January 16, 2024

Ann E. Misback
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Ave. NW
Washington, DC 20551

Chief Counsel's Office
Attention: Comment Processing
Office of the Comptroller of the Currency
7th Street SW
Suite 3E-218
Washington, DC 20219

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

Re: Regulatory Capital Rule: Large Banking Organizations with Significant Trading Activity
Docket No. R-1813, RIN 7100-AG64 (Federal Reserve)
Docket ID OCC-2023-0008 (OCC)
RIN 3064-AF29 (FDIC)

Via regs.comments@federalreserve.gov

Dear Ms. Misback:

I am pleased to submit these comments regarding the rule jointly proposed by the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation (collectively, the "proposing agencies") entitled "Regulatory Capital Rule: Large Banking Organizations with Significant Trading Activity."[1]

The proposed rule's actual changes to the Code of Federal Regulations amount to 160 pages.[2] The proposed rule contains, by my count, 74 complex formulas and over 25 tables assigning risk weights to various types of assets and operations. The idea that the proposing agencies are going

[1] "Regulatory Capital Rule: Large Banking Organizations with Significant Trading Activity," Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation, Proposed Rule, *Federal Register*, Vol. 88, No. 179, September 18, 2023 https://www.govinfo.gov/content/pkg/FR-2023-09-18/pdf/2023-19200.pdf. The comment period was extended until January 16, 2024. See "Global Systemically Important Bank Holding Companies; Systemic Risk Report (FR Y–15); Extension of Comment Period," The Board of Governors of the Federal Reserve System, *Federal Register*, Vol. 88, No. 207, October 27, 2023, p. 73772.
[2] From page 64183 to page 64343 of the proposing release, or 160 pages.

to mandate methodology that accurately predicts risk is, even on average, unlikely. They have a poor record of having done so in the last several financial crises – opining each time that all was well until it most assuredly and most obviously was not. The idea that one set of highly prescriptive rules is going to accurately predict risks for all of the financial institutions subject to those rules, given their high degree of heterogeneity, is simply mistaken. Finally, the idea that highly prescriptive rules published in 2023 are going to accurately predict risk years into the future after markets have evolved, exogenous risks have changed and monetary, fiscal and regulatory policies in the United States and abroad have changed is also simply mistaken. In short, the method of ensuring the safety and soundness of U.S. banking institutions chosen by the proposing agencies in this proposed rule is fundamentally poorly conceived. It will not achieve the objective it is designed to achieve. It will, however, enrich countless lawyers, accountants, compliance officers and consultants. It will enlarge the budgets and staff counts at the proposing agencies. And it will make our capital markets less flexible, less efficient, and more costly.

The proposing agencies should focus instead on promoting honest accounting, rather than permitting or encouraging fictitious accounting. They should encourage rather than impede the ability of banks to off-load risks to reinsurers. They should encourage increased transparency and robust capital standards by banks.

Mark-to-Market versus the 'Held to Maturity' Fiction

Assets such as long-term bonds, preferred stock and rental real estate with long-term leases not indexed to inflation will decline in value when interest rates rise. This is basic finance. The present discounted value of a fixed (or relatively invariant) future income stream declines when the discount rate rises. One need not to be a finance genius to understand that when interest rates were approaching the lower bound of zero that they had nowhere to go but up. Yet this fact appears to have escaped the notice of bank regulators and more than a few bankers. It is the primary reason for SVB's failure. But SVB had plenty of company.

Unrealized losses on bank securities are now approximately ten times quarterly bank earnings. Unrealized losses are nearly ten times what they were in the last financial crisis. Unrealized losses amount to 32 percent of Tier 1 capital.[3] This is unprecedented in the post Great Depression period.[4] Yet requiring honest accounting for these losses is not addressed by this voluminous and extraordinarily complex rulemaking.

Were the proposing agencies to require honest accounting for these losses, it would nearly erase three years of bank earnings and demonstrate how severely degraded bank capital already is. Yet we are told by FDIC Chairman Martin J. Gruenberg that "[t]he banking industry continued to show resilience in the third quarter. Net income remained high, overall asset quality metrics remained favorable, and the industry remained well capitalized."[5] If the unrealized losses of

