CBA | CONSUMER BANKERS ASSOCIATION

January 14, 2024

Via Electronic Mail and Electronic Submission

Federal Reserve System (*via regs.comments@federalreserve.gov)*
Federal Deposit Insurance Corporation (*via comments@FDIC.gov*)
Office of the Comptroller of the Currency (*via https://www.regulations.gov*)

Re: Regulatory Capital Rule: Amendments Applicable to Large Banking Organizations and to Banking Organizations with Significant Trading Activity [R-1813]

To Whom it May Concern:

The Consumer Bankers Association ("CBA") is America's only member-driven trade association focused exclusively on retail banking.[1] Since 1919, CBA has partnered with member banks to promote sound policy, prepare the next generation of diverse bankers to lead the industry, and enable consumers' individualized approaches to the American dream.

We write to provide comment on the proposal by the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency to implement the international agreement colloquially known as "Basel III Endgame" (the "Proposal").

CBA believes it is necessary and important for banks to be adequately capitalized. However, excessive capital mandates limit growth and raise the cost of loans and other financial products. Inappropriately high capital standards will harm low- and moderate-income consumers and provide a competitive advantage to the less regulated shadow banking sector. Regulatory capital standards need to be established with these concerns in mind. Capital is an important tool to enhance bank safety and – along with appropriate macro-economic policies – can reduce the potential for future crises and mitigate their consequences when they occur, but it must be used carefully to avoid unintended consequences that would be harmful to financial inclusion and longer-term consumer financial resilience.

The Proposal's sweeping changes would have profound impacts on our members' ability to serve their customers. While regulators acknowledge that the Proposal would impact different banks in different ways, we are concerned that the Proposal is not appropriately calibrated with respect to retail banking. Regulators similarly acknowledge multiple times in the Proposal that its changes may have detrimental impacts on consumers, making this overhaul an area of particular interest and concern for CBA. Despite the Proposal's hundreds of pages, it contains no

[1] Our corporate members include the nation's largest retail banks, with 85 percent holding over $10 billion in assets.

actual analysis of the specific impacts its regulatory changes will have on consumers, much less different groups of consumers.

Accordingly, we share the attached white paper, which we incorporate as part of this comment letter, about the impact of the Proposal on consumers on the margins of the financial system. Given the Proposal's sweeping impact on American consumers, the white paper is written with lay readers and the general public in mind. We hope to broaden the conversation to a wider range of stakeholders that care about consumer financial health, but who may have little expertise in bank regulation.

Our fundamental concern is: *Is it appropriate for regulators to proceed with changes of this magnitude without first providing stakeholders enough information to understand how it will impact consumers?*

As further described in the white paper, we have concerns about many of the aspects of the Proposal. We emphasize, however, that our primary concern is with the Proposal's overall calibration and the cumulative impacts of its various components. Even if one, two or several modifications are made, the Proposal still may make it materially more difficult for low- and moderate-income consumers by virtue of its overall impact. To simply maintain the current environment for low- and moderate-income consumers, every issue discussed in the White Paper must be addressed simultaneously, and the Proposal's overall calibration must be reconsidered.

Accordingly, the following changes to the Proposal may help establish an appropriate balance between ensuring a safe and sound banking system while still freeing up enough capital for banks to maintain their lending to low- and moderate-income consumers, as well as small and medium-sized businesses:

- The Proposal's approach to operational risk capital should be rethought and recalibrated. Once it is adopted, the operational risk component of the Federal Reserve Board's stress test should be eliminated.

- The Proposal's 10 percent Credit Conversion Factor should be lowered. In no case should it be higher than 6.5 percent.

- The Proposal should retain the 25 percent deferred tax asset deduction threshold for large banks.

- The retail risk weights in the Proposal are not based on an empirical assessment of actual risk and significantly overstate that risk, in addition to being 10 percent higher across the board than the retail risk weights of the Basel framework. They require fundamental changes and should be revised downward to reflect actual risk.

- The Proposal should exclude the $1 million cap from the definition of regulatory retail exposure.

- The granularity limit should be eliminated from the definition of regulatory retail exposure.

- The definition of transactor exposure should provide for a 6-month lookback period, as opposed to a 12-month lookback period.

- A separate risk weight of 85 percent should be applied to small and medium-sized enterprises.

