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Ann E. Misback

Secretary, Board of Governors of the Federal Reserve System

Attn: Comments – RIN 7100–AG64

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Dear Secretary Misback:

This is a comment on the proposed regulation "Regulatory capital rule: Amendments applicable to large banking organizations and to banking organizations with significant trading activity" RIN 3064-AF93.

The 2007-2009 financial crisis is mentioned directly or referenced indirectly more than a dozen times throughout the proposed rule. In a majority of these appearances, the event is used as a baseline from which to justify some part of the proposed rule, however, this is an arbitrary comparison. Since the financial crisis, capital requirements and risk assessment mandates have changed significantly. (The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 is just one example of such a change, one which imposed widespread and sweeping mandates.) In fact, the justification given in the proposed rule for these new various supposed safeguards to the financial system was precisely that the changes would increase stability and reduce risk compared to the period before and during the financial crisis.

The justification for the changes already made since the 2007-2009 financial crisis means that the current environment is necessarily different than during and before that crisis. Saying otherwise would be to admit that those changes have had no effect. Therefore, the proposed rule must take those changes into account because the proposed rule is not being implemented in the

same regulatory framework that existed before and during the 2007-2009 financial crisis. Rather, the proposed rule will be in addition to, or replacing, the existing changes which have been made since that financial crisis. It is, therefore, an arbitrary comparison to say that the proposed rule will create a more stable financial system with reduced risk than what existed during and before the 2007-2009 financial crisis. In the same way, it would be equally arbitrary to compare the proposed rule to the 1929-1933 financial crisis that marked the beginning of the Great Depression.

For the proposed rule to increase stability and reduce risk in the financial system, it needs to do so from current conditions, not from a regulatory framework that no longer exists. Using any baseline other than current conditions is an arbitrary comparison which does not support or justify the proposed rule, but instead makes the changes arbitrary and capricious.

While the proposed rule contains many alleged benefits, it does not make any attempt to quantify several costs which are likely to stem from these regulatory changes, and thus it fails to produce a sufficient cost-benefit analysis. For example, there is no assessment of the proposed rule's impact on consumers, such as the tighter credit conditions which will result from a higher cost of capital. By increasing capital requirements, the proposed rule necessarily makes capital more expensive since, *ceteris paribus*, the more capital that must be kept in reserve, the less capital that can be used for lending to earn a return on investment. Scarcer capital creates tighter credit conditions which increases borrowing costs for consumers. Since the proposed rule nowhere indicates that these regulatory changes would decrease demand for consumer borrowing, the reduction of supply coupled with consistent demand will reliably result in a higher price. In this case, the price of loanable funds is the cost of borrowing, with most of those costs captured by the interest rate, although other charges to consumers are likely to rise as well. Citing only the benefits of these regulatory changes and failing to consider the tighter credit conditions for consumers renders the agency's evaluation of the proposed rule arbitrary and capricious because it is not a true cost-benefit analysis.

Likewise, the proposed rule does not make any attempt to quantify the impact on economic growth from these regulatory changes. Due to the large size of capital markets relative to the size of the national economy, even a change which is small in percentage terms can have a nominal impact of trillions of current dollars over the typical budget window of 10 years. The empirical

economic literature is quite clear that a higher cost of capital results in lower economic growth, *ceteris paribus*. Yet, there is no mention of this anywhere in the over 1,000 pages of the proposed rule.

While it is asserted that these regulatory changes will reduce the likelihood of severe financial crises, which should theoretically result in faster economic growth over time, the proposed rule must evaluate how much of that increase is offset by slower economic growth from a higher cost of capital. Indeed, the proposed rule does not even attempt to quantify how much the cost of capital would increase from higher capital requirements. Thus, the proposed rule has not even taken the first step in conducting this crucial cost-benefit analysis. First, the agency must estimate by how much the cost of capital will increase from these proposed regulatory changes. Second, the agency must estimate by how much that increased cost of capital will retard economic growth. Lastly, this cost to the economy must be compared to the alleged benefit of the regulatory changes. As the proposed rule stands now, it fails to conduct any part of this cost-benefit analysis, merely stating supposed benefits, and thus is arbitrary and capricious because the agency has not performed this mandatory process. Indeed, before empirical evidence is even presented, the agency must at least begin by making the claim of benefits exceeding costs. Even this elementary component of the rule's justification is lacking.

The proposed rule also fails to consider several other consequences of the higher cost of capital beyond lower economic growth. On a more microeconomic level, differentiation between market participants is completely ignored in several aspects of this rule. One such area is the fact that financial activity is not confined to the banking sector currently, nor would financial activity become confined to the banking sector as a result of the proposed rule. Non-bank financial institutions are already market participants and would remain so under these regulatory changes. However, those non-bank firms would not be subject to these regulatory changes. Thus, the proposed rule will affect market participants differently depending upon their status as banks or nonbanks.

