

Testimony of Jonathan V. Gould
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Before the U.S. House Financial Services Subcommittee on
Financial Institutions and Monetary Policy
hearing on
“Regulatory Recipe for Economic Uncertainty: The Endless Basel Endgame and an
Onslaught of Hurried Rulemaking Undertaken by the Biden-Harris Administration”

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Chairman Barr, Ranking Member Foster and Members of the Subcommittee: thank you for the opportunity to discuss the Basel III endgame. This Committee’s bipartisan engagement with the Federal banking agencies on the Basel III endgame proposal has been a case study in how Congress can exercise its oversight authority in constructive fashion.

My testimony is my own. I am speaking today solely in my personal capacity; I am not speaking on behalf of any clients or my law firm.

In July 2023, the Federal banking agencies released the Basel III endgame proposal.¹ Unlike the similarly-named *Avengers: Endgame* movie, which achieved record-breaking box office success, the Basel III endgame proposal was criticized from many different quarters on both substantive and procedural grounds. Since its initial release, the agencies have taken several steps to address this criticism and the proposal’s shortcomings, including an after-the-fact data collection effort to “clarify the estimated effects of the proposal and inform any final rule,”² various public statements promising “broad and material” changes to the proposal,³ and, most recently, a speech by the Federal Reserve’s Vice Chair for Supervision Michael Barr telegraphing certain changes he intends to recommend the Board make to the proposal.⁴ In the meantime, we are left gaming out various scenarios and timelines while the agencies settle on one set of capital requirements out of a dizzying number of possible options. Unlike Marvel Comics fans, banks and other market players cannot exist in more than one universe at a time. They need certainty to plan

¹ See Federal Reserve, “Agencies request comment on proposed rules to strengthen capital requirements for large banks” (July 27, 2023), available at <https://www.federalreserve.gov/newsevents/pressreleases/bcreg20230727a.htm>. The Federal Reserve also released a related G-SIB surcharge proposal. *Id.*

² Federal Reserve, “Federal Reserve Board launches data collection to gather more information from the banks affected by the large bank capital proposal it announced earlier this year” (Oct. 20, 2023), available at <https://www.federalreserve.gov/newsevents/pressreleases/bcreg20231020b.htm>.

³ *E.g.*, *The American Banker*, “Powell: ‘Broad and material changes’ coming to Basel III proposal” (March 6, 2024), available at <https://www.americanbanker.com/news/powell-broad-and-material-changes-coming-to-basel-iii-proposal> (quoting Federal Reserve Chair Jerome Powell, but not clarifying whether a re-proposal would be forthcoming).

⁴ See Michael S. Barr, Federal Reserve Vice Chair for Supervision, “The Next Steps on Capital” (Sept. 10, 2024), available at <https://www.federalreserve.gov/newsevents/speech/barr20240910a.htm>.

balance sheet allocations and product offerings. This uncertainty around regulatory capital puts a damper on banks' ability to support real world economic activities.

My testimony will address the impetus to this latest regulatory capital production, the procedural and substantive shortcomings thus far, and some suggestions for any future sequels.

A Brief History

Prior to releasing the Basel III endgame proposal, Vice Chair Barr undertook a nine-month, "holistic review" of current capital requirements. This review was important because "[c]apital requirements are multi-layered with different components" and the "requirements function as a system."⁵ He disclosed the results of this review in a speech, concluding that the "existing approach to capital requirements is sound," but nevertheless announcing his intent to pursue a broad set of changes to risk-based requirements, stress testing, and capital buffers.⁶ The review, which provided the rationale for many aspects of the Basel III endgame proposal, does not appear to have been memorialized in any form other than his speech. This invited questions about the analytical rigor of such review, including the failure to release publicly any underlying data that exists,⁷ and the agencies' piecemeal approach to implementing the conclusions from it has frustrated the public's ability to comment in meaningful fashion. As Vice Chair Barr noted: "Banks manage their operations with an eye on the entire system, and as such, adjustments to one part of the regime may imply adjustments to another."⁸

Two weeks after the announcement of the holistic review's conclusions, the Federal banking agencies released their Basel III endgame proposal. Its substantive and procedural shortcomings have been detailed at length before this Committee.⁹ Among other things, these shortcomings include lack of factual support, absence of rigorous or informed cost benefit analysis, failure to disclose underlying data and assumptions, disregard for statutory tailoring requirements, and material deviations from the capital neutral intent of the Basel Committee on Banking

⁵ Michael S. Barr, Federal Reserve Vice Chair for Supervision, "Holistic Capital Review" (July 10, 2023), available at <https://www.federalreserve.gov/newsevents/speech/barr20230710a.htm>.

⁶ *Id.*

⁷ See, e.g., Letter from Patrick McHenry, Chairman of the House Financial Services Committee, *et al* to Michael S. Barr, Martin J. Gruenberg, and Michael J. Hsu (Sept. 13, 2023), available at https://financialservices.house.gov/uploadedfiles/2023-09-13_fsc_gop_letter_to_bank_regulators.pdf.