- The Proposal should retain the 100 percent risk weight category for non-significant equity exposures; expand the 100 percent risk weight category for equity exposures pursuant to a national legislated program; and allow an exposure to a small business investment company to continue to be treated as such if the small business investment company has voluntarily surrendered its license.

- The risk weight of the residential mortgage exposures category should be redeveloped using a risk-based, empirical analysis to more accurately reflect the risk presented by a mortgage and to avoid unnecessary and potentially harmful impacts on American homeownership, as well as low- and moderate-income and minority borrowers and communities.

- The definition of defaulted real estate exposure should clarify that an exposure that has undergone a distressed restructuring but has resumed performing its payment obligations no longer qualifies as a defaulted real estate exposure.

Ultimately, however, regulators should withdraw the Proposal to study its impacts on consumers, particularly those on the margins of our financial system. Regulators should then re-submit any modified version of the Proposal with that supporting data, so that all stakeholders can appropriately engage on the trade-offs that will ultimately be borne by the people that the Consumer Bankers Association's members and regulators should be most focused on helping.

Sincerely,

Lindsey D. Johnson
President and Chief Executive Officer
Consumer Bankers Association

Enclosure: "*The Impact of the Basel III Endgame Proposal on Consumers on the Margins of the U.S. Financial System*"

CBA | CONSUMER BANKERS ASSOCIATION

The Impact of the Basel III Endgame Proposal on Consumers on the Margins of the U.S. Financial System

A primer for regulators and the general public

Consumer Bankers Association

January 2024

The Consumer Bankers Association ("CBA") is America's only member-driven trade association focused exclusively on retail banking.[1] Since 1919, CBA has partnered with member banks to promote sound policy, prepare the next generation of diverse bankers to lead the industry, and enable consumers' individualized approaches to the American dream.

In the summer of 2023, our nation's prudential bank regulators[2] proposed a sweeping set of new bank capital regulations, which would purport to implement an international agreement colloquially known as "Basel III Endgame" (the "Proposal"). Among other changes, the Proposal would substantially revise the "risk-based capital framework" for all banks with $100 billion or more in assets.[3]

The Proposal's sweeping changes would have profound impacts on our members' ability to serve their customers. While regulators acknowledge that the Proposal would impact different banks in different ways, we are concerned that the Proposal is not appropriately calibrated with respect to retail banking. Regulators similarly acknowledge multiple times in the Proposal that its changes may have detrimental impacts on consumers, making this overhaul an area of particular interest and concern for CBA. Despite the Proposal's hundreds of pages, it contains no actual analysis of the specific impacts its regulatory changes will have on consumers, much less different groups of consumers.

We aim to start a broader conversation with regulators and the public about how the Basel III Endgame Proposal would impact consumers

Given the Proposal's sweeping impact on American consumers, we hope to broaden the conversation to a wider range of stakeholders that care about consumer financial health, but who may have little expertise in bank regulation. Our fundamental concern is: *Is it appropriate for regulators to proceed with changes of this magnitude without first providing stakeholders enough information to understand how it will impact consumers?*

With that in mind, we approach this discussion in five parts.

Section 1 starts with the basics: What is "capital?" Why is capital regulated?

We discuss the trade-offs between capital regulation and the cost of credit and how capital regulation has evolved over the years. In doing so, we explain why America joined the Basel Committee on Banking Supervision almost 50 years ago: to ensure that other countries' capital requirements were at least as strict as America's, so that international banks could not use cheaper credit to undercut American banks.

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[1] Our corporate members include the nation's largest retail banks, with 85 percent holding over $10 billion in assets.
[2] The Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency collectively proposed and seek comment on the Proposal.
[3] Regulatory Capital Rule: Large Banking Organizations and Banking Organizations with Significant Trading Activity, 88 Fed. Reg. 64028 (proposed Sept. 18, 2023), https://www.federalregister.gov/d/2023-19200.

Section 2 unpacks how the Proposal would impact retail lending (lending to consumers, as well as small and medium-sized enterprises).

Again, we start with fundamentals, explaining what "risk weights" are and how the Proposal would make changes to existing rules. We also walk through several other ways that the Proposal would impact retail banking. Throughout the discussion, one question looms in the background: Given that America originally joined the Basel Committee to ensure that other countries' banks couldn't undercut our banks with less strict capital regulation, how have we gotten to a point where the Proposal would lock in retail lending capital requirements that are 10 and even 20 percent *higher* than international standards?

