HFSC Subcommittee Discusses Prudential Rulemakings

Executive Summary

On Sept. 25, the House Financial Services (HFSC) Subcommittee on Financial Institutions and Monetary Policy held a hearing on various prudential rulemakings, with a particular focus on regulators' Basel III Endgame capital proposal and long-term debt (LTD) proposal. During the hearing, members on both sides of the aisle generally expressed some optimism regarding the Basel proposal following a speech by Federal Reserve (Fed) Vice Chair for Supervision Michael Barr outlining various potential changes two weeks prior. Nonetheless, lawmakers continued to voice some reservations. Subcommittee Republicans raised concerns over the proposal's treatment of market risk and fee and commission income, as well as its potential impact on lending and U.S. competitiveness. Some Democrats also voiced concern that the rulemaking could limit credit access — including for underserved communities and residential mortgage loans — and brought up issues with its operational risk calibration and risk weighting of loans to non-publicly traded companies.

There was also some bipartisan opposition to regulators' LTD rulemaking as currently proposed. Republicans, their invited witnesses, and **Rep. Gregory Meeks (D-NY)** agreed that that proposal should not move forward until regulators' Basel III Endgame proposal is finalized and implemented, as well as that regional banks should have the flexibility to hold debt at the holding company level rather than both the insured depository institution (IDI) and holding company level under the LTD proposal. Additional subjects raised included the spring 2023 bank failures, the Federal Deposit Insurance Corporation's (FDIC) proposed rule on brokered deposits, and diversity disclosures.

Opening Statements

Chair Andy Barr (R-KY) (statement) reiterated committee members' concerns over the potential effects of the Basel III proposal on mortgage markets, tax credits, various business models, and financial products such as derivatives. He said that, while some of the proposed changes to the Basel III proposal outlined by Fed Vice Chair Barr in his recent speech are "encouraging," there is still "considerable work" to be done, especially regarding its treatment of market risk. He contended that Vice Chair Barr offered only "limited hints" as to what a re-proposal may contain and noted that, despite the Vice Chair's claim that the changes would be voted on "soon," no vote has yet been held. The Chair also briefly criticized various other rules proposed by prudential regulators on LTD, brokered deposits, bank mergers, and executive compensation, saying that there has been a lack of cost-benefit analysis to determine the combined impact of these rulemakings.

Ranking Member Bill Foster (D-IL) remarked that he was "encouraged" to hear Fed Vice Chair Barr address concerns raised by committee members regarding treatment of residential mortgages, tax equity investments in renewable energy, and investments in companies that are investment grade but not publicly traded. However, he pointed out that, while some of the changes outlined by the Vice Chair sound good "in theory," lawmakers have not yet seen the text of regulators' Basel III re-proposal, and he accordingly called the present hearing "premature" and speculative. The Ranking Member referred to regulators' Basel III proposal, LTD proposal, and forthcoming liquidity proposal as "essential" and important to "get right." He concluded by voicing concern that the European Union (EU) may delay aspects of its Basel reforms due to inaction in the U.S.

WITNESS TESTIMONY

Mr. Jonathan Gould (testimony), of Jones Day, spoke of a need for greater clarity regarding prudential regulators' plans for capital requirements. He cited uncertainty around whether some, or any, of Fed Vice Chair Barr's proposed changes to the Basel III Endgame proposal will be accepted, as well as whether that rulemaking will be re-proposed in full or in part. Mr. Gould called for lawmakers to provide U.S. banking agencies with more explicit legislative direction on matters such as regulatory capital that involve political and economic trade-offs, and he concluded that the agencies lack the political, and potentially even legal, "legitimacy" to make these decisions.

Mr. Kenneth Bentsen, Jr. (testimony), President and CEO of SIFMA, said that it is important for Congress and other policymakers to ensure that capital requirements entail an "appropriate" balance between financial stability and macroeconomic growth. He applauded Fed Vice Chair Barr's recent comments as a welcome "first step" but voiced concern that the Basel III proposal may still increase capital requirements by nine percent above current levels. Mr. Bentsen outlined various recommendations for a re-proposal, including: (1) addressing overlaps with stress tests and other capital requirements; (2) accounting for interactions and overlaps between the Global Market Shock (GMS) and Fundamental Review of the Trading Book (FRTB); (3) providing credit for diversification in the FRTB; (4) including changes to facilitate banks' ability to use internal models; and (5) allowing commercial end users of over-the-counter derivatives to receive more favorable treatment

Dr. Marc Jarsulic (testimony), of the Center for American Progress, made four main points. First, he contended that the U.S. banking system and economy benefit from strong regulatory capital rules. Second, a proposed requirement that unrealized gains and losses on securities be included in regulatory capital ratio calculations for banks with assets above $100 billion is a "welcome change" that will prevent banks from avoiding acknowledgment of losses by classifying securities as "held to maturity," he said. Third, Dr. Jarsulic claimed that regulators' proposed risk-based capital requirements will not "sufficiently" raise minimum bank equity or substantially improve the chances that the GSIBs and other banks would stay solvent when faced by shocks. He concluded that regulators should take action on strong leverage requirements.

