

January 16, 2024

Ms. Ann E. Misback  
Secretary  
Board of Governors of the Federal Reserve System  
20th Street and Constitution Avenue NW  
Washington, DC 20551  
Docket No. R-1813, RIN 7100-AG64

Mr. James P. Sheesley  
Assistant Executive Secretary  
Attention: Comments/Legal OES  
Federal Deposit Insurance Corporation  
550 17th Street NW  
Washington, DC 20429  
RIN 3064-AF29

Mr. Benjamin McDonough  
Chief Counsel  
Office of the Comptroller of the Currency  
400 7th Street, NW  
Suite 3E-218  
Washington, DC 20219  
Docket ID OCC-2023-0008

***Re: Regulatory Capital Rule: Large Banking Organizations and Banking Organizations with Significant Trading Activity***

Dear Ms. Misback, Mr. Sheesley, and Mr. McDonough:

We, the undersigned scholars of banking and finance, submit this letter in support of the federal banking agencies' proposed regulatory capital rule for large banking organizations and banking organizations with significant trading activity (the "Proposed Rule").<sup>1</sup> The Proposed Rule would better calibrate large banks' capital requirements to the risks they pose to society and, in doing so, would reduce the likelihood of financial crises that could devastate the economy. At the same time, the Proposed Rule would enhance large banks' resilience and ensure that they are able to continue lending to households and businesses throughout the economic cycle. Accordingly, we urge the agencies to adopt the Proposed Rule.

In this letter, we make four main points. First, bolstering large banks' capital buffers will make the banking system safer and more efficient. Second, rather than impairing credit availability, the Proposed Rule will better equip large banks to supply credit during periods of economic or financial stress. Third, specific elements of the Proposed Rule—including reduced reliance on internal bank models, improved calibration of the market risk framework, and application of certain capital rules to large regional banks—are critical to reducing risks in the banking system. Fourth, several common criticisms of the Proposed Rule are inaccurate and unconvincing. We conclude by encouraging the agencies to finalize the Proposed Rule without weakening its provisions. Doing so will strengthen the U.S. banking system and, by extension, the availability of financial services to American households and businesses.

**I. The Proposed Rule Will Make the Banking System Safer and More Efficient**

The Proposed Rule marks the culmination of the United States' implementation of the Basel Committee on Banking Supervision's framework for improving the banking system's resilience in

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<sup>1</sup> Regulatory Capital Rule: Large Banking Organizations and Banking Organizations with Significant Trading Activity, 88 Fed. Reg. 64028 (proposed Sept. 18, 2023) [hereinafter Proposed Rule].

response to the 2008 financial crisis. The Proposed Rule also begins to correct the regulatory weaknesses exposed in 2023 by three of the four largest bank failures in U.S. history. Taken together, the Proposed Rule’s enhancements to the U.S. regulatory capital framework are critical for strengthening the largest U.S. banking organizations and reducing the likelihood of future financial crises at remarkably modest, if any, cost.

As an initial matter, it is helpful to clarify what bank capital is, and what it is not. Contrary to a common misconception, bank capital is not money that is “set aside” or locked away in a vault. Bank capital requirements simply establish the minimum extent to which a bank must fund itself through equity rather than through debt. Far from being unavailable for the bank to use, bank capital is never idle. It is a source of funds that banks routinely deploy for lending, trading, and other activities.

Bank capital requirements strengthen the banking system in three ways. First, capital requirements protect banks’ safety and soundness by ensuring that they maintain a financial cushion to absorb losses. Banks prefer to fund themselves with debt because equity is a more expensive funding source from the bank’s perspective.<sup>2</sup> Banks’ reliance on debt can pose a threat to the financial system as a whole. As a result of high leverage, even modest losses can deplete a bank’s capital and impair its functioning or even render it insolvent. When a large part of the banking system is insufficiently capitalized, an adverse shock can lead to widespread failures, as the United States experienced in 2008. This vulnerability reflects a key externality: through runs, fire sales, and reduced supply of credit, a bank’s failure imposes costs on other intermediaries, as well as on households and nonfinancial firms. Capital requirements thus aim to ensure that banks internalize these spillover costs by maintaining a capital cushion sufficient to function effectively even under stress.

Second, capital requirements create better incentives for bank shareholders and executives to manage risk. In nonfinancial businesses, creditors typically discipline borrowers by demanding additional compensation for assuming a higher risk of default. These market mechanisms are less effective in banking, however, because explicit and implicit government guarantees protect bank creditors from losses in the event of a bank insolvency. This is a moral hazard problem: creditors who expect to be shielded from losses do not monitor banks and, as a result, tolerate excessive risk taking. Capital requirements ensure that shareholders have sufficient “skin in the game” to monitor and discipline bank managers. When a bank’s shareholders face more downside risk, they are more likely to insist that executives manage risk prudently. Conversely, when capital is scarce, both shareholders and managers may favor gambling for resurrection.