Section 3 then explores how the Proposal would impact the American consumer.

Some of these impacts are straightforward – the Proposal would make it more expensive for many consumers to borrow money from a bank. But the Proposal creates a number of other effects that may have lifelong negative impacts on consumer financial health. Because the Proposal would only apply to banking organizations, it would advantage non-bank lenders that are not subject to the same stringent capital standards. Consumers already borrow from non-banks so much that banks and credit unions provided less than 40 percent of unsecured personal loans to consumers at the end of 2022. We will explain how, by accelerating the consumer transition away from banking services, the Proposal would increase consumers exposure to products with different consumer protections and which also may not benefit from regular oversight at the federal level. We will explain how increased use of non-bank products impacts consumer credit scores and even credit "visibility." This, in turn, could have stubbornly pervasive, cumulative negative impacts on consumer financial health, particularly for consumer populations who historically need the most help. By impacting credit scores, the Proposal can even impact consumers' lives outside of banking, like renting a home, getting a job, or in some cases, receiving medical services.

In Section 4 we put these pieces together with a case study of a single consumer's financial journey under the Proposal.

We walk through the Proposal's impacts on "Charlotte's" personal version of pursuing the American dream, beginning with trying to build a credit score, start a small business, and eventually own a home.

Finally, in Section 5 we close with a few suggestions for policymakers that aim to mitigate these impacts to consumers.

Ultimately, however, the evidence (or in many cases, the lack of evidence) points to an urgent call for regulators to withdraw the Proposal; study its impacts on consumers, particularly those on the margins of our financial system; and then republish any modified version of the Proposal with that supporting data. This would allow all stakeholders to appropriately engage with regulators on the trade-offs that the Proposal would cost our economy and the American consumer, particularly low-and moderate-income consumers and minorities.

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Contents

Section 1: What is capital and why do we regulate it? 1

Bank Regulation 101: Two major types of bank regulation 1

Capital rules are a type of safety and soundness regulation 2

Capital regulation has evolved over the years 4

The U.S. joined the Basel Committee on Banking Supervision to address concerns about unfair competition from outside the U.S. banking sector 5

Basel's risk-based capital standards are part of a growing and overlapping set of capital regulations for U.S. banks 7

Section 2: How would the Proposal impact retail lending? 11

The Proposal would increase the risk weights associated with retail lending relative to the Basel III framework 11

The Proposal would introduce a new "Credit Conversion Factor," which would require banks to hold capital for lines of credit that are not yet drawn 12

The Proposal would create a new, untested, standardized approach for holding capital for operational risk...13

The Proposal would raise effective risk weights for bank lending to small and medium-sized enterprises, as well as bank investments in such companies 14

The Proposal would reduce the deferred tax asset deduction limit for all banks with $100 billion or more in total assets...15

The Proposal would not recognize banks' restructuring agreements with consumers that default on their mortgages 16

Section 3: How would the Proposal impact consumers? 17

The Proposal would reduce consumers' access to credit, resulting in higher retail interest rates and fees 17

The Proposal would create incentives for consumers to seek credit access outside the banking system..19

The Proposal would expose consumers to non-bank products with fewer consumer protections than bank products 20

The Proposal would inhibit consumers' ability to grow their credit scores and build their credit histories 24

The Proposal would disproportionately impact consumers on the margins 27

The Proposal would disproportionately impact low- and moderate-income and minority consumers in the credit card market 28

The Proposal would disproportionately impact low- and moderate-income and minority consumers working to build their small businesses 31

The Proposal would disproportionately impact low- and moderate-income and minority consumers in the mortgage market 32

The Proposal would interfere with banks' compliance with the Community Reinvestment Act 33

The Proposal would impact consumers across products and across time, at each stage of their financial lives 34

Section 4: A consumer's financial life under the Proposal 36

Credit Cards 36

Small Business 38

Residential Mortgage 39

Section 5: Conclusion and Recommendations 42

Section 1: What is capital and why do we regulate it?

Bank Regulation 101: Two major types of bank regulation

The Federal Reserve Board explains that "[j]ust like any other business, a bank earns money so that it can run its operations and provide services."