⁸ Michael S. Barr, Federal Reserve Vice Chair for Supervision, "Holistic Capital Review" (July 10, 2023), available at <https://www.federalreserve.gov/newsevents/speech/barr20230710a.htm>.

⁹ See, e.g., House Financial Institutions and Monetary Policy Subcommittee Hearing, "Implementing Basel III: What's the Fed's Endgame?" (Sept. 14, 2023), available at <https://financialservices.house.gov/calendar/eventsingle.aspx?EventID=408961>; House Financial Institutions and Monetary Policy Subcommittee Hearing, "Rules Without Analysis: Federal Banking Proposals Under the Biden Administration" (Jan. 31, 2024), available at <https://financialservices.house.gov/calendar/eventsingle.aspx?EventID=409121>.

Supervision’s (BCBS) international framework¹⁰ as well as from that framework’s limited scope of application to internationally active banks.¹¹

Several months elapsed before the banking agencies took steps to gather the data that should have informed its proposal in the first place. In October 2023, the Federal Reserve launched a voluntary data collection effort inviting the banks subject to its proposal to submit information on the proposal’s impact, with a particular focus on the impact to risk-weighted assets.¹² But the deadline for responding to the voluntary data collection effort was exactly the same day as the deadline for providing comments on the Basel III endgame proposal. Thus the agencies ensured that public comments could not possibly be informed by any data collected. Although Vice Chair Barr has stated that the Federal Reserve intends to publish its analysis of the information collection exercise and to invite public comments, it has yet to do so.¹³

As hinted by statements from Federal Reserve officials over the course of 2024 promising “broad and material” changes, Vice Chair Barr’s speech earlier this month set forth the changes he intends to recommend to the Federal Reserve. These include “all major areas of the rule.”¹⁴ But considerable uncertainty remains. Substantively, we do not yet know whether the Federal Reserve will accept the Vice Chair’s recommendations, much less whether the FDIC or OCC will. And the generalities of a speech are no substitute for an actual proposal, which could incorporate some, all, or none of the Vice Chair’s recommendations, and make additional changes as well. As to process, it is unclear whether the Federal Reserve (and the other banking agencies) will re-propose the rule in full or, as Vice Chair Barr suggests, merely a portion of it.¹⁵ Such a process is, at a minimum, highly irregular and leaves commenters in the unenviable place of speculating on the meaning of any omissions from the original proposal as well as what areas, if any, are already agreed to among the agencies. We should expect – and administrative law may demand – more from a rulemaking process addressing one of the most complex and consequential aspects of U.S. banking regulation.

¹⁰ See Basel Committee on Banking Supervision, “Basel III: Finalising post-crisis reforms” (Dec. 7, 2017), available at <https://www.bis.org/bcbs/publ/d424.htm>.

¹¹ The Basel III endgame proposal applies to many banking organizations that are not internationally active.

¹² See Federal Reserve, “Federal Reserve Board launches data collection to gather more information from the banks affected by the large bank capital proposal it announced earlier this year” (Oct. 20, 2023), available at <https://www.federalreserve.gov/newsevents/pressreleases/bcreg20231020b.htm>.

¹³ See *The American Banker*, “Regulators will take comments on Basel III endgame impact analysis” (Jan. 9, 2024), available at <https://www.americanbanker.com/news/regulators-will-take-comments-on-basel-iii-endgame-impact-analysis>.

¹⁴ Michael S. Barr, Federal Reserve Vice Chair for Supervision, “The Next Steps on Capital” (Sept. 10, 2024), available at <https://www.federalreserve.gov/newsevents/speech/barr20240910a.htm>.

¹⁵ See *id.* (noting “While these proposed changes affect some of the most important aspects of the proposals, the agencies have not made final decisions on any aspect of the re-proposals, **including those that are not explicitly addressed in the re-proposal**. The public should not view **any omission** of a potential change in these re-proposals as an indication that the agencies will finalize a provision as proposed. We continue to consider comments already received on the 2023 proposal, and we will consider those comments together with any comments submitted on the re-proposals as part of any final rulemakings.” [emphasis added]).

Observations and Recommendations

The agencies' decision to propose another round of regulatory capital revisions in 2023 is not the result of any direct congressional mandate. Rather, as the name implies, it stems in the first instance from the agencies' "commitment" to implement a 2017 BCBS framework, which represented "unfinished business" from the 2008 financial crisis. In the second and third places, it stems (at least rhetorically) from Vice Chair Barr's holistic review and the bank failures of spring 2023, respectively. The fundamental point is that this current rulemaking exercise is undertaken on the agencies' own initiative; unlike the regulatory capital tailoring of 2019, which it seeks to undo,¹⁶ the Basel III endgame proposal lacks any direct and explicit congressional mandate.

