Written Testimony before the House Financial Services Committee
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Hearing Entitled:Implementing Basel III: What's the Fed's Endgame?
September 14, 2023 10:00 AM in 2128 RHOB

Thank you Chairman McHenry and Ranking Member Waters for the opportunity to testify today. I am Alexa Philo, the Senior Policy Analyst on Banking and Systemic Risk at Americans for Financial Reform, a coalition of more than 200 consumer, community, labor, civil rights, and other organizations dedicated to advocating for policies that shape a financial sector that serves workers, communities and the real economy, and provides a foundation for advancing economic and racial justice. Prior to joining AFR, I supervised large, complex domestic and foreign, as well as regional and community banks with the Federal Reserve Bank of New York and worked at UBS, maintaining the firm's U.S. Risk Management Framework and overseeing assessments of each business and control function's conformance with underlying U.S. regulations, among other responsibilities.

Today, I would like to talk about the importance of the Federal Reserve (Fed), the (FDIC) and the Office of the Comptroller of the Currency's (OCC) notice of proposed rulemaking (NPR) for Large Bank regulatory capital and the Fed's rulemaking to modify risk-based capital surcharges applicable to U.S. Global Systemically Important Banks (GSIBs). These proposals are essential to strengthening the banking industry's ability to withstand stresses and shocks that can imperil banks' financial viability, create uncertainty for depositors and customers, and negatively affect the economy.

The Large Banking Organization Regulatory Capital NPR[1] (hereafter "Large Bank" proposal) published on July 27, 2023, aims to implement the final components of the Basel III agreement. Also known as the Basel III Endgame, this proposed rule revises the risk-based capital framework to improve the risk sensitivity of risk-weighted assets (RWA) for firms with at least $100 billion in total assets and for firms with significant trading activities. The proposal reduces the Large Banking Organizations' use of internal models for measuring capital requirements and requires them instead to use more risk-sensitive standardized approaches for market, operational and credit risk exposures.

[1] Basel III Notice of Proposed Rulemaking (federalreserve.gov), July 27, 2023.

The Risk-Based Capital Surcharges for GSIB's NPR[2] (hereafter, the GSIB Surcharge proposal) also published on July 27, improves the sensitivity of the Fed's risk-based capital surcharge to changes in an institution's systemic risk profile and adds derivatives to the calculation of cross-border exposures.

Together, the proposals will improve the comprehensiveness, consistency, and transparency of the capital requirements applicable to large banking firms. Robustly implementing the Basel III Endgame and restoring enhanced capital requirements for Category IV banks — removed by the banking regulators' rulemaking under the prior administration — will result in more adequate capital levels that more accurately reflect risk-taking activities and systemic risk profiles. As the Fed's Chair for Supervision Michael Barr explained in September 2022:

> [N]othing is more basic to the safety and soundness of banks and the stability of the financial system than capital. Capital enables firms to serve as a source of strength to the economy by continuing to lend through good times and bad. To continue to perform these functions, banks must have a sufficient level of capital to ensure that they can absorb losses and continue operations during times of stress in the financial system when losses may be significant.[3]

Without the proposed changes, bank capital sufficiency and financial stability in the U.S. are at risk. As the Silicon Valley Bank and other bank failures in 2023 evidenced well, a bank can be well capitalized on paper but still lack a sufficient capital cushion[4] to weather severe financial or non-financial stresses. As Assistant Secretary of the Treasury for Financial Institutions Graham Steele noted recently:

> One factor motivating the depositors' run on SVB was a concern about its solvency, particularly the risk that the unrealized losses on the firm's securities holdings were larger

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[2] Federal Register notice: Regulatory Capital Rule: Risk-Based Capital Surcharges for Global Systemically Important Bank Holding Companies; Systemic Risk Report (FR Y 15) (federalreserve.gov)
[3] Making the Financial System Safer and Fairer, Remarks by Vice Chair for Supervision Michael S. Barr, Brookings Institution, Washington, D.C.September 07, 2022.
[4] Explore Confidence Cushions Articles | Starling Insights (starlingtrust.com), June 7, 2023.

than the firm's equity. This loss of confidence underscores the importance of credible and robust capital standards and prompt regulatory intervention.[5]

This is particularly important in the face of novel risks, for example, related to advancements in digitalization and incorporation of machine learning and artificial intelligence into banking.