> First, customers deposit their money in a bank account. The bank provides safe storage and pays interest on customers' deposits. The bank is required to keep a percentage of deposits in reserve as cash in its vault or in an account at a Federal Reserve Bank. The bank can lend the rest to qualified borrowers. Potential borrowers may wish to buy a house or a new car; however, they may not have enough money to pay the full price at one time. Instead of waiting to save the money to pay for a new house, which could take years, they take out a loan from a bank. Borrowers are charged interest on the loan – a bank's primary source of income.[4]

Economists refer to this conversion of deposits to longer-term loans as "credit intermediation." It's an important contributor to the growth of the economy – and even more so, a critical tool for individual consumers to advance their own versions of the American dream.

Credit intermediation, however, has certain inherent risks. Borrowers don't always pay back their loans. The cumulative losses from too many defaulted loans could threaten bank safety and soundness and the deposits a bank holds for consumers. If this happens across a number of banks, the financial stability of the entire economy could be at risk. And those are just some of the risks involved with banking consumers. With the rapid growth of consumer lending after World War II and the social justice and civil rights movements of the 1960s, Americans have grown increasingly concerned about ensuring that consumers have equitable access to credit and sufficient information to make informed financial decisions.[5]

Accordingly, banks have gradually been subject to increasing regulation, which can be broadly divided between safety and soundness regulation and consumer protection regulation. With each type of regulation, "rules" can come in many different forms. In each case, rules almost always start with Congress writing a law. The law usually directs an agency to write

[4] Supervision and Regulation, Federal Reserve Education, https://www.federalreserveeducation.org/about-the-fed/archive-structure-and-functions/archive-banking-supervision/ (last visited Dec. 20, 2023).

[5] See, e.g. Federal Reserve Bank of Minneapolis, Banking Regulation: The Focus Returns to the Consumer (June 1, 2004) https://www.minneapolisfed.org/article/2004/banking-regulation-the-focus-returns-to-the-consumer.

regulations, implementing the laws. Unlike most industries, banks are also subject to *examination* for compliance with laws and rules.[6]

As we will discuss, although safety and soundness and consumer protection rules exist to address different kinds of risks, as they have grown more complex over time, they often create overlapping and potentially conflicting impacts on the banks and consumers that they serve.

Capital rules are a type of safety and soundness regulation

Capital represents owners' interest in a bank. If a bank is forced to liquidate, the bank's creditors (including depositors)[7] generally get paid back before any money is returned to the bank's owners. So, if the combination of the bank's assets and capital exceed total debt, creditors are more likely to be paid back if the bank fails. Federal Reserve Board Vice Chair for Supervision Michael Barr has described capital as "the cushion that allows a bank to absorb losses—no matter their source."[8] As Vice Chair for Supervision Barr continues, "banks with inadequate levels of capital are vulnerable, and that vulnerability can cause contagion, which threatens the stability of the banking system and hurts families and businesses."[9]

So just about everyone agrees that capital regulation is important. What's less clear, though, is where the lines should be drawn – in this case, how much capital is enough? Consider the tradeoffs involved with setting highway speed limits. Policymakers could reduce traffic fatalities to near zero if they set speed limits at five miles per hour. But that would have big tradeoffs. It would be much harder for people to get to work, for instance. And it would be a lot harder to ship goods from one city to another. In other words, overregulation can do a lot of harm to economic growth. Policymakers working on capital regulation face similar trade-offs. They could reduce the risk of bank failures to near zero by requiring banks to completely fund themselves with capital. But that would completely eliminate the very basic function of a bank:

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[6] The Board of Governors of the Federal Reserve System, Understanding Federal Reserve Supervision (Apr. 27, 2023), https://www.federalreserve.gov/supervisionreg/understanding-federal-reserve-supervision.htm.

[7] Depositors are technically bank creditors who loan money banks through their deposits. Under federal law, depositors have a preference over other creditors in a failure and are thus paid back before bondholders and general creditors.

[8] Opening Statement on the Large Bank Capital Requirement Proposal by Vice Chair for Supervision Michael S. Barr at 1 (July 27, 2023) https://www.federalreserve.gov/aboutthefed/boardmeetings/barr-statement-20230727.pdf.