DISCUSSION AND QUESTIONS

Basel III Endgame & Capital Requirements

- Citing a rumor that the Basel re-proposal would leave untouched the market risk components of the original rulemaking, Chair Barr prompted Mr. Bentsen to explain why this would be bad for economic growth. Mr. Bentsen warned that this could raise the cost for banks to engage in capital markets activities, as well as result in banks pulling back in certain areas.
- Chair Barr prompted Mr. Bentsen to discuss how under the original Basel III proposal there would be an additional cost to hedging interest rate risk. Mr. Bentsen pointed to the proposal's treatment of cleared and uncleared derivatives, which he said was inconsistent with other jurisdictions and would inform a capital tax on hedging activities.
- Ranking Member Foster asked Dr. Jarsulic how research by the Fed and other, unspecified experts on the "socially optimal" level of capital for U.S. banks has informed his thinking on how regulators should approach capital rules. Dr. Jarsulic voiced his agreement with some conclusions that: (1) higher ratios of equity to risk-weighted assets would reduce the likelihood of financial crisis; and (2) a "significant" increase in risk-weighted capital ratios would produce net economic benefits.
- When **Rep. Roger Williams (R-TX)** asked how the Basel III proposal might impact bank lending and the cost of credit for small businesses, Mr. Gould cautioned that it could result in either re-pricing or banks exiting higher-cost business lines.
- Reps. Williams and **John Rose (R-TN)** noted that, while U.S. regulators' Basel III re-proposal may increase capital requirements by nine percent, the Bank of England's implementation of Basel III will result in a combined increase of less than one percent and the EU's will result in a less than six percent increase. Mr. Gould agreed that this would harm U.S. firms' global competitiveness and that U.S. regulators' proposal should be capital neutral.
- **Full Committee Ranking Member Maxine Waters (D-CA)** pointed out that, although the Basel Committee adopted guidelines for Basel III back in 2017, regulators under the Trump administration did not act on them, and she criticized Republicans and industry stakeholders for seeking to block regulators' current Basel III proposal.
- Ranking Member Waters questioned the argument that Basel III would result in reduced bank lending. Dr. Jarsulic asserted that banks with higher levels of equity-to-asset ratios are more easily able to obtain financing that can be used for lending and thus that capital requirements are in fact a benefit for credit creation.
- Echoing Chair Barr, Rep. Rose contended that issues remain with regulators' Basel proposal following Fed Vice Chair Barr's speech, particularly regarding its market risk component. He warned that higher capital charges on underwriting and market-making would raise the costs for local governments, businesses, and others to access capital markets.
- **Rep. Brad Sherman (D-CA)** called for regulators to remove from their Basel re-proposal what he called a "discount" — namely, a 65 percent rather than 100 percent risk weight — for loans to publicly-traded companies. When Rep. Meeks later asked about the potential impact of higher capital charges for lending to non-financial companies and other public and private entities that are not publicly traded, Mr. Bentsen expressed his hope that regulators

will adjust the rule to treat non-publicly traded but investment-grade businesses the same as publicly traded companies.

- Rep. Sherman questioned the idea that Basel III will "burden" the underwriting process and deny access to capital markets for companies going public or local governments issuing bonds. When prompted, however, Mr. Bentsmen did not have time to answer.
- Rep. Meeks said that he was "encouraged" by Fed Vice Chair Barr's acknowledgment that "broad and material" changes to the Basel proposal are warranted, citing his and other lawmakers' concerns around the proposal's potential "unintended consequences" — particularly for underserved and minority communities seeking small business credit and mortgage loans — and operational risk calibration.
- When **Rep. Scott Fitzgerald (R-WI)** raised concern that regulators' Basel III re-proposal may still require banks to hold capital against fee and commission income, Mr. Bentsen said that he was "encouraged" by Fed Vice Chair Barr's proposal to allow certain deductions or credits for fee-based income.
- **Rep. Juan Vargas (D-CA)** voiced concerns that regulators' Basel III proposal would increase the cost of loans for banks, and in particular lending to small businesses and homeowners. Mr. Bentsen agreed that increased capital requirements would make it more expensive for banks to do various types of lending, including mortgage lending.
- **Rep. Young Kim (R-CA)** asked whether a 60-day comment period is sufficient to examine and offer input on regulators' Basel III re-proposal. Messrs. Gould and Bentsen answered in the negative, citing a need for time to compare the re-proposal to the original proposal and conduct a quantitative impact analysis.
- Rep. Kim expressed her concern that U.S. regulators "have not thought through" how the Basel standards should apply to foreign banks operating in the U.S., saying this risks retaliation against U.S. banks operating abroad. Mr. Bentsen agreed this is a valid concern.