I. The Proposed Changes & Related Impacts

The Large Bank NPR proposed by Fed, FDIC and OCC, introduces the Basel III Endgame for U.S. large banking organizations with total assets over $100 billion, both strengthening certain capital standards and expanding Basel III applicability to include Category IV firms. Importantly, this proposal would strengthen capital standards for midsize banks on the heels of three midsize bank failures in 2023. The GSIB Surcharge NPR, introduced by the Fed, fixes a gap in the Global Systemically Important Bank calculation of cross-border exposure by requiring the calculation to include derivatives, among other improvements. The updated calculation will better align the U.S. GSIBs' surcharges with their systemic risk profile. Combined, these changes will raise capital requirements most for the largest firms, by 19 percent, and increase capital requirements for regional banks by 6 percent.[6]

A. Basel III Endgame

The Basel III Endgame bank capital rules proposed on July 27, 2023 have been in the works since 2017. When finalized, these rules will finish incorporating lessons hard-learned from the 2008 financial crisis. The largest institutions were woefully undercapitalized and overleveraged in major part because their

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[5] Michael S. Barr, Vice Chair for Supervision, Board of Governors of the Federal Reserve System, Letter Regarding Review of the Federal Reserve's Supervision and Regulation of Silicon Valley Bank (April 28, 2023).

[6] For Category I and II banking organizations, Tier 1 capital requirements would increase by an estimated 19%; for Category III and IV US bank and savings and loan holding companies, an estimated 6%; for Category III and IV US intermediate holding companies of foreign banking organizations, an estimated 14%. https://www.federalreserve.gov/aboutthefed/boardmeetings/frn-basel-iii-20230727.pdf, Footnote, 465.

internal models did not come close either to estimating the severity of losses or estimating the amount of capital that would have been needed to prevent the 2008 bank failures.[7]

Today, the Basel 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. However, the Basel Accord's internal models' approaches fell substantially short during the crisis of 2008, and this significant shortcoming was not addressed in the first round of Basel III changes finalized in 2013. Regulators have placed limits on the use of these models, but as former FDIC chair Sheila Bair noted, the large banks are still relying on internal models that "understate their risks" and "allow them to lower their capital requirements to boost their returns,".[8] A number of academic studies speak to this view, finding widespread variations in the way lenders conduct assessments that enable them to "cheat" the system by using models that understate their risks and allow them to hold less capital, potentially giving them a trading advantage.[9]

One analysis by the European Banking Authority reinforces this point, finding "significant variation in the [risk weights] and [expected losses] across banks." Drivers of this variation included differences in definitions of default, differences in the granularity of credit ratings used, and data limitations (European Banking Authority 2013). With the potential for such wide variation of results based in significant part on the [internal] modeling choices that banks make (such as the length of data periods used), there have been growing concerns about the achievement of lower capital requirements through the manipulation of models rather than through the actual reduction of RWAs.[10]

One of the key features of the Endgame proposal aims to remedy this issue. Particularly for market risk, the proposal effectively eliminates the reliance on internal models and instead requires banks to transition to improved standardized model results that are more transparent and consistent. It does so

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[7] Remarks by Chairman Martin J. Gruenberg on the Basel III Endgame at the Peterson Institute for International Economics, June 22, 2023.

[8] The truth about proposed bank capital rules, New measures are an important step to protect the US and world economies against future financial crises, Sheila Bair, September 2, 2023. https://www.ft.com/content/cbfc316b-7049-4658-941f-6d25559d754d

[9] Capital requirement, bank competition and stability in Africa - ScienceDirect, Volume 7, Issue 1, June 2017, Pages 45-51.