Third, capital requirements lower the costs to the public and to healthy banks when a poorly managed bank fails. Consider the 2023 bank failures. The collapses of Silicon Valley Bank, First Republic Bank, and Signature Bank collectively imposed an estimated \$34.1 billion loss on the Deposit Insurance

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<sup>2</sup> However, the *social* cost of equity funding is far lower than the *private* cost to banks. Legal provisions that lower the private cost of debt funding for banks—the tax deductibility of interest payments, the limited liability of shareholders in bankruptcy, and the range of public guarantees for deposits and other bank liabilities—do *not* affect the social cost. In fact, greater reliance on equity funding counters what are in effect government subsidies to bank shareholders for using debt funding. See Anat R. Admati, Peter M. DeMarzo, Martin F. Hellwig & Paul Pfleiderer, *Fallacies, Irrelevant Facts, and Myths in the Discussion of Capital Regulation: Why Bank Equity is Not Socially Expensive* (Oct. 22, 2013); see also ANAT ADMATI & MARTIN HELLWIG, *THE BANKERS’ NEW CLOTHES: WHAT’S WRONG WITH BANKING AND WHAT TO DO ABOUT IT* (2d ed., 2024); Anat R. Admati & Martin F. Hellwig, *The Parade of Bankers’ New Clothes Continues: 44 Flawed Claims Debunked* (Stanford Univ. Graduate Sch. of Bus. Rsrch. Paper No. 15-58, 2024), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2292229](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2292229).

Fund (DIF).<sup>3</sup> Had these large banks been required to maintain more capital, their shareholders would have been forced to internalize the costs of their losses. Instead, the FDIC must now recoup nearly half of these DIF losses by imposing special fees on surviving banks, with the costs ultimately falling on some combination of banks' depositors and borrowers. Absent higher capital requirements, this approach of post hoc assessments perversely subsidizes risk-taking and taxes prudent management, encouraging a race to the bottom among depositories.

In sum, capital is akin to self-insurance for the banking system. Much like the deductibles and co-pays imposed by insurers, it creates an incentive to manage risk. Within the past 15 years, policymakers have repeatedly provided extraordinary backstops to the banking system, either directly or indirectly, through Federal Reserve lending facilities, fiscal support measures, and equity injections. Stronger capital requirements like those contained in the Proposed Rule help counter the poor incentives that these rescues have fostered and can reduce the need for such extraordinary interventions in the future. The Proposed Rule will require large banking organizations to maintain capital cushions more commensurate with their risk-taking and their systemic importance, rather than relying on public backstops. Given the enormous costs of financial crises, a precautionary approach to setting large bank capital requirements is warranted.

## **II. The Proposed Rule Will Promote Credit Availability Throughout the Economic Cycle**

In addition to preventing financial crises that can devastate households and businesses, strong capital funding supports a more stable supply of credit across the economic cycle. By strengthening banks' capital cushions, the Proposed Rule will help to ensure that the largest banking organizations can continue lending even under stressful economic conditions.

Better capitalized banks lend more during economic and financial stress, precisely when households and businesses need credit the most. In general, the supply of bank credit is procyclical. When the economy slows, borrower default risk rises and banks' capital ratios typically decline, encouraging greater caution. Experience shows that better capitalized banks have a bigger cushion to support lending during challenging economic times. For example, the Basel Committee on Banking Supervision's Research Task Force observed that "a country whose banks enter a crisis with a one percentage point higher capital ratio experiences 0.29 percentage points higher annual loan and 0.18 percentage points higher GDP growth in the following five years, compared to other countries."<sup>4</sup> Thus, the task force determined, "bank capital ... significantly lower[s] the cost of a crisis by sustaining bank lending during the resulting recession."<sup>5</sup>

Because they have skin in the game, well-capitalized banks also have a stronger incentive to scrutinize potential borrowers, leading to a more efficient allocation of credit. Screening is most important in a fragile economic environment, when lenders must identify projects that will prosper in adverse conditions. Yet, it is precisely in these circumstances that the quality of lending by poorly capitalized

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<sup>3</sup> See Remarks by Chairman Martin J. Gruenberg on Oversight of Prudential Regulators Before the Committee on Financial Services, United States House of Representatives (Nov. 15, 2023), <https://www.fdic.gov/news/speeches/2023/spnov1523.html>

<sup>4</sup> Basel Comm. on Banking Supervision, *The Costs and Benefits of Bank Capital—A Review of the Literature* 10 (Bank for Int'l Settlements, Working Paper No. 37, June 2019), <https://www.bis.org/bcbs/publ/wp37.pdf>.

