Testimony of

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Emeritus Professor, Harvard Law School;

President of the Committee on Capital Markets Regulation

Before the

Subcommittee on Financial Institutions and Monetary Policy

of the

Financial Services Committee

United States House of Representatives

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Thank you, Chairman Barr, Ranking Member Foster, and members of this Subcommittee for inviting me to testify before you today on the joint proposal of the Office of the Comptroller of the Currency, the Federal Reserve, and the Federal Deposit Insurance Corporation, entitled "Regulatory Capital Rule: Amendments applicable to large banking organizations and to banking organizations with significant trading activity" (the "Capital Proposal").[1] My testimony today

[1] OFFICE OF THE COMPTROLLER OF THE CURRENCY, FEDERAL RESERVE SYSTEM, FEDERAL DEPOSIT INSURANCE CORPORATION, *Regulatory capital rule: Amendments applicable to large banking organizations and to banking organizations with significant trading activity* (July 27, 2023), https://www.federalregister.gov/documents/2023/09/18/2023-19200/regulatory-capital-rule-large-banking-organizations-and-banking-organizations-with-significant [the "Capital Proposal"].

regarding the Capital Proposal draws on the May 1, 2023, statement of the Committee on Capital Markets Regulation regarding Basel Finalization and U.S. Bank Capital Requirements[2] but my testimony today is my own.

The Capital Proposal would materially increase the capital requirements for large U.S. banks and other banks with significant trading activity at a time when such an increase would be both unnecessary and counterproductive. There are three key reasons why U.S. bank regulators should not increase capital requirements at this time. First, there is no need for a capital increase to maintain the stability of the banking system, as U.S. bank capital levels are strong. Second, there would be significant economic costs from raising bank capital requirements, as there is extensive empirical evidence that increasing capital requirements reduces banks' lending and capital markets activities and increases borrowing costs for businesses and consumers, slowing economic growth. Third, raising bank capital requirements at this time could reduce the precision of the Fed's monetary policy and thereby interfere with the Fed's ongoing efforts to fight inflation. An increase in bank capital requirements now could pose problems for the Fed's monetary policies even after inflation is contained by counteracting the Fed's efforts to restore economic growth with lower interest rates.

1. The Capital Proposal Would Require Banks to Carry Significantly Greater Amounts of Capital

The Capital Proposal would significantly increase capital requirements for U.S. banking organizations with $100 billion or more in assets and other banking organizations with significant trading activity. The Capital Proposal's changes are nominally intended to bring the United States

[2] COMMITTEE ON CAPITAL MARKETS REGULATION, BASEL FINALIZATION AND U.S. BANK CAPITAL REQUIREMENTS (2023), https://capmktsreg.org/wp-content/uploads/2023/05/CCMR-Statement-on-Bank-Capital-Basel-Finalization-05.01.23.pdf

into conformity with international standards promulgated by the Basel Committee on Banking Supervision – commonly referred to as "Basel Finalization." In fact, Basel Finalization was not intended to result in an aggregate increase in bank capital requirements. In 2017, then-ECB President and Chair of Basel's Group of Governors and Heads of Supervision stated that Basel Finalization was not expected to "create a significant capital increase in the aggregate of the banking system."[3] Furthermore, the Basel Committee's quantitative impact study indicated that Basel Finalization would in fact reduce the largest banks' capital requirements.[4] The Capital Proposal thus goes far beyond what Basel Finalization contemplates.