[10] The credibility of European banks' risk-weighted capital: structural differences or national segmentations? Brunella Brunoa, Giacomo Nocerab, Andrea Restic, October 10, 2014.

by replacing the advanced approaches measures with new risk-based capital measures for market, operational, and credit risk. 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 proposal impacts capital requirements for market, operational, credit and derivatives credit valuation adjustment (CVA) risk, primarily for megabanks with large trading books and banks with significant operational risk losses in their history. Important improvements include:

- **High market risk charges for megabanks that use internal models currently**

In the lead up to the financial crisis, the largest banks were not holding nearly enough capital to account for their real market risk, particularly for the severity of price declines and unprecedented volatility in a number of markets. Stock indices lost over 50% of their value from the October 2007 peak to the March 2009 trough.[12] 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"[13] and that typical models did not predict the extreme outcomes necessary for the estimation and allocation of capital.[14] The proposal will improve risk-based capital for market risk by better accounting for stress losses and increasing the requirements applied to less liquid trading positions.

[11] Basel III: Finalising post-crisis reforms, December 2017. https://www.bis.org/bcbs/publ/d424.htm
[12] Stock Market Volatility in the 2008 Crisis, Kiran Manda, Leonard N. Stern School of Business Glucksman Institute for Research in Securities Markets Faculty Advisor: Menachem Brenner April 1, 2010. https://www.stern.nyu.edu/sites/default/files/assets/documents/uat_024308.pdf
[13] Haldane, Andrew, "The Dog and The Frisbee"; International Monetary Fund (2009), "Global Financial Stability Report, Chapter 3",
[14] Risk Management Lessons from the Global Banking Crisis of 2008 October 21, 2009. https://www.newyorkfed.org/medialibrary/media/newsevents/news/banking/2009/SSG_report.pdf

- **Higher operational risk charges for banks with a history of operational risk losses**

The improved standardized approach for operational risk includes accounting for prior losses associated with a bank's operational risk exposure. "Operational risk exposures have been, and continue to be, a persistent and growing risk for financial institutions. For example, large financial institutions faced stiff settlement costs associated with their mortgage activities leading up to the 2008 financial crisis, while in recent years ransomware attacks, as well as other cybersecurity risks, have increased significantly," noted FDIC Chairman Martin Gruenberg.[15]

- **Mixed credit risk impacts, with the greatest impacts for megabanks that are over reliant on their own models in the current capital regime**

Before the 2008 crisis, the megabanks were over-reliant on their own models for credit risk, and these models failed spectacularly to predict the magnitude of credit losses during the 2008 financial crisis. The proposal improves the standardized approach for credit risk by incorporating more credit risk drivers (for example, borrower and loan characteristics) that differentiate between types of credit risk.

- **Higher charge for Credit Valuation Adjustment (CVA) Risk[16]**

Before the financial crisis, parties to a derivatives contract never considered the other counterparties' credit risk due to the generally high credit rating of counterparties and the relatively small size of derivative exposures. This mindset was indicative of a belief that the derivatives counterparties were "Too-Big-to-Fail" and thus could not default on their financial obligations like parties in other business lines. However, during the 2008 financial crisis, dozens of financial institutions collapsed, including large derivative counterparties. As a result, market participants started incorporating CVA risk when calculating the value of over-the-counter derivative instruments.[17]

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[15]Remarks by Chairman Martin J. Gruenberg on the Basel III Endgame at the Peterson Institute for International Economics, June 22, 2023.

[16] The valuation change of OTC derivative contracts resulting from the risk of the counterparty's defaulting prior to the expiration of the contracts, known as the credit valuation adjustment (CVA), depends on (1) counterparty credit spreads, which reflect the creditworthiness of the counterparty perceived by the market; and (2) credit exposure generated by CVA risk covered positions.

[17] CVA refers to adjustments to transaction valuation to reflect the counterparty's credit quality. CVA is the fair value adjustment to reflect CCR in valuation of derivatives.

The reform will improve the risk sensitivity of CVA risk to losses on certain derivatives contracts by replacing the current approaches for measuring capital requirements for CVA risk with non-model based approaches, including a less burdensome option intended for less complex banking organizations.