<sup>5</sup> *Id.* at 11.

banks often suffers: to postpone or conceal losses that might cause their failure, weak banks are prone to sustain lending to zombie firms, helping to transform cyclical recessions into persistent stagnation.<sup>6</sup>

Recent U.S. experience also confirms that raising capital requirements is consistent with sustained credit creation and economic expansion. In the aftermath of the 2008 financial crisis and the Dodd-Frank Act of 2010, policymakers substantially increased bank capital requirements during what became the longest U.S. expansion on record. Focusing on bank performance and credit availability between 2013 and 2019, one analysis found that banks made *more* loans and maintained their profitability, even as they increased their capital levels.<sup>7</sup> The authors concluded: “To be as clear as we can possibly be, higher capital requirements have not hurt banks [and] they have not hurt borrowers ... [I]t is difficult to find any social costs associated with increasing capital requirements and improving the resilience of the financial system.”<sup>8</sup> This assessment is consistent with the Basel Committee’s Research Task Force, which found that “in normal times, bank capital does not seem to be negatively correlated with loan growth.”<sup>9</sup>

In theory, an extremely high capital requirement might impede bank lending, but the Proposed Rule does not come close to reaching this tipping point. There is an ample body of literature assessing the economic trade-offs associated with higher capital requirements. While the results are sensitive to assumptions and modeling techniques, the weight of the evidence suggests that setting capital requirements for large banks in the range contemplated by the Proposed Rule poses little risk of impairing the supply of credit. As a result, in the steady state, a slightly lower equilibrium interest rate probably would be sufficient to offset fully the likely minor impact on lending from the Proposed Rule. This conclusion is consistent with the banking agencies’ assessment of the Proposed Rule’s impact: “Although a slight reduction in bank lending could result from the increase in capital requirements, the economic cost of this reduction would be more than offset by the expected economic benefits associated with the increased resiliency of the financial system.”<sup>10</sup>

In addition to the broad empirical evidence on capital levels, there are two reasons specific to the Proposed Rule that it will not impair credit availability: (1) the Proposed Rule applies to less than one percent of U.S. banks, and (2) the majority of the proposed increase in capital requirements is associated with large banks’ trading and fee-generating businesses, not their lending activities.

First, the Proposed Rule applies to only 37 large banking organizations, and the biggest proposed capital increases are concentrated among eight global systemically important banks. The Proposed Rule does not apply to the nation’s 4,500 community and mid-sized banks. While large banking organizations account for a large share of financial activity, the business model of community and mid-sized banks focuses more on relationship lending, reflecting their local presence and knowledge of their communities. This relationship-based lending model is critically important for the small

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<sup>6</sup> See, e.g., Caballero, Ricardo, Takeo Hoshi & Anil K. Kashyap, *Zombie Lending and Depressed Restructuring in Japan*, 98 AM. ECON. REV. 1943 (2008).

<sup>7</sup> Stephen G. Cecchetti & Kermit L. Schoenholtz, Setting Bank Capital Requirements, *Money and Banking Blog* (Oct. 12, 2020), <https://www.moneyandbanking.com/commentary/2020/10/11/setting-bank-capital-requirements>.

<sup>8</sup> *Id.*

<sup>9</sup> See Basel Comm. on Banking Supervision, *supra* note 4, at 11.

<sup>10</sup> Proposed Rule, *supra* note 1, at 64167.

businesses that drive employment and local economic activity.<sup>11</sup> Community and mid-sized banks hold a far higher proportion of their assets in small business loans compared to large banks,<sup>12</sup> and borrowers report better outcomes when working with smaller banks.<sup>13</sup> Rather than impairing their ability to supply credit, the Proposed Rule could help level the competitive playing field for community and mid-sized banks by ensuring that the largest banking organizations maintain capital levels commensurate with their risks. For comparison, we note that the Tier 1 leverage ratio of the eight G-SIBs is only about 7%, while that of community banks exceeds 10%.<sup>14</sup>

Second, the Proposed Rule will not impair credit provision because the majority of the proposed capital increase is associated with large banks' trading and fee-generating businesses, not their lending activities. As the agencies' impact analysis shows, the proposed increase in risk-weighted assets associated with trading activity is more than double the proposed increase associated with lending.<sup>15</sup> The Proposed Rule would actually decrease risk-weighted assets for some categories of loans, including retail exposures and commercial real estate.<sup>16</sup> To the extent that the largest banks optimize their balance sheets to reduce the Proposed Rule's capital impact, those adjustments could result in a relatively greater focus on lending. As Bank Policy Institute CEO Greg Baer stated, "Clearly, under the proposal, the best thing you could do is be a bank that all it does is make loans."<sup>17</sup> In sum, the Proposed Rule will not adversely impact credit availability and, in fact, will better equip large banks to serve borrowers throughout the economic cycle.