The proposed rule does not evaluate this disparate impact. In fact, even the impact of the proposed rule on banks is not properly evaluated in terms of the cost of doing business. Just as the agency fails to present a cost-benefit analysis for consumers, so too does it fail to present such an analysis here. The regulatory changes in the proposed rule will increase the cost of doing

business for banks, putting them at a competitive disadvantage. There is no empirical estimation of this effect in the over 1,000 pages of the proposed rule. Conversely, nonbanks, which are not subject to these regulatory changes, will also not share in these higher costs of doing business. That means nonbanks will have relatively lower costs compared to the banks subject to this regulation and will operate with wider margins from which to offer discounts to consumers. The proposed rule provides no estimation for the magnitude of these effects.

Customers will shift from banks to nonbanks because of the relatively lower cost of credit. This shift in consumer choice will occur even if nonbanks raise prices, as long as they raise prices by less than the banks, who are passing their cost increases on to customer. The proposed rule fails to estimate the market share which will be lost by banks to nonbanks. This is important because it alters the alleged effectiveness of the regulatory changes. By failing to account for market share transferring from banks to nonbanks, the proposed rule implicitly assumes that banks will retain their market share and the same amount of capital subject to current regulation will be subject to the new regulation in the proposed rule. Making such a fundamentally unsound assumption is arbitrary and capricious. The agency fails to demonstrate that the business of banks would not shift to nonbanks, reducing the amount of capital subject to this regulatory change. Using the extreme case to illustrate the point, if all business were to leave banks and go to nonbanks, then the new capital requirements would be regulating precisely zero capital and would therefore have no effect on the stability and safety of the banking system. Meanwhile, nonbanks would now have the entirety of the capital market, and not be subject to the proposed rule. In that case, the rule has no effect and therefore none of its alleged benefits can possibly be manifested. To determine the effectiveness of the new capital requirements in the proposed rule, the agency needs to first determine how much market share will be lost by banks to nonbanks. Without this prerequisite estimation, the agency cannot possibly estimate the effectiveness of the regulatory changes. Being unsure of the degree to which the proposed rule's alleged benefits will actually be manifested renders the proposed rule arbitrary and capricious.

Similarly, the agency makes no assessment of the amount of banking business which will shift from the domestic to the international market. Just as banks can lose market share to nonbanks, so too can they lose market share to foreign banks. Because foreign banks would not be subject to the same regulatory changes under the proposed rule, they would not face the same cost increases, as outlined previously in this regulatory comment. Just as nonbanks would be at a

competitive advantage compared to banks, so too would foreign banks be at a competitive advantage over domestic banks. Nowhere in the proposed rule's over 1,000 pages is there any attempt to quantify the disparate impact of the regulatory changes on foreign versus domestic banks. Consequently, there is no empirical estimation as to how much market share would be lost by domestic banks to foreign banks. Furthermore, no empirical estimation is made as to how much this shift in market share would limit the effectiveness of the proposed rule in providing stability and safety to the financial system. Also, since domestic banks will be at a competitive disadvantage to foreign banks, domestic banks will have to hunt for yield, and therefore will take on more risk due to the risk-reward tradeoff. This higher risk taking is completely unaccounted for in the over 1,000 pages of the proposed rule. Once again, the proposed rule demonstrates its arbitrary and capricious nature by showing not even at attempt as addressing these vital issues which potentially have significant consequences on the entire justification for the proposed rule.

Just as the proposed rule will affect domestic banks differently than foreign banks and it will affect nonbanks differently from banks, so too will it affect banks differently from each other based on their relative sizes. For example, the proposed rule will have the largest impact on category 1 (Cat 1) banks, as judged by the regulatory changes and as acknowledged by the proposed rule itself. This is once again problematic because the agency does not provide a justification for this disproportionate treatment. While Cat 1 banks are classified as global systemically important banks, there is no explanation as to why the current regulation governing Cat 1 banks needs to be changed more than the current regulations governing category 2 through category 4 banks. In other words, the agency provides no reason to believe that Cat 1 banks pose more of a risk today than any other category. The fact that a bank is systemically important does not mean that the current regulatory framework is insufficient relative to a non-systemically important bank. Furthermore, because the agency has failed to perform any kind of cost-benefit analysis on the effects of the proposed rule, they have necessarily failed to perform a cost-benefit analysis on the disparate treatment of Cat 1 banks versus imposing identical requirements for all categories of banks. Without such empirical analysis, these regulatory changes are arbitrary and capricious.