- **Changes in systemic-risk calculation for the GSIB surcharge.**[18]

The current GSIB surcharge methodology is outdated and is not sufficiently risk sensitive to changes in a firm's systemic risk profile. The GSIB Surcharge NPR improves the sensitivity of a firm's GSIB surcharge to changes in a firm's systemic footprint by measuring the systemic risk indicators on an average basis over the full year versus only as of year end currently.

The proposal also addresses a gap in current practice by adding derivatives to the calculation of the firm's cross-border derivatives exposure as a systemic-risk indicator. Omitting derivatives from the calculation of cross-border exposure materially understates the complexity and transmission channels for financial distress that result from large derivatives exposure in a disorderly wind down. This change is expected to materially increase the cross-border exposure measure for[19] five foreign and two domestic banks, and shift them to a more advanced Tailoring category[20] — that is, apply a higher standard — that more appropriately reflects their true risk when including derivatives relationships.

B. Capital Reforms for Category IV Banks

The proposal also remedies weaknesses in current capital standards revealed by the failure of Silicon Valley Bank (SVB)and other midsize banks in 2023. The SVB and other failures illustrated the speed with which contagion can take hold, something that has accelerated since the 2008 crisis. Further, a robust capital cushion that inspires the confidence of stakeholders and counterparties only increases in

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[18] Under the existing capital rules, a GSIB must maintain an additional buffer, known as the GSIB capital buffer, to strengthen the firm's resiliency based on the risks of its failure or distress could pose to the US financial system.
[19] Fed's GSIB surcharge tweak could have big impact on foreign banks | American Banker, Kyle Campbell August 22, 2023.
[20] Tailoring Rule visual (federalreserve.gov),

importance with advancements in digitalization and artificial intelligence that can be expected to introduce novel risks.

- **The proposal restores Basel III requirements for Category IV banking organizations**

A key lesson of the 2023 crisis is that midsize banks were not sufficiently 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.[21] The banking agencies' rulemaking in 2019 — going further to deregulate in addition to what was required by legislation — paved the way for 2023 failures by removing all Category IV firms from enhanced capital and other prudential standards.

- **The proposal ends Category III[22] and IV banks' omission of unrealized securities losses (and gains) in regulatory capital**

Currently, Category III and Category IV banks can choose not to report unrealized losses or gains in their calculation of regulatory capital. This opt-out clause has allowed banks to keep the impact of unrealized securities losses on capital in a high interest rate risk environment less transparent to investors and other counterparties. SVB was a highly vulnerable firm in ways that SVB's board of directors, senior management, and Federal Reserve supervisors failed to act on, according to the Fed's SVB report. This was, at least in part, because Category IV firms, along with those in Category III, had the ability to opt out of including securities losses in their accumulated other comprehensive income (AOCI) for calculating regulatory capital. With SVB's large concentration of unrealized securities losses, its regulatory capital appeared substantially higher than it would become once its securities losses were realized. This lack of transparency, in turn, made it harder for the firm, supervisors, depositors, and investors to gain a full understanding of the impact the underwater securities portfolio would have on capital. According to the Fed's SVB report:

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[21] The Fed's post-mortem analysis of SVB's failure finds that "while the proximate cause of SVB's failure was a liquidity run, the underlying issue was concern about its solvency.

[22] Category III includes banking organizations with ≥ $250b Total Assets or ≥ $75b in nonbank assets, weighted short-term wholesale funding, or off-balance sheet exposure.

> Recognizing unrealized gains and losses on its available-for-sale securities in its CET1 capital would have reduced SVB's regulatory capital by $1.9 billion in the fourth quarter of 2022, potentially causing it to raise capital sooner.[23]

The Large Bank proposal removes the opt-out clause for Category III and IV firms, aligning this aspect of the regulatory capital calculation across firms in all four categories.