### **III. The Proposed Rule Addresses Salient Risks in the Banking System**

In addition to strengthening large banks' capital requirements, the Proposed Rule makes several specific adjustments to the United States' regulatory capital framework that will help address salient risks in the banking system. In this section, we identify three such enhancements: (1) reducing reliance on banks' internal models, (2) enhancing the market risk framework, and (3) applying appropriately stringent capital rules to Category III and IV banking organizations.

#### **1. Reducing Reliance on Internal Models**

The Proposed Rule improves the existing capital framework by standardizing the calculation of banks' credit and operational risk capital requirements instead of relying on banks' internal models. Since the United States implemented Basel II, the largest U.S. banking organizations have used internal models to calculate their risk-weighted assets for credit, operational, and market risk. Although banks' internal models in theory enhance the capital framework's risk sensitivity, significant flaws with this approach

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<sup>11</sup> See Eldar Beiseitov, *Small Banks, Big Impact: Community Banks and Their Role in Small Business Lending*, FED. RSRV. BANK OF ST. LOUIS (Oct. 20, 2023), <https://www.stlouisfed.org/publications/regional-economist/2023/oct/small-banks-big-impact-community-banks-small-business-lending>.

<sup>12</sup> See BD. OF GOVERNORS OF THE FED. RSRV. SYS., AVAILABILITY OF CREDIT TO SMALL BUSINESSES (Oct. 2022), <https://www.federalreserve.gov/publications/2022-october-availability-of-credit-to-small-businesses.htm>.

<sup>13</sup> See FED. RSRV. BANKS, 2023 REPORT ON EMPLOYER FIRMS: FINDINGS FROM THE 2022 SMALL BUSINESS CREDIT SURVEY 7 (2023), [https://www.fedsmallbusiness.org/-/media/project/smallbizcredittenant/fedsmallbusinesssite/fedsmallbusiness/files/2023/2023\\_sbcs-employer-firms.pdf](https://www.fedsmallbusiness.org/-/media/project/smallbizcredittenant/fedsmallbusinesssite/fedsmallbusiness/files/2023/2023_sbcs-employer-firms.pdf).

<sup>14</sup> See Sabrina Pellerin, *Bank Capital Analysis Semiannual Update*, FED. RSRV. BANK OF KAN. CITY, (2023), [https://www.kansascityfed.org/documents/9905/Bank\\_Capital\\_Analysis\\_Report\\_-\\_2Q\\_2023\\_-\\_final.pdf](https://www.kansascityfed.org/documents/9905/Bank_Capital_Analysis_Report_-_2Q_2023_-_final.pdf).

<sup>15</sup> Proposed Rule, *supra* note 1, at 64169-70.

<sup>16</sup> See *id.*

<sup>17</sup> *Capital Wrap: A Roundup From Capitol Account's Basel Endgame Event*, CAPITOL ACCOUNT (Oct. 27, 2023), <https://www.capitolaccountdc.com/p/capital-wrap-a-roundup-from-capitol>.

have become apparent over time. For example, since each bank selects its own modeling assumptions, capital ratios are not necessarily comparable across firms. Indeed, as the agencies noted in the Proposed Rule, reliance on internal models has “produced unwarranted variability across banking organizations in requirements for exposures with similar risks.”<sup>18</sup> The Basel Committee has likewise found that inconsistency in modeling assumptions may skew a bank’s capital ratio by as much as five percent.<sup>19</sup> In addition, although supervisors attempt to back-test banks’ internal models to ensure that they do not inappropriately underestimate risk exposure, empirical validation using historical data is often limited by the fact that severe credit risk and operational risk losses occur sporadically. Reliance on banks’ internal models also introduces unnecessary complexity into the capital framework and inhibits market participants from accurately assessing banks’ financial condition.

To address these issues, the Proposed Rule disallows the use of internal models for credit and operational risk and instead requires large banking organizations to use standardized approaches. The proposed standardized methodologies under the expanded risk-based approach are meaningful improvements over internal models. Most importantly, the proposed standardized methodologies will enhance consistency across firms, ensuring that large banks maintain a comparable amount of capital for similar risk exposures. Further, the standardized methodologies will increase transparency and comparability so that supervisors and market participants may more accurately gauge large banking organizations’ capital adequacy. The use of standardized methodologies for credit and operational risk will also help simplify aspects of the capital framework that have become excessively complex. For these reasons, the agencies should adopt their proposal to reduce reliance on internal models for credit and operational risk.

