THORN RUN PARTNERS
GOVERNMENT RELATIONS

Hearing Summary

January 31, 2024

HFSC PANEL SCRUTINIZES BASEL III PROPOSAL

EXECUTIVE SUMMARY

On January 31, the House Financial Services (HFSC) Subcommittee on Financial Institutions and Monetary Policy held a hearing entitled "Rules Without Analysis: Federal Banking Proposals Under the Biden Administration" focusing on the Federal Reserve (Fed), Federal Deposit Insurance Corporation (FDIC), and Office of the Comptroller of the Currency's (OCC) Basel III Endgame capital proposal. The discussion featured testimony from industry experts who shared their views on the proposal, as well as what they saw as opportunities for change. Notably, there was bipartisan opposition to the proposal on several issues, including credit availability, risk weights for mortgages and small business loans, and treatment of tax equity in relation to certain tax credits, among others.

Subcommittee Republicans were unanimously critical of the prudential regulators' proposal over a perceived lack of adequate quantitative economic analysis and "arbitrary" approach to various metrics used in the proposal. On the other hand, Democrats appeared to be divided on the impact the capital proposal will have. Several Democrats on the panel defended the rule, arguing that it is necessary to prevent another financial crisis or additional slews of regional bank failures. However, other Democratic lawmakers voiced concern that the mortgage provisions may discourage mortgage lending in low-income communities.

OPENING STATEMENTS

Chair Andy Barr (R-KY) (statement) voiced concern about the Basel III Endgame proposal, which he deemed under-analyzed and influenced by politics. He criticized the perceived lack of analysis and administrative procedures in the regulatory process, emphasizing that rules without adequate analysis could lead to unintended consequences. Chair Barr urged regulators to reevaluate and start over, ensuring proper quantitative analysis and adherence to the Administrative Procedure Act (APA).

Ranking Member Bill Foster (D-IL) emphasized the importance of maintaining safety and soundness in the banking system to prevent a repeat of the 2008 financial crisis. He acknowledged the challenges in balancing the costs and benefits of raising capital requirements, expressing concern about potential unintended consequences and the difficulty in predicting how changes in regulations might affect the broader economy and the behavior of banks.

Witness Testimony

Mr. Greg Baer (testimony), of the Bank Policy Institute, highlighted concerns about the proposed capital rule by federal banking agencies, emphasizing its potential impact on the cost of credit for businesses and consumers. He criticized its lack of analytical rigor and reliance on outdated risk weights, arguing that the proposal fails to consider historical experience and imposes "arbitrary" surcharges. Additionally, Mr. Baer raised objections to the elimination of the advanced approach for credit risks and the substantial increase in capital requirements, suggesting that the agencies should withdraw the proposal, provide a more transparent analysis, and seek public input.

Mr. Bryan Bashur (testimony), of Americans for Tax Reform, argued that the proposal, aimed at heightening regulations on banks with over $100 billion in assets, "circumvents congressional intent, abuses regulatory discretion, and is arbitrary and capricious." Mr. Bashur expressed concerns about the potential negative impact on borrowing costs, dividends, share repurchases, and the availability of credit cards and mortgage loans, suggesting that such "micromanagement" is inappropriate for private banks.

Mr. Randall Guynn (testimony), of Davis Polk, argued that the proposal would act like an excise tax that raises the cost and reduces the supply of credit to businesses and families. Mr. Guynn highlighted concerns about the impact on regional banks, increased market risk capital requirements, international discrepancies, potential shifts of credit to non-bank financial institutions, and a lack of supporting data and rigorous cost-benefit analysis.

Mr. Jeremy Kress (testimony), of the University of Michigan, offered support for the Basel III proposal. He asserted that the rules would enhance the safety and efficiency of the banking system, reduce the need for public bailouts during financial crises, and promote credit availability throughout economic cycles. Mr. Kress criticized the banking sector for spreading "misinformation" in resistance to these proposals, emphasizing the importance of stronger capital requirements in sustaining credit creation and economic expansion.

Discussion and Questions

Mortgages

- **Rep. Bill Posey (R-FL)** echoed Subcommittee Republican interest in inquiring how the proposal's adjustments to the risk-weighted asset (RWA) framework might increase capital requirements for banks. Using mortgages as an example, Mr. Baer noted that the adjustments will increase the amount of capital needed to be held against mortgages and argued that regulators have not justified the need for these adjustments. Mr. Guynn suggested that the RWA adjustments adversely impact small businesses, explaining that they do not qualify for lower risk weights on their assets because they do not have publicly-traded securities. Mr. Bashur voiced concern over how holding credit cards as off-balance-sheet exposure may impact the supplementary leverage ratio (SLR), arguing that it will hinder the ability of Category IV banks' ability to issue new credit.

- **Reps. David Scott (D-GA)** and **Gregory Meeks (D-NY)** asked Mr. Kress if he has seen any indication to suggest that regulators are open to revisiting the proposal's treatment of high loan-to-value (LTV) residential mortgages. Mr. Kress indicated that regulators plan to factor in comments received with respect to residential mortgage provisions. Rep. Scott wondered whether Mr. Kress was concerned about the proposal's requirement that banks hold more capital against certain residential mortgages. Mr. Kress asserted that much of the mortgage lending he is referring to is conducted by smaller community banks that are not affected by the proposal. However, there was broad bipartisan concern over how the proposal treats various mortgages.
- Rep. Scott pressed Mr. Baer on what the impact on mortgages would be with the new risk weights, compounded with operational risk charge and stress tests. Mr. Baer argued that the impact would be "profound," pointing to a downward trend of mortgage origination inside the traditional banking system.