Across all banking organizations subject to the Capital Proposal, the amount of required common equity tier 1 ("CET1") capital is expected to increase on average by 16%.[5] For the largest banks, the increase is expected to be 19%.[6] While these are already substantial increases, the increases for the subset of such banks that focus their businesses on supporting our capital markets and providing valuable services such as custody protections for customer assets – both important components of the U.S. banking sector – are likely to be even more severe. First, by changing the calculation of risk-weightings for banks' trading assets, the Capital Proposal would drastically increase the amount of capital that banks must carry to cover market risk. Market risk is an important driver of overall capital requirements for banks that focus on activities such as market making and securitizations, which are crucial to the efficiency of our capital markets. According to regulators' own estimates, the Capital Proposal's modifications would result in an increase of

[3] Bank for International Settlements ["BIS"], GHOS Media Conference (Dec. 7, 2017), https://www.bis.org/bcbs/b3/ghos_20171207_2.htm.
[4] BIS, *Basel III Monitoring Report - Results of the cumulative quantitative impact study* (Dec. 7, 2017), https://www.bis.org/bcbs/publ/d426.htm.
[5] Capital Proposal at 494.
[6] *Id*. at Note 465.

more than 40% in the amount of capital that banks must carry to cover market risk.[7] Second, by incorporating operational risk into the standardized approach for calculating risk-weighted assets, the Capital Proposal would disproportionately increase capital requirements for banks that provide valuable non-lending services, such as providing custody for customer assets.[8] This would be the first time that U.S. regulators include an explicit charge for operational risk in the standardized approach. Although Basel Finalization's operational risk-inclusive standardized approach differs significantly from those that U.S. regulators declined to apply in the past, the methodology remains untested and unjustified. Moreover, charges for operational risk are already included in the Fed's stress test methodologies and will continue to be included after the Capital Proposal becomes effective unless regulators take action to address this potential redundancy, as explained further below.

2. There is Substantial Evidence That Current Levels of Bank Capital Are Sufficient.

The Capital Proposal is premised on a view that large U.S. banks are undercapitalized. But this premise is at odds with the evidence before us. As the New York Fed reported in its most recent quarterly report, U.S. bank capital is "high by historical standards" and "well above" its pre-2008 crisis levels.[9] In particular, the average CET1 capital ratio of U.S. banking organizations for the 2001-2007 period was 8.25%.[10] As of Q1 2023, it had increased by nearly four percentage points to 12.81%.[11] The total amount of CET1 capital across all such banks has more than doubled over

[7] Matthew Bisanz et al., *Overhaul of Regulatory Capital Requirements Proposed by US Banking Regulators* (Aug., 21, 2023), https://wp.nyu.edu/compliance_enforcement/2023/08/21/overhaul-of-regulatory-capital-requirements-proposed-by-us-banking-regulators/.
[8] *Id.*
[9] FEDERAL RESERVE BANK OF NEW YORK, *Quarterly Trends for Consolidated U.S. Banking Organizations* (Q12023), https://www.newyorkfed.org/medialibrary/media/research/banking_research/QuarterlyTrends2023Q1.pdf?sc_lang=en&hash=BA60FA5D43F77B6475947A7FFC56166C
[10] *Id*.
[11] *Id.*

the past 14 years, rising from $610 billion in 2009 to $1,237 billion as of Q1 2023.[12] The strength of U.S. bank capital is further underscored by the results of the 2022 stress tests, which showed that total loss absorbency of the 33 tested banks was over $2.8 trillion – more than nine times the losses associated with a recurrence of market stress comparable to the 2008 crisis.[13]

Furthermore, bank capital was also not strained by the severe market turmoil that occurred in March 2020 as a result of the COVID-19 pandemic. Indeed, the aggregate CET1 capital ratio across U.S. banks declined by only 15 basis points over the course of 2020, from 12.25% as of year-end 2019 to its lowest point in 2020 of 12.10%, before swiftly climbing back to the higher historic levels we see today.[14]

Nor does the recent crisis of Silicon Valley Bank ("SVB") evidence a need to increase bank capital requirements. SVB failed to manage interest rate risks that significantly reduced the market value of its portfolio of Treasuries and mortgage-backed securities. The concentration of its deposit base and its high percentage of uninsured deposits, combined with the supervisory failure to control its exposure to interest rate risk, contributed to a bank run of a size and speed that were unprecedented in U.S. banking history. SVB could not meet depositors' withdrawal requests because the speed and size of the run overwhelmed its supply of liquid assets, which were extensive, and because operational impediments at both the Fed and Federal Home Loan Banks ("FHLBs") and overly restrictive collateral policies at the Fed, prevented SVB from obtaining needed liquidity lending from those institutions. While one could argue that SVB should have had more capital, its failure