## 2. Enhancing the Market Risk Framework

In 2012, the banking agencies implemented the Basel 2.5 reforms to correct some of the most glaring weaknesses in the market risk capital framework that were exposed by the 2008 financial crisis.<sup>20</sup> It was widely understood, however, that these initial reforms would be followed by a more comprehensive reevaluation of the market risk framework. To that end, the Basel Committee has undertaken a decade-long fundamental review of the trading book to assess what improvements are necessary. The Proposed Rule would implement key aspects of the Basel Committee’s fundamental review in the United States and thereby better protect large banking organizations against risks arising from their trading activity.

The proposed changes to the market risk framework are critical improvements to ensure that banks with significant trading activity maintain adequate capital cushions. Two enhancements are particularly notable. First, the Proposed Rule would better account for tail risk by replacing the existing value-at-risk measurement with an expected shortfall approach that is calibrated to a period of significant stress. This change will ensure that banks are better prepared to withstand low-probability, high-impact trading losses. Second, while the Proposed Rule retains an option for banks to use internal models to measure market risk, it would require more stringent supervisory approval of those models at the trading-desk level. Shifting the model approval process from the banking organization level to individual trading desks will ensure that only trading desks that can accurately reflect their risk via

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<sup>18</sup> Proposed Rule, *supra* note 1, at 64031.

<sup>19</sup> Basel Comm. on Banking Supervision, *Regulatory Consistency Assessment Programme (RCAP)—Analysis of Risk-Weighted Assets for Credit Risk in the Banking Book 3* (Bank for Int’l Settlements, April 2016), <https://www.bis.org/bcbs/publ/d363.pdf>.

<sup>20</sup> Risk-Based Capital Guidelines: Market Risk, 77 Fed. Reg. 53060 (Aug. 30, 2012).

internal models are permitted to use this methodology to calculate their risk-weighted assets.<sup>21</sup> Taken together, these two reforms to the market risk framework will better protect against the types of trading losses that banks experienced in 2008.

### 3. Applying Appropriate Capital Rules to Category III and IV Banking Organizations

Finally, the Proposed Rule will ensure that large regional banks with between \$100 billion and \$700 billion in assets—so-called Category III and IV banking organizations—are subject to appropriate capital rules. When initially implementing Basel III, the banking agencies exempted banking organizations with less than \$250 billion in assets from certain key provisions, including the supplementary leverage ratio, the operational risk capital framework, and the requirement to recognize the effects of accumulated other comprehensive income (AOCI) in capital.<sup>22</sup> As a result, large regional banks were allowed to opt out of recognizing the capital impact of unrealized losses on their available-for-sale (AFS) investment securities. In 2019, policymakers further relaxed capital rules for large regional banks, permitting banks with up to \$700 billion in assets to exclude AOCI's capital impact, among other regulatory “tailoring.”<sup>23</sup>

A lasting lesson of the 2023 turmoil is that large regional banking organizations should be subject to a capital framework that is more closely aligned with the very largest banks. The banking turmoil in early 2023 highlighted that distress experienced by Category III and IV banking organizations can destabilize the broader system.<sup>24</sup> Moreover, as a result of the extraordinary interventions by the banking agencies to stem the panic and resolve the failed banks, investors may expect a similar treatment for Category III and IV banks in the future. That is, they will again expect policymakers to invoke systemic risk exceptions as needed to restore stability even in cases where the relevant banks egregiously failed to manage risk.<sup>25</sup> To limit the resulting moral hazard, such banks must be subject to appropriately stringent capital rules that will compel them to internalize the potential spillovers from their failure.

The Proposed Rule will help ensure that the surviving Category III and IV banking organizations operate within a capital framework that is commensurate with the consequences of their potential failure. Most notably in light of recent events, the Proposed Rule will eliminate the AOCI opt-out for Category III and IV banking organizations, thereby requiring them to recognize unrealized losses on AFS securities in their regulatory capital. In addition, the proposal will require Category IV banks to comply with the supplementary leverage ratio and the countercyclical capital buffer in light of their macroprudential significance. The Proposed Rule will further mandate that Category III and IV banks, which had previously been exempted from advanced approaches requirements, calculate their capital

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<sup>21</sup> Empirical evidence has shown that banks strategically underreport risks in their trading books when they have lower equity capital, suggesting that stronger supervisory oversight of internal models is warranted. See Taylor A. Begley, Amiyatosh Purnanandam & Kuncheng Zheng, *The Strategic Underreporting of Bank Risk*, 30 REV. FIN. STUDS. 3376 (2017).

<sup>22</sup> Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Capital Adequacy, Transition Provisions, Prompt Corrective Action, Standardized Approach for Risk-weighted Assets, Market Discipline and Disclosure Requirements, Advanced Approaches Risk-Based Capital Rule, and Market Risk Capital Rule, 78 Fed. Reg. 62018 (Oct. 11, 2013).