[9] *Id*. Beyond serving as a loss-absorbing cushion, requiring that owners hold sufficient capital in banks also serves another purpose: reducing the risk that banks make unnecessarily risky decisions because they're gambling with other peoples' money. As described by FDIC Director Member Jonathan McKernan, "Capital is skin in the game. With more capital, shareholders are more likely to bear the consequences of their bank's decisions." Statement by Jonathan McKernan, Member FDIC Board of Directors on the proposed Amendments to the Capital Framework last updated July 27, 2023) https://www.fdic.gov/news/speeches/2023/spjul2723c.html. ("That is basic fairness. That also mitigates moral hazard and fosters market discipline over excessive risk taking.").

taking deposits, pooling them, and lending them to people that need funds ("credit intermediation").[10]

When we talk about harm to "economic growth," we aren't trying to come up with a euphemistic way to talk about preserving bank profits. Overregulation of capital not only creates harmful impacts to banks, but it also impacts consumers who act as both depositors and borrowers, in addition to other stakeholders. For instance, when a bank takes a customer's deposits, the bank is using a funding source other than its owners' equity (i.e., something other than capital).[11] The bank holds back a fraction of those deposits and then lends out the rest (along with deposits from other depositors) to other consumers, like someone that's getting a credit card for the first time, a person that needs a small business loan to start a restaurant, or another person that needs a mortgage to buy her first home. The borrowers pay interest on the loan, which the bank then uses for many purposes, like funding new loans and investments, paying depositors interest, or paying shareholders dividends.

The depositor benefits from this transaction by having a safe place to store her money, which also returns interest.[12] In addition, the depositor can quickly withdraw her money if needed and also enjoy all the transaction services that a bank provides (such as the ability to transfer and receive cash from others).

Perhaps the most important beneficiary is the consumer that gets to borrow from the bank, by getting a new credit card, small business loan, or mortgage. This, in turn, grows the broader economy. Raising capital requirements restricts access to that critical service. Federal Reserve Board Chair Jerome Powell has specifically acknowledged that "raising capital requirements. . . increases the cost of, and reduces access to, credit."[13] A wide range of independent academics, standard-setting bodies including the Basel Committee on Banking

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[10] Eliminating the ability of banks to fund loans through deposits would also make it much more difficult for regulators to implement monetary policy.

[11] *See,* e.g., Gary Gorton & Andrew Winton, *Liquidity Provision, Bank Capital, and the Macroeconomy* JOURNAL OF MONEY, CREDIT AND BANKING, Vol. 499 No. 1 (Feb. 2017) https://spinup-000d1a-wp-offload-media.s3.amazonaws.com/faculty/wp-content/uploads/sites/20/2020/11/Liquidity-Provision-Bank-Capital-and-the-Macroeconomy.pdf

[12] It's easy to take for granted that deposits are a type of investment, much less investments with particular "superpowers." But as the Federal Reserve Bank of Richmond explains, "[i]ndividuals and businesses derive significant benefits from holding checkable deposits in banks." Deposit accounts differ from investments in stocks and bonds, for instance, because they can be quickly available if the consumer needs the money back. Also, unlike stocks and bonds, deposits generally have a very predictable value (the deposit + interest). Per the Federal Reserve Bank of Richmond, "[t]hese features of deposits make them attractive to investors (depositors) and, as a result, banks can pay a lower rate of interest for deposit funding than the nondeposit funding offered by non-banks." John Walter *US Bank Capital Regulation: History and Changes since the Financial Crisis*, ECONOMIC QUARTERLY Vol. 105 No. 1 1st Quarter 2019, https://www.richmondfed.org/-/media/RichmondFedOrg/publications/research/economic_quarterly/2019/q1/walter.pdf.

[13] Statement by Chair Jerome H. Powell, Board of Governors of the Federal Reserve System Joint Press release (July 27, 2023).

Supervision, and central banks such as the Federal Reserve Board broadly agree.[14] The problem, as we will discuss, is that the Proposal does not make clear what the exact relationship is between its increased capital requirements and the cost of borrowing, much less the impact to particular consumer populations that could be most harmed by increases in the cost of bank lending.