[12] FEDERAL RESERVE BANK OF NEW YORK, Quarterly Trends Report Data (Q1 2023), https://www.newyorkfed.org/research/banking_research/quarterly_trends.
[13] Testimony of Greg Baer, Implementing Basel III: What's the Fed's Endgame? (Sept. 14, 2023), https://docs.house.gov/meetings/BA/BA20/20230914/116339/HHRG-118-BA20-Wstate-BaerG-20230914.pdf.
[14] FEDERAL RESERVE BANK OF NEW YORK, *supra* note 12.

was due to a liquidity not a capital problem. Requiring SVB to hold more capital would not have decreased its exposure to a bank run. No reasonable amount of capital can ever stop a bank run.

It has been suggested that the Capital Proposal's modifications could have prevented SVB's failure by requiring SVB to take certain unrealized losses on its securities portfolio into account in calculating its capital requirements, thus alerting the market to the existence of those losses earlier. This reflects a fundamental misapprehension of the basic facts of what occurred. The unrealized losses inherent in SVB's securities portfolio were no secret to the market. They were disclosed in SVB's publicly filed financials.[15] It was the revelation that SVB had been required to sell those assets to fund withdrawals– that is, a problem with liquidity, not capital – that sparked the run on SVB.

In fact, far from demonstrating that banks are undercapitalized, the SVB crisis is yet another indicator that U.S. banks are well capitalized. Many of the largest banks— those that would be subject to the Capital Proposal—served as a source of strength to the banking system during the crisis, including by voluntarily injecting $30 billion in uninsured deposits in First Republic Bank when it was under stress, followed by JPMorgan's acquisition of First Republic Bank's deposits and assets. Furthermore, the SVB and Signature bank problems offer no justification for a steep capital increase for all banks.

3. Increasing Capital Will Entail Significant Costs for the U.S. Economy.

Empirical research shows that higher capital reduces bank lending and capital markets activities and increases borrowing costs, each of which slows economic growth. A 2016 report by the Bank for International Settlements ("BIS") summarized this extensive body of literature as indicating

[15] SVB FINANCIAL GROUP, *Annual Report on Form 10-K for fiscal year ended Dec. 31, 2022* at 125 (filed Feb. 24, 2023), https://d18rn0p25nwr6d.cloudfront.net/CIK-0000719739/f36fc4d7-9459-41d7-9e3d-2c468971b386.pdf.

that for every one percentage point increase in capital ratios, banks tend to cut their lending in the long run by 1.4–3.5%.[16] According to modelling conducted by the International Monetary Fund, central banks, and bank regulators across 15 jurisdictions, higher borrowing costs and reduced credit supply associated with a 1% increase in bank capital ratios reduces GDP by up to 16 basis points.[17] An estimate by the Bank Policy Institute that applied this modelling to the Capital Proposal found that the Capital Proposal can be expected to permanently reduce U.S. GDP by more than $67 billion per year.[18]

The economic costs of this reduced and more expensive lending activity can fall disproportionately on specific economic sectors, particularly small businesses and retail consumers. As one among several examples, a 2017 study (Acharya et al.) found that the reduction in bank lending stemming from the introduction of Dodd Frank stress testing was particularly pronounced for credit card and small business borrowers.[19]

In the case of capital markets activities, empirical evidence demonstrates that heightened capital requirements can have an even greater detrimental effect. Baker et al. (2017) found that CET1 capital requirements imposed greater constraints on the activities of banks with a capital markets focus compared to traditional banks, requiring capital markets banks to continuously build more CET1 capital in the post-2008 period.[20] Indeed, banks have demonstrated a strong tendency to reduce the ratio of their trading assets to total assets since late 2008. Wang & Zhong (2019) found