Nor is the Basel III endgame an exercise in which the banking agencies are merely applying their technical expertise to implement a preexisting policy mandate.¹⁷ On the contrary, the banking agencies are engaged in weighing and making trade-offs that balance system risk tolerance with economic growth. Their decisions about which risk weights to apply and which calculation methodologies to employ for specific risks and exposures will drive bank behaviors and alter credit allocation going forward. These are questions of vast economic and political significance that will impact the structure of the U.S. banking industry and the economy it supports. If the original proposal was unhinged from informed analysis, Vice Chair Barr's recommendation to re-propose with lower aggregate capital increases than the original does nothing to allay concerns that the entire exercise was nothing more than one of political opportunism and expedience.¹⁸ And, to the extent the agencies are currently engaged in political horse-trading over pending rules like the Basel III endgame and other related proposals, surely Congress is a better forum for that than the interagency process.

As Vice Chair Barr has noted, the Basel III endgame proposal is part of a larger and interconnected framework. For example, the agencies have also proposed – again, on their own initiative – a long-term debt requirement for large banks that are not G-SIBs. The amount of debt a bank would have to hold under that proposal depends upon the revised risk weights under the Basel III endgame. It is thus impossible for a bank to know what amount of debt it would have to issue under the long-term debt proposal until the Basel III endgame proposal is finalized. The agencies therefore have no way to determine the impact of the long-term debt rule in the absence of a final Basel III endgame rule. Accordingly, the long-term debt proposal should be shelved at least until the Basel III endgame proposal is resolved. And even this is not the limit of the capital rules' complexity. Other aspects of the capital framework include stress testing, various capital buffers, and the enhanced supplementary leverage ratio. Absent a comprehensive vision, preferably one specified by the legislative branch, it is impossible to assess the overall impact of any one change to the capital framework in isolation.

¹⁶ See, e.g., Written Testimony of Andrew Olmem, House Financial Institutions and Monetary Policy Subcommittee Hearing, "Implementing Basel III: What's the Fed's Endgame?" (Sept. 14, 2023), available at <https://docs.house.gov/meetings/BA/BA20/20230914/116339/HHRG-118-BA20-Wstate-OlmemA-20230914.pdf>.

¹⁷ See *id.*

¹⁸ See Bank Policy Institute Statement on Vice Chair Barr Announcement (Sept. 11, 2024), available at <https://bpi.com/bpi-statement-on-vice-chair-barr-announcement/>.

Agency entrepreneurialism is a problem. As with the Basel III endgame proposal, when agencies undertake major regulatory initiatives absent a congressional mandate, their reforms lack credibility and may be increasingly vulnerable to legal challenge. Too often agency initiatives provide convenient cover for the agencies' own shortcomings in carrying out the missions assigned them with the authorities Congress has given them. Agency entrepreneurialism can also be a distraction from issues that require agency leadership and resources, whether they be matters of personnel management or bank supervision.¹⁹

To address some of the problems that have been the hallmark of the Basel III endgame rulemaking, Congress should provide the agencies with more explicit legislative direction on matters like regulatory capital that inherently and unavoidably involve political and economic trade-offs of major significance. Likewise, if the current, statutory deposit insurance scheme is to be altered through imposition of a long-term debt requirement on large banks, then Congress should be the one to do so.²⁰ The banking agencies lack the political (and possibly legal) legitimacy to make these decisions on behalf of the American public. Congress should also direct the agencies on the role they may play in future BCBS initiatives and the role such initiatives should play in the agencies' regulatory and supervisory agendas. The current BCBS capital framework bears little to no resemblance to the 1988 accord, and, as others have noted, we are overdue for a reconciliation of that process to American interests.²¹

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The agencies' latest adventure in regulatory capital has been an unforced error. It has consumed vast agency resources and leadership attention that should have been spent elsewhere. Hardly an "endgame," a more realistic moniker might be the Basel III Infinity War. Ultimately, as this Committee has demonstrated over the course of the Basel III rulemaking process, congressional engagement can improve agency process and substance, and I encourage this Committee's continued and indispensable oversight.

Thank you again for the opportunity to testify. I look forward to your questions.

¹⁹ See, e.g., Report for the Special Review Committee of the Board of Directors of the Federal Deposit Insurance Corporation (April 2024), available at <https://www.fdic.gov/sites/default/files/2024-05/cleary-report-to-fdic-src.pdf>; Review of the Federal Reserve's Supervision and Regulation of Silicon Valley Bank (April 2023), available at <https://www.federalreserve.gov/publications/files/svb-review-20230428.pdf>.

²⁰ See Andrew Olmem, "From FDICIA to Silicon Valley Bank: the Evolution of the Systemic Risk Exception," *The Banking Law Journal* (Sept. 2023).

²¹ See, e.g., William M. Isaac, *The American Banker*, "It's time for the US to withdraw from the Basel capital accords" (Sept. 9, 2024), available at <https://www.americanbanker.com/opinion/its-time-for-the-us-to-withdraw-from-the-basel-capital-accords>.