<sup>23</sup> Changes to Applicability Thresholds for Regulatory Capital and Liquidity Requirements, 84 Fed. Reg. 59230 (Nov. 1, 2019); Prudential Standards for Large Bank Holding Companies, Savings and Loan Holding Companies, and Foreign Banking Organizations, 84 Fed. Reg. 59032 (Nov. 1, 2019).

<sup>24</sup> For a discussion of the 2023 banking turmoil, see SVB AND BEYOND: THE BANKING STRESS OF 2023 (Viral V. Acharya, Matthew P. Richardson, Kermit L. Schoenholtz & Bruce Tuckman, eds., 2023).

<sup>25</sup> 12 U.S.C. § 1823(c)(4)(G).

ratios under the “dual stack” approach. This reform will ensure that Category III and IV banks’ capital requirements are appropriately robust and risk sensitive. This change will not substantially increase regulatory burden because the new expanded risk-based approach is generally based on standardized methodologies and will not require Category III and IV firms to implement the complex internal models that were previously the basis for the advanced approaches.

#### **IV. Criticisms of the Proposed Rule Are Unconvincing**

Opponents of stronger capital requirements for large banking organizations have advanced several arguments against the Proposed Rule. In this section, we address three such criticisms: (1) the Proposed Rule will increase systemic risks by shifting financial activity to nonbanks; (2) the Proposed Rule will impair U.S. banks’ international competitiveness; and (3) the banking agencies lack legal authority to implement the Proposed Rule. As we explain below, each of these claims lacks merit.

##### **1. Effect on Nonbanks**

Critics of the Proposed Rule have alleged that strengthening capital requirements for large banking organizations will increase systemic risks by shifting financial activity to the lightly regulated nonbank sector. However, it is not necessarily the case that bolstering large bank capital requirements will cause financial activity to migrate to nonbanks. In fact, large banks may compete even more effectively when the Proposed Rule is implemented because stronger capital cushions will better prepare them to withstand fluctuations in the economic cycle. Indeed, as previously mentioned, one analysis that focused on the impact of Dodd-Frank and Basel III on credit provision found that banks *increased* their share of credit provision to the nonfinancial sector between 2013 and 2016.<sup>26</sup> Moreover, academic research has shown that some nonbank financial companies already maintain twice as much equity capital funding as comparable banks.<sup>27</sup> These findings demonstrate that bank capital requirements alone are not determinative of how the financial sector provides credit to the real economy.

In any case, the migration of financial activity to nonbanks is no justification for allowing large banking organizations to operate with insufficient capital. Where the nonbank sector poses significant risks to financial stability, the proper response is to address these risks directly. Policymakers have mechanisms, including through the Financial Stability Oversight Council, to mitigate risks to financial stability posed by nonbank financial companies. Policymakers should use these tools to ensure that these companies do not trigger another financial crisis. The banking agencies should not, however, shirk their statutory responsibility to protect the safety and soundness of the banking system merely to keep financial activity within the banking perimeter.

##### **2. International Competitiveness**

Opponents of the Proposed Rule also contend that stronger capital requirements will impair U.S. banks’ international competitiveness. This is a popular argument whenever the banking agencies propose to strengthen domestic safeguards, including when the United States implemented Dodd-Frank and Basel III after the 2008 crisis. Empirical evidence demonstrates, however, that concerns

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<sup>26</sup> Cecchetti & Schoenholtz, *supra* note 7.

<sup>27</sup> Erica Jiang, Gregor Matvos, Tomasz Piskorski & Amit Seru, *Banking Without Deposits: Evidence from Shadow Bank Call Reports* (Nat’l Bureau of Econ. Rsch., Working Paper No. 26903, 2020).

about international competitiveness are misguided. Indeed, after the United States implemented Dodd-Frank and Basel III over the banking sector’s “gold plating” objections, U.S. banks outperformed their European competitors.<sup>28</sup> In the decade following Dodd-Frank, U.S. banks beat European banks on stock price appreciation, net interest margin, and return on assets, among other performance metrics.

U.S. banks’ outperformance makes sense precisely because capital makes our financial system strong and resilient. The real risk to international competitiveness is not stronger capital rules, but rather lax prudential regulation. Indeed, the trend of U.S. banks outperforming European banks eventually reversed in 2023, after the United States rolled back some of its post-2008 safeguards and experienced another banking crisis due, in part, to lax oversight of large regional banks.<sup>29</sup> The lessons are clear: U.S. banks perform best when they are subject to appropriate prudential regulation and the system as a whole is resilient to adverse shocks.