[16] BIS, *Literature Review on Integration of Regulatory Capital and Liquidity Instruments* 7 (2016), https://www.bis.org/bcbs/publ/wp30.pdf.
[17] BIS, *Assessing the Macroeconomic Impact of the Transition to Stronger Capital and Liquidity Requirements* (2010), https://www.bis.org/publ/othp12.pdf.
[18] Baer, *supra* note 13 at 5.
[19] Viral V. Acharya et al., *Lending Implications of U.S Bank Stress Tests: Costs or Benefits?* J. OF FIN. INTERMEDIATION (2017), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2972919.
[20] Colleen Baker et al., *The Impacts of Financial Regulations: Solvency and Liquidity in the Post-Crisis Period*, FRB of Philadelphia Working Paper No. 17-10 (2017), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2958121.

that higher capital requirements under Basel III led to an overall decrease in market making by banks.[21] And Cimon (2019) found that the implementation of capital increases under Basel III caused banks to change their market making business models by holding fewer positions on their balance sheets and increasingly operating on an agency basis, which reduced investor welfare.[22] A 2014 BIS study observed that, following the implementation of Basel III, bank market-makers increased their focus on activities requiring less capital and balance sheet capacity and that banks in many jurisdictions allocated less capital to their market-making activities and reduced their holdings of less liquid assets.[23] Liang & Parkinson (2020) found evidence that elements of the methodology for the calculation of the capital surcharge for global-systemically important banks has restrained the market making activities of banks particularly in times of market stress.[24]

The U.S. capital markets are the largest and among the most liquid and efficient in the world. In the United States, capital markets activities have a much larger role in financing the economy compared to other countries. In 2022, capital markets generated 77.5% of debt funding for nonfinancial corporations in the United States, whereas other large economies rely more heavily on bank loans.[25]

Banks have a crucial role in supporting capital markets by performing functions such as market making and facilitating asset securitizations. As such, capital increases that make it more costly for banks to engage in capital markets activities are of heightened importance to the U.S. economy.

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[21] Xinjie Wang & Zhaodong Zhong, *Post-Crisis Regulations, Market Making, and Liquidity in Over-the-Counter Markets* (2019), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3318671.

[22] David A. Cimon & Corey Garriott, *Banking Regulation and Market Making* (2019), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2882594.

[23] BIS, COMMITTEE ON THE GLOBAL FINANCIAL SYSTEM, *Market-Making and Proprietary Trading: Industry Trends* (2014), https://www.bis.org/publ/cgfs52.pdf.

[24] Nellie Liang & Pat Parkinson, *Enhancing Liquidity of the U.S. Treasury Market Under Stress*, Hutchins Center Working Paper No. 72, 3 (2020), https://www.brookings.edu/wp-content/uploads/2020/12/WP72_LiangParkinson.pdf

[25] SIFMA, 2022 Capital Markets Fact Book 6 (2022), https://www.sifma.org/wp-content/uploads/2022/07/CMFact-Book-2022-SIFMA.pdf

The empirical evidence cited above indicates that to the extent banks pull back further from such activities because of increased capital charges imposed on those activities, liquidity in U.S. capital markets can be expected to decline. Liquidity is a primary driver of trading costs, and a reduction in liquidity is thus likely to increase financing costs for businesses that rely on capital markets for funding as well as increase trading costs for U.S. investors. The Capital Proposal's disproportionate impact on capital markets activities will thus put the U.S. at a competitive disadvantage.

Despite the voluminous and wide-ranging evidence that increasing capital requirements will impose significant costs on the U.S. economy, the Capital Proposal does not contain any meaningful consideration or quantification of these costs or any attempt to weigh them against the proposal's purported benefits.