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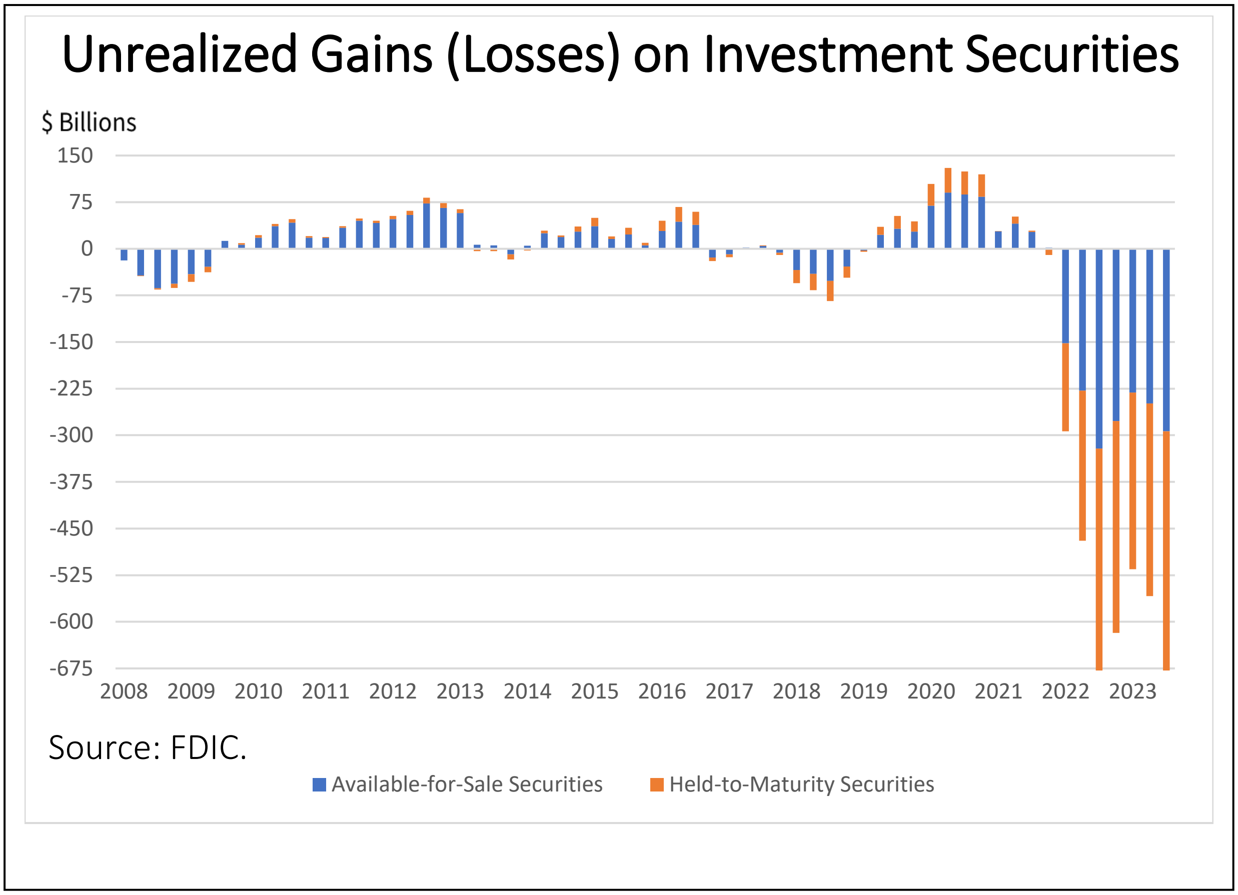
[3] "Unrealized losses on held-to-maturity securities totaled $390.5 billion in the third quarter, while unrealized losses on available-for-sale securities totaled $293.5 billion." https://www.fdic.gov/news/press-releases/2023/pr23099.html. This is a total of $684 billion, which is 32 percent of Tier 1 capital ($2,140 billion). See "Balance Sheet." https://www.fdic.gov/analysis/quarterly-banking-profile/qbp/timeseries/balance-sheet.xlsx.
[4] See, for example, FDIC Quarterly Banking Profile, Third Quater 2023, Chart 7. Unrealized Gains (Losses) on Investment Securities https://www.fdic.gov/analysis/quarterly-banking-profile/qbp/2023sep/.
[5] "FDIC-Insured Institutions Reported Net Income of $68.4 Billion in Third Quarter 2023," Press Release, FDIC,

banks were accurately accounted for, this statement would simply be untrue. And forgive me for



saying so, but this sounds a lot like Ben Bernanke's August 2007 assurance, one month before the last major financial crisis began, that "[w]e believe the effect of the troubles in the subprime sector on the broader housing market will likely be limited, and we do not expect significant spillovers from the subprime market to the rest of the economy or to the financial system."[6] History does not repeat itself but it rhymes. The graph above illustrates the magnitude of the problem.[7]

This, of course, does not reflect the potentially large losses that are likely coming from commercial and other rental real estate loans. These loans are likely to become troubled for two reasons. First, vacancy rates are high and rental income is declining.[8] Second, building owners will start to experience major cash flow issues as they start to refinance their mortgages at much higher interest rates provided that they can find lenders at all.

November 29, 2023 https://www.fdic.gov/news/press-releases/2023/pr23099.html.

[6] "Bernanke sees no Spillover from Mortgage Woes," Reuters, August 9, 2007 https://www.reuters.com/article/idUSWBT006985/.