Long-Term Debt

- Rep. Williams asked whether regulators should delay their LTD rulemaking until their Basel III proposal has been finalized and implemented. Mr. Bentsen agreed that they should.
- Rep. Sherman expressed his hope that U.S. prudential regulators will require banks to mark-to-market all their LTD.
- **Rep. Barry Loudermilk (R-GA)** wondered whether purported internal disagreements between the Fed and FDIC on Basel III Endgame's implementation may also in turn delay implementation of other prudential proposals, including on LTD. Mr. Gould declined to speculate but expressed his view that these other proposals should be delayed.
- When prompted by Rep. Meeks, Messrs. Gould and Bentsen agreed that regulators should not move forward with their LTD rule until both the Basel III rulemaking is finalized and changes to the LTD proposal are made, including giving regional banks the same flexibility as global banks to hold debt at the holding company level rather than both the IDI and holding company level. Rep. Fitzgerald similarly called for regional banks to have this flexibility under regulators' LTD proposal.
- Pointing to a "significant gap" between regulators' and industry stakeholders' cost estimates for the LTD proposal, **Rep. William Timmons (R-SC)** wondered about the impact of

potentially underestimating the proposal's costs. Mr. Gould said that it is incumbent on the regulators to consider these different cost estimates.
- When asked by Rep. Timmons what aspects of regulators' LTD proposal should be adjusted, Mr. Bentsen reiterated a call to change the requirement that LTD be held at both the holding company and IDI level. The witness also expressed opposition to the proposed minimum denomination requirement of $400,000.

Spring 2023 Bank Failures

- Chair Barr asked Mr. Gould whether he believed that regulatory tailoring was responsible for the failures of Silicon Valley Bank (SVB) and Signature Bank, as well as whether it is legal for regulators to undo this tailoring. Mr. Gould answered in the negative, attributing the failures to management decisions coupled with rapid interest rate increases. Chair Barr concurred.
- When Ranking Member Waters asked whether the failure of SVB entailed a problem with capital, Dr. Jarsulic said that it occurred because the bank was insufficiently capitalized.
- Rep. Timmons accused U.S. banking agencies of pursuing regulatory proposals that have "nothing to do with" the spring 2023 bank failures.
- **Rep. Al Green (D-TX)** voiced concern over the speed with which bank runs now occur, noting the run on SVB and the role of social media. Dr. Jarsulic agreed that this is a concern.

Additional Matters

- Ranking Member Foster questioned whether many federal judges and lawmakers are capable of parsing and understanding financial regulatory language following the Supreme Court's decision in *Loper Bright* overturning the *Chevron* doctrine, which directed courts to defer to agency interpretations of ambiguous statutes. While he agreed that this is a "fair point," Mr. Bentsen maintained that it is Congress's role to be involved in the regulatory process.
- Rep. Fitzgerald warned that reducing access to brokered deposits could limit community banks' lending capacity. Mr. Gould agreed that the FDIC's proposed rule on these deposits could reduce liquidity options for these banks. When Rep. Fitzgerald asked how the FDIC's proposal on brokered deposits would potentially limit options for retail investors, Mr. Bentsen claimed that the proposal lacks independent analysis and would raise costs for non-affiliated and bank-affiliated broker-dealers.
- Rep. Meeks highlighted his Improving Corporate Governance Through Diversity Act (H.R.4177), which would require public companies to disclose the gender, race, ethnicity and veteran status of their board directors, nominees, and senior executive officers on an annual basis. When prompted, all witnesses agreed that diversity can be good for business.
- **Rep. Sean Casten (D-IL)** brought up the House-passed GUARDRAIL Act (H.R.4790), which would, among other provisions, remove the designation of a Fed Vice Chair for Supervision and limit regulators' ability to work with global financial governance organizations. He asked why it is useful for U.S. regulators to engage with these global entities. Dr. Jarsulic explained that bodies such as the Basel Committee offer the U.S. the opportunity to address regulatory problems and argue for more effective and efficient regulation.

Rep. Monica De La Cruz (R-TX) raised concern over the combined impact of prudential regulators' rulemakings — including on Basel III, LTD, and the global systemically important bank (GSIB) surcharge — particularly regarding community banks.