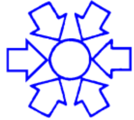 Federal Financial Analytics, Inc.

MEMORANDUM

TO: Federal Financial Analytics Clients

FROM: Karen Petrou

DATE: September 25, 2023

What struck me most about the HFSC hearing at which I testified last week was how lukewarm Democrats are to the new rules unless they feel compelled to defend the White House or core political objectives. When the partisan spotlight dimmed, more than a few Democrats said that the rules might have both small and even significant perverse consequences. Given that GOP-led repeal of the rules is impossible and court overturn is at best a lengthy process, hard work to get the rules more to the middle is essential. Even if large banks still think the rules are bad, they'll be better and that's all to the good.

What's the how-to? In short, it's a concerted campaign to fix the most problematic technical confusions in the massive body of new rules – these are manifest and manifold, focusing hard on obvious flaws and saving raging debates such as those over how big banks should be for another day. I think this approach is best not only because it avoids political landmines, but also because it works.

In the mid-2000s, a group of custody banks with which we worked laid out numerous unintended consequences in the Basel II approach to operational risk-based capital. By the time this landed in the final Basel III rules, it wasn't great, but it was a lot, lot better in terms of actually capitalizing real risk at savings mounting to billions in what would have been unnecessary regulatory capital.

My testimony lays out a road-map of problems all but the most dogged regulators have to recognize in the new proposals because assertions are based on detailed analytics. For example, it's simply indisputable that evaluating the long-term debt (LTD) proposal FSM based on current capital rules makes no sense because the agencies know that capital standards will change if they get what they elsewhere propose. What's needed is sound Measurement of what the "capital refill" model means given what the banking agencies want capital to be combined with fact-based projections of likely demand for this much LTD in a higher-for-longer regime. This will surely shake ambivalent regulators out of their political hidey-holes, forcing real change at the Fed that then presses the OCC and FDIC hard enough to redesign the rule. Repeal it they won't; revise it, they must.

Another obvious bit of nonsense in the proposals is the "higher-of" construct for credit-risk rules feeding into a mysteriously-calculated output floor. In the final Basel III end-game rules, the output floor is a limit on internal models that led to unduly-low risk-weighted asset calculations outside the U.S. However, the U.S. proposal generally does away with models. Why then have an output floor?

The only possible rationale is that it's meant as a control on new standardized charges stipulated by the banking agencies, but this still makes no sense at all. As our assessment of the credit-risk rules details, the new standardized charges are at least a little better for mortgages, small-business loans, credit for many households and larger corporations. Lowering risk weightings in these prudent ways would significantly support equitable growth. If they are wrong, why propose them? If they are right, why continue to require the higher capital charges crafted over a decade ago and perpetuate their perverse consequences?

And, while tackling tailoring per se is a political third rail, why mandate complex, costly market-risk capital calculations if a bank's market risks are immaterial? The proposal seeks comment on a materiality provision, but it never explains why this self-evident idea wasn't immediately proposed.

The only reason I can think of is that the agencies here as with a question about mortgages are waving a few bones they might throw to smaller regional banks. That's a bit of all-too-obvious stage management that should be quickly called out so that the agencies can't just concede a bit and call it quits.

And, no matter how much Democrats want the biggest banks brought to heel, how can agencies speak to the impact of the GSIB-Surcharge proposal when their numbers address only one calculation methodology, but the rule has two? Do the new Fed/FDIC living-will requirements blur the boundaries between insured depositories and parent companies to the point at which the bankruptcy resolution mandated by law for them becomes impossible? Does the FDIC's insured-depository resolution proposal in fact require banks to ensure that uninsured deposits are covered even in dissolution and, if so, are all deposits de facto insured? Is this the policy the U.S. should adopt?

Finally, when the sum total impact of all the rules is considered – and considered it must be – what kind of a banking system will the U.S. have visited upon itself? The agencies' overt and awful desire to avoid the holistic analytics Michael Barr rightly espoused at this confirmation hearing melted into the morass now before us. Clear thinking would force express policy prioritization between big-bank impregnability based on a raft of rules in concert with Fed and FDIC backstops or stringent resolution standards made unnecessary by all of the tough rules other than under exogenous emergencies when government supports rightly kick in. Instead of building banking fortresses that will be doomed business enterprises, regulators can and should ensure that even the biggest banks can be broken apart and then resolved at no cost to anyone but themselves. Stringent resolvability standards are hard, hard going that big banks won't much like, but they are better than redefining banking by dint of regulation to the point at which it disappears in any business in which anyone else thinks that there's money to be made.