Even if stronger capital rules were to cause some financial activity to migrate overseas, the banking agencies should not prioritize banks’ international competitiveness over the stability of the U.S. financial system. Unlike certain jurisdictions, such as the United Kingdom, U.S. regulators do not have a statutory mandate to promote the financial sector’s international competitiveness.<sup>30</sup> Instead, Congress instructed the banking agencies to prioritize the safety and soundness of the U.S. banking system. This policy choice was both deliberate and wise, because setting financial regulatory policy to maximize international competitiveness would assuredly lead to a destructive race-to-the-bottom. As Bank of England Governor Andrew Bailey observed with respect to the UK’s international competitiveness mandate from before the 2008 financial crisis: prioritizing international competitiveness “didn’t end well for anyone.”<sup>31</sup>

### 3. Legal Authority

Finally, critics have contended that the agencies lack legal authority to adopt the Proposed Rule. Nothing could be further from the truth. Congress has granted the banking agencies wide discretion to set capital requirements and thereby protect the banking system. The International Lending Supervision Act (ILSA) directs the banking agencies to “cause banking institutions to achieve and maintain adequate capital by establishing minimum levels of capital for such banking institutions and by using such other methods as the appropriate Federal banking agency *deems appropriate*.”<sup>32</sup> ILSA likewise grants the banking agencies authority to “establish such minimum level of capital for a banking institution as the appropriate Federal banking agency, *in its discretion*, deems to be necessary or appropriate in light of the particular circumstances of the banking institution.”<sup>33</sup> ILSA’s legislative

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<sup>28</sup> See, e.g., Matheiu Simoens & Rudi Vander Venet, *Bank Performance in Europe and the US: A Divergence in Market-to-Book Ratios*, 40 FIN. RSCH. LETTERS 101672 (2021).

<sup>29</sup> See, e.g., Robin Wigglesworth, *Europe is Having a Better Banking Crisis Than the US*, FIN. TIMES (Mar. 23, 2023), <https://www.ft.com/content/81e811d1-e45e-47f5-b70e-1a4638b43010>.

<sup>30</sup> See Financial Services and Markets Act 2000, § 1EB (instructing the Financial Conduct Authority to “facilitate[e] the international competitiveness of the economy of the United Kingdom (including in particular the financial services sector)”).

<sup>31</sup> Andrew Bailey, Chief Exec., Fin. Conduct Auth., *The Future of Financial Conduct Regulation* (Apr. 23, 2019), <https://www.fca.org.uk/news/speeches/future-financial-conduct-regulation>.

<sup>32</sup> 12 U.S.C. § 3907(a)(1) (emphasis added).

<sup>33</sup> 12 U.S.C. § 3907(a)(2) (emphasis added).

history makes clear that Congress intended for the banking agencies to have wide latitude in establishing capital requirements:

The Committee believes that establishing adequate levels of capital is properly left to the *expertise* and *discretion* of the agencies. Therefore, in order to clarify the authority of the banking agencies to establish adequate levels of capital requirements, to require the maintenance of those levels, and *to prevent the courts from disturbing such capital*, the Committee has provided a specific grant of authority to the banking agencies to establish such levels of capital.<sup>34</sup>

Nothing in the Dodd-Frank Act or any subsequent legislation curtailed the agencies' legal authority to set capital requirements as they deem appropriate. Critics contend that the Proposed Rule violates the Economic Growth, Regulatory Relief, and Consumer Protection Act's (EGRRCPA's) "tailoring" mandate, which requires the Federal Reserve to "differentiate among companies on an individual basis or by category."<sup>35</sup> This claim is incorrect. The EGRRCPA's tailoring provision applies only to "enhanced prudential standards" that the Federal Reserve issues pursuant to section 165 of the Dodd-Frank Act. The Proposed Rule, however, does not establish enhanced prudential standards pursuant to Dodd-Frank—rather, it sets minimum capital adequacy requirements as required by ILSA. Indeed, it is clear that the Proposed Rule relies on the banking agencies' broad authority under ILSA, not the Dodd-Frank Act, because all three agencies issued the proposal jointly, whereas only the Federal Reserve has authority to establish enhanced prudential standards under Dodd-Frank. Moreover, the Proposed Rule applies to insured depository institutions that are not owned by bank holding companies, which are exempt from section 165 of Dodd-Frank. Thus, allegations that the Proposed Rule violates the EGRRCPA's tailoring provision are inaccurate because the Proposed Rule does not rely on Dodd-Frank's statutory authority.