Impact on Banks

- Chair Barr pressed Mr. Baer to discuss the Basel III proposal's treatment of market risk and how it might impact credit availability. Mr. Baer suggested that the proposal's market risk provisions are duplicative to existing market risk-measuring requirements.
- Chair Barr prompted Mr. Baer to comment on the proposal's ban on the use of internal risk models, voicing concern that this may "homogenize" risk across the banking sector. Mr. Baer noted that regulators have not raised any concerns with the use of the existing Standardized Approach or Advanced Approach risk modeling methodologies.
- Chair Barr asked Mr. Guynn to refute Fed Vice Chair for Supervision Michael Barr's assertion that the proposal will only "modestly" affect banks. Mr. Guynn pointed to the Operational Risk and Market Risk provisions as areas likely to have the most substantial impact on banks, arguing that the proposal will likely increase the cost of capital, which he reiterated in questioning with **Rep. John Rose (R-TN)**.
- Pushing back on the assertion that the proposal has duplicative risk measures, Ranking Member Foster questioned whether existing stress measures account for factors such as geopolitical risk — pointing to a hypothetical scenario in which China invades Taiwan. Mr. Baer contended that the existing stress methodologies — namely, the Global Market Shock (GMS) and Fundamental Review of the Trading Book (FRTB) — are designed to simulate dire economic conditions and suggested that capitalizing banks on these assumptions is overly burdensome. Mr. Kress disagreed, arguing that the Fed's existing stress test did not measure against a rising interest rate environment in the case of Silicon Valley Bank (SVB).
- Rep. Rose asked how the Basel III proposal and long-term debt (LTD) requirement rulemaking might impact foreign banking organizations' (FBO) ability to finance foreign direct investment (FDI) in the U.S. Mr. Baer contended that FBOs will face many of the same capital charges that U.S. banks do, increasing the cost of operating in the U.S.
- **Reps. Roger Williams (R-TX)** and **Young Kim (R-CA)** inquired how the Basel III proposal may place U.S. banks at a competitive disadvantage globally. Mr. Bear acknowledged that the impact on competitiveness will vary but said that it will be most noticeable in financial markets.

- **Rep. Joyce Beatty (D-OH)** asked whether the proposal decreases risk weights for all small businesses or only a subset. Mr. Kress noted that the risk weight would not change for private businesses and would decrease for their publicly-traded counterparts. Rep. Beatty wondered what changes could be made to ensure small businesses are not disadvantaged. Mr. Kress explained that regulators are constrained in that they are not allowed to use credit ratings to set risk weights.

Renewable Energy Tax Credit

- **Reps. Brad Sherman (D-CA), Ralph Norman (R-SC),** and **Blaine Luetkemeyer (R-MO)** criticized the proposal's treatment of available-for-sale (AFS) versus held-to-maturity (HTM) securities. They were also concerned about potential impacts on small businesses, municipal bonds, lack of credit for private mortgage insurance (PMI), and the treatment of green energy tax credits.
- **Rep. Sean Casten (D-IL)** voiced concern that the proposal will reduce the ability of banks to invest in renewable energy projects. Mr. Baer acknowledged that this outcome is likely.
- **Rep. Scott Fitzgerald (R-WI)** questioned whether regulators' granting of an exception for green energy tax credits would jeopardize the Fed's political independence. Mr. Bashur suggested that it would be a "bad message."
- **Full Committee Ranking Member Maxine Waters (D-CA)** asserted that Basel III would have averted the three regional bank failures in the spring of 2023, a view that Mr. Kress agreed with. Echoing her Republican colleagues, Rep. Kim pushed back on this notion, arguing that the failure of SVB was due to liquidity rather than capital.
- Rep. Meeks inquired how the various collective provisions in the proposal might interact with one another. Mr. Baer noted that the overlay between operational risk and credit risk has not been considered, adding that "punitive" charges on securitization may make it more difficult for institutions to make mortgage and auto loans.
- **Rep. Byron Donalds (R-FL)** asked if banks are competitive to other forms of raising capital, such as private equity or venture capital. Mr. Guynn insisted that this may exacerbate the trend of credit issuance occurring outside the traditional banking system. Mr. Baer added that while it is an issue that non-banks do not face the same regulatory scrutiny as traditional banks, the greater concern is that non-banks are not structured to function as durable lenders.
- Reps. Fitzgerald and Kim wondered whether newly proposed bank merger guidance — coupled with Basel III and the LTD requirement — would lead to increased consolidation to address compliance burdens. Mr. Guynn suggested that the two run contrary to one another, adding that increasing difficulty for regional banks to engage in mergers will weaken banks as they attempt to meet the compliance costs associated with the Basel III proposal. He urged for legislation to make the merger process more transparent.
- **Rep. William Timmons (R-SC)** pressed Mr. Baer to discuss how regulators could adjust the LTD requirement to minimize its economic impact. Mr. Baer suggested that the proposed calibration rate is too high and should be lowered. Referencing the three-year compliance period, Rep. Timmons asked Mr. Baer what the consequences may be of an "artificial" flood

of LTD into the market. Mr. Baer acknowledged this concern, adding that that the $400,000 minimum threshold may prevent institutional investors from purchasing the debt.

Other Topics

- Several Republicans on the panel, led by Chair Barr, were critical of regulators for not conducting a quantitative impact study in conjunction with the release of the rule.
- **Reps. Barry Loudermilk (R-GA)** and **Andy Ogles (R-TN)** raised the notion of regulators withdrawing the rule to address the various issues that have been highlighted. Mr. Baer agreed that this would be appropriate.
- Rep. Beatty prompted Mr. Kress to comment on whether the proposal constitutes a violation of the APA. Mr. Kress asserted that it did not, arguing that it contains the most “substantial” impact study he has seen.