[7] FDIC, Quarterly Banking Profile, Third Quarter 2023, Chart 7. Unrealized Gains (Losses) on Investment Securities https://www.fdic.gov/analysis/quarterly-banking-profile/qbp/2023sep/.

[8] Certainly, relative to expectations and projections. For large commercial operations, there may be an absolute decline in real terms.

For safety and soundness regulatory purposes, historical cost is irrelevant. What is relevant is the fair market value of the assets held by an institution. In other words, what price can the institution be reasonably expected to receive if it cannot hold the asset to maturity but must sell the asset to pay liabilities (either depositors or other short-term liabilities)? An "economic reality" rule should apply. Not the fictional "held to maturity" world of bank managements where historical cost governs and real-world economic losses are ignored. Although it is a disservice to the investing public, FASB[9] and the SEC can continue to indulge the fictional accounting by banks with respect to securities that bank managements designate as "held to maturity" securities. Banking regulators cannot afford to do so. If the assets have declined in value, potentially dramatically so, then so has the bank's capital and its ability to meet its liabilities. Bank capital for regulatory purposes should reflect this reality. Banks should be required mark their assets to market for purposes of safety and soundness capital adequacy regulation. This requirement should apply to any asset for which there is an active secondary market. This would include, but not be limited to, all Treasury notes and bonds, all foreign sovereign notes and bonds, virtually all corporate bonds, publicly traded equities and most swaps, futures and many other derivatives.

The accounting for the losses on the underlying asset and for any gains on a hedging transaction (or vice versa) should be symmetrical. Ergo, a bank that fully hedged its risk would show no net losses (or gains).

Reinsurance

The proposing agencies should expand the definition of "eligible guarantor" to permit credit risk transfer using reinsurance by well capitalized insurance companies and meaningful capital relief for reinsurance credit risk transfer. If a bank has shifted risk to a third-party (by acquiring insurance and paying a premium), the banking regulations should not simply ignore that fact and treat the insured loan (or other asset) as if it subjected the bank to the same level of risk as an uninsured loan or asset. Banking regulations should reflect reality and the reality is that an insured asset poses less risk to the bank (and the FDIC insurance fund for that matter) than does an uninsured asset. Moreover, it is generally desirable, for safety and soundness reasons, for banks to off-load risk to the extent that they can cost-effectively do so. Banking regulations should not irrationally impede their ability to do so.

Inadequate Economic Analysis

In a 316-page proposing release making 160 pages in CFR changes, containing about 74 complex formulas and over 25 tables assigning risk weights to various types of assets and operations, the economic analysis runs 4 ½ pages long.[10] A reader of this economic analysis will search in vain for a justification of the various assigned risk weights or an analysis of why the chosen formulas and models are appropriate or any better than the models or formulas used by banks that they will replace. Such justification is not provided. The reason is probably that it simply does not exist but that instead the entire rulemaking is an exercise of arbitrariness.

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[9] Statement of Financial Accounting Standards No. 115, "Accounting for Certain Investments in Debt and Equity Securities," Financial Accounting Standards Board, May 1993. See especially "Held-to-Maturity Securities."
[10] Proposing release, pp. 64167-64171.

The proposed rule is the most detailed, voluminous, mathematical exercise in arbitrariness that I have ever read, but it is nonetheless an exercise in arbitrariness. The proposing agencies are saying, in effect, do this because we say so and not because there is any factual, empirical or theoretical predicate for the choices manifest in this extraordinarily complex and prescriptive rulemaking. The lawyers wrote the rules and the economists were forced to come up with some kind of plausible sounding justification.

Most the four and half pages is a variation on the theme that higher capital requirements have benefits and costs and the proposing agencies think the benefits outweigh the costs. Why? Because the proposing agencies say so, citing a few academic studies showing that higher capital requirements have benefits and costs. But the economic analysis actually says nothing about this rule and the choices it imposes on our capital markets.

Two examples should suffice to illustrate my point.

> While this increase in requirements could lead to a modest reduction in bank lending, with possible implications for economic growth, the benefits of making the financial system more resilient to stresses that could otherwise impair growth are greater. [p. 64169 (col. 3)]
>
> Similarly, while increases in market risk capital requirements could have some spillover impact on lending, increases in capital requirements in general should also enhance the resilience of the banking system, supporting lending and economic activity in downturns. [p. 64170 (col. 1)]

But there is absolutely nothing in the economic analysis justifying **this** rule, **this** set of risk assignment, **this** set of models, and **this** set of formulas. Nothing.

The proposing agencies should do better and seriously consider less prescriptive and less burdensome alternatives. There should be an actual factual predicate for rules this prescriptive. But the proposing release gives no indication that there is. The rule should be withdrawn.

Sincerely,

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