There are also more granular issues with these regulatory changes. The alteration of risk weights is largely unjustified. Nowhere in the proposed rule's over 1,000 pages is an empirical analysis presented which explains precisely how these new figures were derived. Instead, the new risk

weights are simply treated as a mathematical assumption. Since no analysis is presented or even referenced, there is no reason to believe that such a crucial piece of work was ever conducted. Indeed, the reassignment of risk weights is so seemingly without reason as to support the idea that such weights were randomly assigned, with the only criteria being that the net effect of the changes would be a 30 percent increase in capital requirements. Without an empirical basis for the new matrix of risk weights, these changes are arbitrary and capricious, undermining the entire proposed rule.

Mortgage risk weights, specifically, are problematic because not only are they presented without justification or any kind of empirical analysis to support their changes, but the new mortgage risk weights also deviate materially from the Basel risk standards imposed previously. Returning, for a moment, to a topic from earlier in this regulatory comment, the proposed rule repeatedly says that its regulatory changes will help reduce the likelihood of another financial crisis like what occurred in 2007-2009. As explained previously, the agency has already implemented many regulatory changes for exactly that purpose, including the Basel risk standards. These new regulatory changes, however, would significantly alter that framework because the proposed rule deviates materially from the Basel risk standards. Importantly, the deviation is not justified and there is no explanation as to why the changes to mortgage risk weights would enhance existing regulations in the mortgage market to prevent another housing market collapse, and broader financial market collapse. Yet again, these changes to existing regulatory doctrine are arbitrary and capricious because no justification for them has been presented.

There are other examples of how the proposed rule deviates from existing regulatory frameworks without any empirical justification for these changes. Furthermore, some of the regulatory changes would increase risk within the banking system, in addition to increasing costs. The increased risk is an important consideration since the proposed rule is being implemented allegedly to reduce risk and increase stability to the baking system. For example, the regulatory changes would penalize the low utilization of credit card accounts. The empirical literature on consumer credit is quite clear that these are precisely the kinds of accounts which are the least likely to default and to incur losses for a bank, threatening capital reserves. Not only does the proposed rule fail to justify why this change would reduce risk, but it also fails to explain why this change would not increase risk. By penalizing accounts with low default risk, the proposed rule is increasing the cost of capital and incentivizing banks to reduce the number of these

relatively safe accounts while incentivizing banks to increase the number of relatively riskier accounts with higher credit utilization rates. Because the proposed rule contains this change which contradicts the agency's justification for the rule and the proposed rule provides no reasoning or logical support for such a regulatory change, the proposed rule is arbitrary and capricious. This same issue arises with mortgages where changes to the treatment of loans to people in low- and moderate-income (LMI) communities are similar to the aforementioned change in the risks assigned to credit card debts. Once again, the proposed rule makes unsupported changes to the regulatory framework by divorcing default risk from the new risk weights to be assigned to these types of debts. The further the proposed rule's new risk weights deviate from assessing default risk, the more ineffective it becomes at reducing systemic risk in the banking system and the more the proposed rule will actually increase that same systemic risk. Since there is no empirical analysis as to the effect of assigning risk weights to an asset independent of the default risks attached to those assets, this is another example of how the proposed rule is arbitrary and capricious.

Lastly, the proposed rule fails to differentiate sufficiently between various levels of quality of capital, relying too heavily on quantity. The case of Silicon Valley Bank (SVB) is a perfect example of why this distinction is so important. SVB did not fail simply because it lacked a sufficient quantity of capital. The problem with the capital held by SVB was its quality, namely that it was selling below par at the time SVB needed to increase its cash holdings to pay depositors and other outlays. The result was that each sale of a portion of SVB's capital did provide cash but also necessitated the sale of additional devalued assets. In such an environment, there would theoretically have been no sufficient level of capital to prevent SVB's insolvency if that capital were all the same quality that SVB already held. Additional devalued assets would not have solved the problem, but it would have allowed SVB to meet the regulatory changes in the proposed rule.

The failure to account for this distinction between quantity and quality is arbitrary and capricious. The proposed rule does not explain why a phenomenon which is less than one year old would not counter the alleged benefits of higher capital requirements. This also relates to stress testing of banks. While SVB was not subject to the same stress testing as larger banks, even if it were, SVB would likely have passed with better marks than its larger rivals. This is because in none of the stress testing scenarios, including the adverse, or most difficult, scenario,

the stress testing operated under the assumption that interest rates would fall, not rise. It was the increase in interest rates without appropriate hedges that caused SVB to suffer catastrophic unrealized, and then eventually realized, losses. Extending this example to the broader banking system, a lack of distinction between quantity and quality of capital can hide risk. More capital that is lower quality, whether because of interest rate risk or something else for which these regulatory changes do not account, will not increase the stability and safety of the banking system. Because the proposed rule fails to even consider this, let alone attempt any empirical analysis of the problem and the effects of the regulatory changes, it is arbitrary and capricious.

In conclusion, the proposed rule does not provide sufficient justification for the changes to capital requirements and the structure of the changes is inadequately supported, arbitrary, and capricious. I look forward to your response addressing these concerns.

Sincerely,

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Public Finance Economist