Finally, even if the EGRRCPA's tailoring provision did apply, the Proposed Rule does not violate it. The tailoring provision requires the Federal Reserve to "differentiate among companies on an individual basis or by category, *taking into consideration their capital structure, riskiness, complexity, financial activities . . . , size, and any other risk-related factors that the Board of Governors deems appropriate.*"<sup>36</sup> As discussed above, the failures of Silicon Valley Bank, Signature Bank, and First Republic Bank in early 2023 had devastating effects on the U.S. financial system, and two of these failures prompted policymakers to invoke the systemic risk exception. The Proposed Rule's establishment of stronger capital rules for Category III and IV banking organizations is consistent with EGRRCPA's tailoring mandate in light of these firms' demonstrated systemic importance. Moreover, the Proposed Rule maintains distinctions between Category I banking organizations and smaller, but still systemically important, firms. For example, Category I banking organizations remain subject to the G-SIB surcharge and the enhanced supplementary leverage ratio, while Category II, III, and IV banking organizations are not. In sum, the Proposed Rule is appropriately tailored to address the risks of various different types of banks.

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<sup>34</sup> S. Rep. No. 98-122, at 16 (1983) (emphasis added).

<sup>35</sup> 12 U.S.C. § 5365(a)(2).

<sup>36</sup> *Id.*

In closing, the Proposed Rule is an important step toward completing the Basel Committee’s post-2008 regulatory framework and correcting regulatory weaknesses exposed by the 2023 banking turmoil.<sup>37</sup> Once implemented, the Proposed Rule will strengthen large banking organizations’ capital cushions, reduce the likelihood of future financial crises, and position large banks to remain a source of credit to households and businesses throughout the economic cycle. We urge the banking agencies to finalize the Proposed Rule without delay and without weakening its provisions.

Sincerely,

Anat R. Admati  
George G.C. Parker Professor of Finance and Economics  
Graduate School of Business  
Stanford University

Hilary J. Allen  
Professor of Law  
American University Washington College of Law

Richard Berner  
Clinical Professor of Finance  
NYU Stern School of Business

John Y. Campbell  
Morton L. and Carole S. Olshan Professor of Economics  
Harvard University

Stephen G. Cecchetti  
Rosen Family Chair in International Finance  
Brandeis International Business School

John Crawford  
Professor of Law  
UC Law San Francisco

Kent Daniel  
Jean-Marie Eveillard/First-Eagle Professor of Business  
Columbia Business School

Darrell Duffie  
Adams Distinguished Professor of Management and Professor of Finance  
Graduate School of Business  
Stanford University

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<sup>37</sup> We note that although the Proposed Rule begins to correct regulatory weaknesses exposed by the 2023 bank failures, additional reforms are also necessary, including strengthening the supervisory framework for large banking organizations.

Adam Feibelman  
Sumter Davis Marks Professor of Law  
Tulane University Law School

Anna Gelpern  
Scott K. Ginsburg Professor of Law and International Finance  
Georgetown University Law Center

Jeffrey N. Gordon  
Richard Paul Richman Professor of Law  
Columbia Law School

Samuel G. Hanson  
William L. White Professor of Business Administration  
Harvard Business School

Kathryn Judge  
Harvey J. Goldschmid Professor of Law  
Columbia Law School

Jeremy C. Kress  
Assistant Professor of Business Law  
University of Michigan Stephen M. Ross School of Business

Lev Menand  
Associate Professor of Law  
Columbia Law School

Todd Phillips  
Assistant Professor of Legal Studies  
Georgia State University J. Mack Robinson College of Business

Amiyatosh Purnanandam  
Michael Stark Professor of Finance  
University of Michigan Stephen M. Ross School of Business

Saule T. Omarova  
Beth and Marc Goldberg Professor of Law  
Director, Jack Clarke Program on the Law and Regulation of  
Financial Institutions and Markets  
Cornell University

Jonathan A. Parker  
Robert C. Merton (1970) Professor of Finance  
MIT Sloan School of Management

Paul Pfleiderer  
C.O.G. Miller Distinguished Professor of Finance  
Graduate School of Business  
Stanford University

Uday Rajan  
David B. Hermelin Professor of Business Administration  
Professor of Finance  
University of Michigan Stephen M. Ross School of Business

Kermit Schoenholtz  
Clinical Professor Emeritus  
NYU Stern School of Business

Heidi Mandanis Schooner  
Professor of Law  
Columbus School of Law  
The Catholic University of America

Amit Seru  
The Steven and Roberta Denning Professor of Finance  
Graduate School of Business, Stanford University  
Senior Fellow, The Hoover Institution

Adi Sunderam  
Professor of Finance  
Harvard Business School

Lawrence J. White  
Robert Kavesh Professor of Economics  
NYU Stern School of Business

David A. Wishnick  
Associate Professor of Law  
Georgetown University Law Center

Arthur E. Wilmarth, Jr.  
Professor Emeritus of Law  
George Washington University Law School

Jeffery Y. Zhang  
Assistant Professor of Law  
University of Michigan Law School