individual consumers. However, it also makes it harder for banking regulators to fully understand how their regulatory proposals could impact every bank and its customers and local economies. A robust notice and comment period as contemplated by the Administrative Procedure Act will help ensure that the final rules incorporate the best data and reflect the unique aspects of the American economy.

2. Simplification. U.S. capital regulations have become very complex, especially since the enactment of the Dodd-Frank Act. They involve hundreds of pages and tomes of supporting guidance and implementation manuals. This complexity has made banks' internal compliance processes very costly both in financial terms and in the number of individuals and hours needed to ensure compliance. It has also made capital requirements less transparent and more difficult for Congress and public to evaluate. Overly complex capital requirements can also have anticompetitive effects. While large banking organizations can certainly be complex and thereby require more complex capital requirements, banking regulators still should seek to simplify capital requirements for all banking organizations to the extent possible. In particular, they should avoid duplicative capital requirements that cover the same risk with different and compounding capital charges.

3. Capital Requirements Should Be Viewed in Totality. Due to the numerous capital requirements now applicable to banking organizations, capital requirements should be crafted and assessed holistically, recognizing that it is their collective impact that matters. All of the various capital requirements should synch together to produce a coherent capital system.

4. 2025 is Different Than 2008. The banking system is in a fundamentally different position than it was during the 2008 Great Financial Crisis. Banking organizations hold substantially more high-quality capital and liquid assets and are subject to far more regulatory constraints and oversight (such as living wills, the Volcker Rule, and risk retention requirements). Further, many banks have shifted their activities from higher-risk activities (such as proprietary trading covered by the Volcker Rule prohibition) to lower-risk activities (such as wealth management and high-quality consumer and business lending). Collectively, these regulatory and market changes mean that the risk-profile for the banking industry has shifted and the pressing issues of today are not the issues of 2008. For example, more recent problems include regulatory distortions that reduce broker-dealer portfolios and contributed to a lack of liquidity in securities markets during the 2020 COVID-19 downturn.

5. Congressional Mandate on Tailoring. In the Dodd-Frank Act and then again in the Economic Growth, Regulatory Relief, and Consumer Protection Act (S. 2155), Congress mandated that capital regulations and other enhanced prudential regulations be tailored based on the risk profiles and business models of banking organizations.[5] The purpose of

[5] 12 U.S.C. § 5365.

this tailoring mandate was to prevent one-size-fits-all regulations from producing uniformity in the banking system and reducing the diversity of banks that is a hallmark of the U.S. banking system. Further, the tailoring mandate aimed to ensure that banks could manage risks in the manner most appropriate for their businesses and could adopt business models designed to serve unique needs of their customers and their local economies. In doing so, the tailoring mandate sought to improve the safety and soundness of the banking system while also promoting affordability and access to credit for American households and businesses.

To ensure compliance with this Congressional tailoring mandate, the banking regulators should review the existing tailoring framework and thresholds to prevent banking organizations from moving into inappropriate enhanced prudential regulatory categories due to the effects of inflation or other factors unrelated to their risk-profiles.

6. Supervision Matters. As important as capital is to the safety and soundness of banks, capital is not a panacea. Capital can quickly evaporate at a troubled bank, especially during a time of general economic stress. Many failed banks had strong levels of capital just months before they failed, but unappreciated risks quickly emerged and produced substantial losses, triggering a loss of confidence in the bank. When customers abandon a bank, no amount of capital can fully protect it. As a result, capital regulations must be supported by effective bank supervision, which can spot and prospectively address safety and soundness risks, particularly such risks that do not emerge on balance sheets or are not otherwise addressed by regulation.[6]

   The ongoing reform of supervision by the banking regulators is a very promising initiative for strengthening the U.S. banking system. The current supervisory system has become far too bureaucratic and focused on process rather than risks, resulting in supervisory matters lingering for years unresolved and supervisory resources being diverted from true safety and soundness risks. Additionally, supervision has been used to advance political goals or simply secure more regulatory control over banks. Supervision should focus on identifying problems at a bank, solving them, and returning the bank to normal operations. In doing so, problematic risks will be addressed faster, averting more serious problems down the road. Undoubtedly, improving the supervision of more than 4,000 banking organizations is not easy. However, successfully accomplishing this task would substantially enhance U.S. bank regulation and strengthen the safety and soundness, as well as the resilience and efficiency, of the U.S. banking system. Accordingly, the banking regulators' ongoing managerial and supervisory reforms deserve Congress's strong support and encouragement.

7. American Interests. Finalizing a revised Basel III Endgame proposal, updating tailoring thresholds and requirements, and reforming bank supervision will not only modernize U.S. bank regulation, but also advance important U.S. interests. First, many countries are waiting to finalize their Basel III Endgame rules until the U.S. finalizes its proposal. To

[6] Liquidity regulations, Federal Reserve Bank discount window lending, and federal deposit insurance also play important roles in preventing bank runs.

the extent other countries follow the U.S.'s lead and adopt the Basel III Endgame, it should create a more level playing field around the globe.

Second, modernizing U.S. bank regulation is important for preserving the U.S.'s status as the world's financial capital. The U.S. benefits greatly from being the jurisdiction in which every major financial institution wants to participate and invest. This investment provides valuable funding for the U.S. economy, helps support the U.S.'s $38 trillion federal debt, and keeps interest rates lower for American households and businesses. However, because capital can move faster than ever around the globe, the U.S. needs to be vigilant in ensuring that its financial regulatory system is considered by the marketplace as the safest, most sophisticated and technically advanced. Yet, the rising cost and complexity of U.S. regulation has made the U.S. a less attractive market. Modernizing bank regulation can help address some of these problems and improve the competitiveness of U.S. financial markets while maintaining the U.S.'s high regulatory standards.

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