4. The Proposal Fails to Consider Overlapping Effects.

Yet another issue with the Capital Proposal is its failure to consider potentially overlapping and redundant aspects of the existing stress testing regime. The most prominent example of this is the potential double taxing of market and operational risks for banks subject to annual stress testing. For banks subject to stress testing, exposure to market and operational risks is already taken into account in the calculation of the bank's stress capital buffer pursuant to the Fed's stress test methodologies. But the Capital Proposal would require such banks to carry even more capital with respect to these very same risks via its modifications to the calculation of market risks and by incorporating operational risks into the standardized approach for calculating risk-weighted assets. The Capital Proposal makes no adjustments to offset this redundancy.

5. The Proposal Could Interfere with the Fed's Efforts to Fight Inflation.

The Capital Proposal is also problematically being put forward while the Fed is combatting inflation by raising interest rates. Higher capital works in the same direction as higher interest rates by slowing the economy. But the combination of the two can undermine the Fed's ability to accurately calibrate and measure the effectiveness of its interest rate policies. And these same capital requirements can also undermine the Fed's ability to revive economic growth after the desired level of inflation is achieved. Thus, Kishan & Opiela (2006), Bolton & Freixas (2006), and Chami & Cosimano (2001) find that higher bank capital requirements increase the negative effect of contractionary monetary policy on loan growth while decreasing the effectiveness of expansionary monetary in stimulating loan growth.[26]

Although these studies evidence the existence of a complex interaction between interest rates, capital requirements, and lending, they are based on theoretical models and do not provide a definitive basis from which to sufficiently calculate the interaction between the capital increases contemplated in the Capital Proposal and the Fed's current monetary policies. Furthermore, the existing literature focuses on bank lending and not capital markets activities, which as noted above are of even greater relevance to the U.S. economy. A capital increase under existing circumstances would therefore not only produce unnecessary costs, but also make the extent of these costs and the effect of ongoing monetary policy efforts more unpredictable. While monetary policy can be fine-tuned as economic variables change, capital requirements cannot be.

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[26] Ruby P. Kishan & Timothy P. Opieala, *Bank Capital and Loan Asymmetry in the Transmission of Monetary Policy* 30(1) J. OF BANKING & FIN. 259 (2006), https://www.sciencedirect.com/science/article/abs/pii/S0378426605000956; Patrick Bolton & Xavier Freixas, *Corporate Finance and the Monetary Transmission Mechanism* 19(3) R. OF FIN. STUDIES 829 (2006), https://www0.gsb.columbia.edu/faculty/pbolton/transmission.pdf; Ralph Chami & Thomas F. Cosimano, *Monetary Policy with a Touch of Basel* IMF Working Paper WP/1/151, 29 (2001), https://www.imf.org/external/pubs/ft/wp/2001/wp01151.pdf.

In addition, once the current contractionary monetary policy cycle ceases, higher bank capital requirements, which cannot be rapidly moderated like interest rates, could make it more difficult to restore lost financing activity with lower interest rates.

Although the Capital Proposal would not become effective until July 1, 2025, these concerns are not alleviated by deferring the effective dates of the capital increases to the future. Banks generally seek to maintain buffers above anticipated regulatory minimums and respond to future increases to bank capital requirements when they are announced, immediately increasing capital even before the implementation date of those reforms. For example, Rios-Rull et al. (2023) and Dagher et al. (2016) document, respectively, how banks tend to maintain capital in excess of regulatory minimums and adjust to impending increases by immediately increasing their capital levels even before the effectiveness of the requirement.[27] The Capital Proposal can thus be expected to slow the economy as soon as it is adopted, if not sooner, and will continue to do so in the recovery period, even if this period actually occurs before the stated transition dates.