After SVB's failure in March, President Joseph Biden said "Americans should expect banks to hold sufficient capital cushions to absorb potential losses during stress events like the ones experienced by Silicon Valley Bank. [We need to] make sure ordinary Americans never again have to experience the devastating financial and economic losses of prior crises."[24] These proposed capital changes are urgently needed to accomplish these goals.

II. Adequate capital levels are important for financial stability and for economic and racial justice

The set of capital reforms in these proposals are essential to prevent further large bank failures and financial system instability, as a result of undercapitalized banks pursuing outsized risk-taking. The "heads: big banks win, tails: the American public loses" approach of too lax standards has 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.

The 2008 financial crises robbed millions of Americans of their wealth and home ownership, with particularly devastating impacts on people and communities of color.[25] Low- and moderate-income people

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[23] Review of the Federal Reserve's Supervision and Regulation of Silicon Valley Bank, supra note 3, at 89.

[24]FACT SHEET: President Biden Urges Regulators to Reverse Trump Administration Weakening of Common-Sense Safeguards and Supervision for Large Regional Banks, March 30, 2023.

[25] Bayer, Patrick, Fernando Ferreira, and Stephen L. Ross. 2018. "What Drives Racial and ethnic Differences in High-Cost Mortgages? The Role of High-Risk Lenders." Review of Financial Studies 31 (1): 175–205.

disproportionately lost savings, homes and home equity to predatory lending and experienced foreclosures. Younger and middle-aged Black and Latinx families were especially hard-hit by a wave of foreclosures from push-marketed subprime loans and declining home prices that reduced or wiped out many owners' home equity that comprised a large part of their net worth before the crash.[26] The real median home equity for Black and Latinx homeowners fell about twice as fast as it did for white homeowners from 2007 to 2016 (falling by 28 percent for Black homeowners, 24 percent for Latinx homeowners, and 14 percent for white homeowners).[27] Communities of color felt the brunt of job and income losses during the recession, with unemployment and poverty rates rising faster and falling slower for Black and Latinx families than for white families.The Bureau of Labor Statistics reported that the peak Black unemployment rate in the wake of the financial crisis was 82 percent higher than the peak white unemployment rate and the peak Latinx unemployment rate was 41 percent higher.[28] An Urban Institute white paper found that the combination of unemployment, foreclosure, and the erosion of home equity eliminated nearly half the wealth of Black and Latinx families (48 percent and 44 percent, respectively), compared to one-fourth of the wealth of white families (26 percent).[29]

On a macroeconomic level, the large bank failures and financial sector free-fall during and after the 2008 crisis set back the U.S. economy for years, evaporating retirement and household savings for millions of families. A 2020 study by Stanford and UCLA economists that looked at recessionary periods over the past 150 years found that “recessions in the aftermath of financial crises are severe and protracted” and “longer and deeper than the recessions surrounding non-financial crises.”[30] Many families — especially Black and Latinx families — barely began to make up for lost ground when the pandemic overturned their economic lives again.[31]

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[26] Household Financial Stability: Who Suffered the Most from the Crisis?, St. Louis Fed, July 01, 2012.

[27] Americans for Financial Reform calculation from Federal Reserve Board Survey of Consumer Finances data.

[28] Cunningham, Evan. Bureau ofLabor Statistics. “Great Recession, great recovery? Trends from the Current Population Survey.” *Monthly Labor Review*. April 2018.

[29] McKernan, Signe-Mary et al. Urban Institute. “Impact of the Great Recession and Beyond: DIsparities in Wealth Building by Generation and Race.” April 2014.

[30] Krishnamurthy, Arvind and Tyler Muir. Stanford University, UCLA, and NBER. “How Credit Cycles across a Financial Crises.” September 2020.

[31] The Conversation, Black Americans were most affected by the 2009 recession. Reuters/Jessica Rinaldi African Americans’ economic setbacks from the Great Recession are ongoing – and could be repeated Published: February 5, 2019.