Capital regulation has evolved over the years

Given the important trade-offs between risk management and economic growth, policymakers have been trying to set the right capital standards since before the Federal Reserve System was even created. In the early days of banking in the United States, aspiring bank owners were required to contribute minimum amounts of gold or silver before they could begin operations.[15] The National Bank Act of 1864 included an early attempt of modifying capital

[14] *See* Sean Campbell, Fixing What Ain't Broken: The Real and Hidden Costs of Excessive Bank Capital Regulation, Financial Services Forum (Jan. 29, 2023), https://fsforum.com/news/fixing-what-ain-t-broken-the-real-and-hidden-costs-of-excessive-bank-capital-regulation. *See, also* Anil Kashyap, Jeremy C. Stein, and Samuel G. Hanson. An Analysis of the Impact of 'Substantially Heightened' Capital Requirements on Large Financial Institutions (May 2010), https://www.semanticscholar.org/paper/An-Analysis-of-the-Impact-of-'Substantially-Capital-Kashyap-Stein/3da1aaf0804139dd9a0c1d5c6fc669a11bece2a3; Federal Reserve Bank of Minneapolis, The Minneapolis Plan To End Too Big To Fail (Dec. 2017), https://www.minneapolisfed.org/~/media/files/publications/studies/endingtbtf/the-minneapolis-plan/the-minneapolis-plan-to-end-too-big-to-fail-final.pdf; Simon Firestone, Amy Lorenc and Ben Ranish, An Empirical Economic Assessment of the Costs and Benefits of Bank Capital in the US, Finance and Economics, Finance and Economics Discussion Series 2017-034, Board of Governors of the Federal Reserve System (2017), https://ideas.repec.org/p/fip/fedgfe/2017-34.html; Douglas J. Elliott, Quantifying the Effects on Lending of Increased Capital Requirements, Brookings (Sep. 2009), https://www.brookings.edu/articles/quantifying-the-effects-on-lending-of-increased-capital-requirements/; Malcolm Baker & Jeffrey Wurgler, Do Strict Capital Requirements Raise the Cost of Capital? Banking Regulation and the Low Risk Anomaly, Working Paper 19018 DOI 10.3386/w19018, National Bureau of Economic Research (May 2013), https://www.nber.org/papers/w19018; Financial Stability Board and Basel Committee on Banking Supervision, An Assessment Of The Long-Term Economic Impact Of Stronger Capital And Liquidity Requirements, Bank for International Settlements (Aug. 2010), https://www.bis.org/publ/bcbs173.htm; Pablo D'Erasmo, Are Higher Capital Requirements Worth It? Federal Reserve Bank of Philadelphia (June 2018), https://www.philadelphiafed.org/-/media/frbp/assets/economy/articles/economic-insights/2018/q2/eiq218-capital_requirements.pdf; Martin Brooke, Oliver Bush, Robert Edwards, et al., Measuring The Macroeconomic Costs And Benefits Of Higher UK Bank Capital Requirements, Financial Stability Paper No. 35, Bank of England (Dec. 2015), https://www.bankofengland.co.uk/-/media/boe/files/financial-stability-paper/2015/measuring-the-macroeconomic-costs-and-benefits-of.pdf; Thomas F. Cosimano and Dalia S. Hakura, Bank Behavior in Response to Basel III: A Cross-Country Analysis, IMF Working Paper 11/119 (May 2019), https://www.imf.org/external/pubs/ft/wp/2011/wp11119.pdf; Michael R. King, Mapping Capital And Liquidity Requirements To Bank Lending, BIS Working Papers No 324, Bank for International Settlements (Nov. 2010), https://www.bis.org/publ/work324.htm; Peter Slovik & Boris Cournede, Macroeconomic Impact of Basel III, OECD Economics Department Working Papers, No. 844 (Aug. 2015), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2650033; Macroeconomic Assessment Group of the Basel Committee on Banking Supervision, Final Report Assessing The Macroeconomic Impact Of The Transition To Stronger Capital And Liquidity Requirements, Bank for International Settlements (Dec. 2015), https://www.bis.org/publ/othp12.pdf.

[15] Congressional Research Service, Bank Capital Requirements: A Primer and Policy Issues Appendix. Historical Capital Frameworks (Mar. 2023), https://crsreports.congress.gov/product/pdf/R/R47447.

requirements based on risk: setting the initial capital needed for de novo charters by reference to the size of the city where the bank was formed.[16] Until the late 1930s regulators usually looked for a ratio of capital to deposits.[17] And in 1933, the newly created Federal Deposit Insurance Corporation ("FDIC") shifted the emphasis to total assets, rather than just deposits.