Thus, if regulators nonetheless believe that capital requirements should be increased, the effective date of such an increase should not be specified in advance. Instead, the increase should only become effective after economic indicators demonstrate that the economy has returned to a steady state. There is a precedent for an approach that links implementation to economic circumstances rather than a specific date: The countercyclical capital buffer ("CCyB") framework specifies a non-exhaustive set of financial sector and macroeconomic indicators that the Fed considers in

[27] JV Rios-Rull et al., *Banking dynamics, market discipline and capital regulations* (2023), https://www.sas.upenn.edu/~vr0j/papers/tvypap-SWP2.pdf; Jihad Dagher et al., *Benefits and Costs of Bank Capital* IMF STAFF DISCUSSION NOTE SDN/16/04 4 (2016), https://www.imf.org/external/pubs/ft/sdn/2016/sdn1604.pdf.

determining whether to implement the CCyB, such as real estate prices, credit-to-GDP ratios, and GDP growth rates.[28]

6. Conclusion

U.S. bank capital levels are at historical highs. They effectively withstood the COVID market turmoil in 2020 and the 2023 banking crisis. The Capital Proposal would nonetheless significantly increase U.S. bank capital requirements without a compelling policy rationale. Such increases are moreover unnecessary to harmonize U.S. capital requirements with Basel Finalization, which was not intended to result in any significant capital increase across the banking system. Also, by failing to consider potentially overlapping and redundant aspects of the existing stress testing regime, the Capital Proposal could require banks to carry capital for the same risk twice. Before Michael Barr became Vice-Chair of Supervision at the Fed in 2022, the Fed was actively exploring ways to offset any capital increases by the adoption of Basel Finalization.

There are a number of ways this could be achieved. The Fed could modify its own stress test methodologies to not require more capital for operational or market risk that was already provided for by Basel Finalization. Conversely, U.S. regulators could modify their implementation of certain aspects of Basel Finalization to neutralize or mitigate the capital increases that would otherwise result by, for example, as suggested by BPI, setting the Internal Loss Multiplier for operational risks at zero or removing the listing requirement for the lower investment grade risk weight for corporate exposures.[29]

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[28] FEDERAL RESERVE SYSTEM, *Regulatory Capital Rules: The Federal Reserve Board's Framework for Implementing the U.S. Basel III Countercyclical Capital Buffer* Docket No. R-1529, 26-27 (2016), https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20160908b1.pdf.

[29] Bank Policy Institute, *Basel Finalization: The History and Implications for Capital Regulation – Part III* (2023), https://bpi.com/basel-finalization-the-history-and-implications-for-capital-regulation-part-iii/.

Regulators in other jurisdictions have made adjustments that have the effect of mitigating capital increases that would otherwise result from Basel Finalization. For example, the EU's implementation of Basel Finalization makes adjustments that the European Banking Authority estimates will reduce European banks' capital requirements by 3.2%.[30] Such Basel adjustments would be particularly justified in the U.S. justified because the U.S., unlike other jurisdictions, is implementing Basel alongside a very robust stress testing regime. The failure of U.S. regulators to make adjustments will put the U.S, economy on an unequal competitive footing.

The adverse economic impacts of the Capital Proposal could also be mitigated by delaying its effectiveness until economic conditions have stabilized.

The empirical evidence makes clear that without these adjustments, the increases currently contemplated in the Capital Proposal will result in needless economic costs in the form of reduced lending and capital markets activities. Furthermore, the implementation of higher capital requirements will unduly complicate the Fed's use of monetary policy to fight inflation. U.S. regulators should therefore withdraw the Capital Proposal and replace it with a proposal that addresses the concerns I have discussed in this statement.

[30] EUROPEAN BANKING AUTHORITY, *Basel III Monitoring Exercise – Results Based on Data as of 31 December 2021 (Annex – Analysis of EU Specific Adjustments)* (Sept. 30, 2022), https://www.eba.europa.eu/sites/default/documents/files/document_library/Publications/Reports/2022/Basel%20III%20monitoring%20report/1039929/Annex%20-%20EU%20specific%20analysis.pdf