III. The Myth of Capital and Credit Availability

Many bank executives and the bank lobby continue to oppose the recent capital proposals, relying on the claim that increased capital requirements will undermine credit availability and encourage balance sheet-intensive businesses to move to the shadow bank sector. We strongly disagree that increased capital requirements will undermine credit availability. Indeed,well-capitalized and secure banks are essential to providing credit to businesses, families, and communities.

A 2020 World Bank report summarized several studies that found that well-capitalized banks in the United States had higher loan growth than nearby banks with fewer capital reserves, that well-capitalized large U.S. banks had higher loan originations and liquidity, and that better-capitalized international banks had lower funding costs that enabled them to increase lending.[32] The World Bank concluded that "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."[33]

We also believe that shadow banking should be more tightly regulated and that the risks in shadow banking should be considered independently from the need for more adequate capital levels in banking. The concerns about another financial subsector should not be the basis for allowing the bank sector to be undercapitalized. It is also important to note that banks and nonbank financial institutions are deeply intertwined in multiple ways that warrant close scrutiny. This set of relationships only increases risk in stressed situations that makes the case for improved capital standards still more compelling.

Robust capital levels are the cornerstone of a resilient banking system that can better serve the U.S. economy. Well-capitalized banks can absorb losses to enable them to continue to lend to their customers through business cycles, including during times of stress. The reality is the customers — businesses and families — of SVB and other recently failed banks lost their access to credit *because* their banks were

[32] World Bank, Global Financial Development Report, 2019/2020, Chapter 3 Bank Capital Regulation p. 85.
[33] World Bank, Global Financial Development Report, 2019/2020, Chapter 3 Bank Capital Regulation p. 85.

undercapitalized. And they would have done so to a much greater extent had the federal government not stepped in to bail them out.

On the other hand, it IS the case that senior business executives and their teams profit from weaker capital rules. Looser capital standards make it easier for executives and bankers to take on excessive risk to increase short-term profits — and their own compensation even when that makes failures with potentially grave public costs more likely. More adequate capital requirements also limit the ability of banks to pursue financial engineering like stock-buybacks and dividend payouts that also increase senior executives compensation. Stronger capital standards can prevent financial engineering designed to artificially boost share prices and executive bonuses through excessive risk taking, and including payment of large dividends and making stock buybacks.

In a 2020 Harvard Law School Forum on Corporate Governance, experts from FCLT Global summarized the interplay between short-termism, buybacks, and executive compensation packages that pose substantial risks to companies:

> Buybacks are often associated with long-term value-destroying behaviors, including several means of personal gain and enrichment, poor timing of investment decisions, and excess leverage. As attractive as buybacks may be as a method to return cash to shareholders, they are a powerful tool that can lead to serious dangers. A common criticism of buybacks is that they can be used by management to manipulate earnings per share (EPS), which could be used to inflate their own compensation metrics and hit quarterly guidance targets. Indeed, according to Institutional Shareholder Services, as recently as 2019, more than 30 percent of all compensation plans were linked to EPS.[34]

These bank capital proposals are critical to improving the industry's resilience to stresses and shocks that, in the worst cases, lead to bank failures that can reverberate across the U.S. economy. The Basel III Endgame components above have been in the works since 2017 with support crossing sectors and

[34] The Dangers of Buybacks: Mitigating Common Pitfalls, Sarah Keohane Williamson, Ariel Fromer Babcock, and Allen He, FCLT Global, on Friday, October 23, 2020.

administrations, as evidenced by Secretary Mnuchin's support. After the final package of Basel III reforms was agreed to in 2017, Secretary Mnuchin stated, "the reforms would standardize the approach to capital regulation, improve the quality and consistency of bank capital requirements, and help level the playing field for U.S. banks".[35]

Banks without the capital reserves necessary to weather economic storms can put the economic fortunes of depositors, customers, and communities in jeopardy. 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 short-term financial gains and mobilize capital to their own ends by paying excessive dividends and buybacks to shareholders. This will advance economic justice and help the economy work better for everyone.

[35] Treasury Secretary Mnuchin's Statement on Basel III (December 7, 2017), https://home.treasury.gov/news/press-releases/sm0232.