As the Federal Reserve Bank of Richmond explains, shortly thereafter, "many of the main features of modern capital requirements had shown up, though in some cases only temporarily, such as minimum capital requirements based on a proportion of deposits or assets (1939), risk-weighted capital requirements (mid-1940s), and the inclusion of off-balance-sheet activities in capital measures (1956)."[18]

The U.S. joined the Basel Committee on Banking Supervision to address concerns about unfair competition from outside the U.S. banking sector

In the 1970s and 1980s, two problems emerged from outside the U.S. banking industry that would become major themes for the future of capital regulation, even through to today. First, banking worldwide regulators realized that they would need to coordinate with regulators from other countries when setting capital requirements. Otherwise, setting new capital requirements in one country would only make it harder for that country's banks to compete in an increasingly international banking market. Second, competition from non-bank financial firms, outside the scope of banking regulation, would distort the regulated banking sector. In 1974, two major banks – one in Germany and one in the United States – failed within a few months of one another. Germany's Herstatt Bank was so involved with international currency markets that its failure actually threatened the payments systems of other countries. The failure of Franklin National Bank in the United States was less impactful (it was the 20th largest bank in the country). Still, the Federal Reserve Board had to provide lender-of-last-resort assistance to the bank's London branch.[19] This ultimately led regulators around the world to form the Basel Committee on Banking Supervision to facilitate international coordination on capital regulation.

Former Federal Reserve Board Governor Daniel K. Tarullo, who wrote the book on "*Banking on Basel*," explains that U.S. banks struggled to weather a trio of major macro-economic issues in the 1970s: the collapse of the Bretton Woods system; the oil embargo and

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[16] John Walter *US Bank Capital Regulation: History and Changes since the Financial Crisis*, ECONOMIC QUARTERLY Vol. 105 No. 1 1st Quarter 2019, https://www.richmondfed.org/-/media/RichmondFedOrg/publications/research/economic_quarterly/2019/q1/walter.pdf ("Specifically, Section 7 required that the founders of the national bank had, at origin or within five months of the bank's opening, $50,000 if the bank was headquartered in a city of fewer than 6,000 people, $100,000 for cities of fewer than 50,000 people, and $200,000 if the city's population was more than 50,000.").

[17] DANIEL K. TARULLO, BANKING ON BASEL: THE FUTURE OF INTERNATIONAL FINANCIAL REGULATION, Chapter 2 (2008).

[18] John Walter *US Bank Capital Regulation: History and Changes since the Financial Crisis*, ECONOMIC QUARTERLY Vol. 105 No. 1 1st Quarter 2019, https://www.richmondfed.org/-/media/RichmondFedOrg/publications/research/economic_quarterly/2019/q1/walter.pdf.

[19] TARULLO, BANKING ON BASEL, Chapter 2.

worldwide recession of 1974-75, and stagflation. U.S. banks responded by taking on more risk, driving their capital ratios down.[20]

Still, commercial banks found themselves caught up in what Governor Tarullo describes as a "business pincer." On one side, the borrowers that U.S. banks typically relied on were increasingly finding cheaper debt with non-bank lenders. On the other side, the net savers that U.S. banks relied on to fund their loans started finding better investments for their money, again outside the banking system, in money market funds. Governor Tarullo explains:

> From 1976 to 1982, the assets of U.S. mutual funds rose from less than $3 billion to about $320 billion. The days when most of the savings of most Americans could be found in commercial and savings banks were fast becoming history. As a result, the time when banks had access to a vast pool of capital, the cost of which was arguably suppressed by the federal deposit insurance system, was also drawing to a close.[21]

At the same time, banks were in a particularly difficult "competitive squeeze" because a range of bank regulations had limited their options. For example, the Federal Reserve Board's Regulation Q limited the interest rate banks could pay on deposits. In the higher interest rate environment of the 1970s and 1980s, banks found themselves unable to compete for deposits with non-bank money market funds. Similarly, as former Governor Tarullo explains, "[r]eserve requirements put domestic banks at a disadvantage in competing with offshore banks."[22]

Congress and regulators responded by both relaxing some of the constraints on commercial banks (e.g., allowing them to enter new markets and lines of business), but simultaneously placing more emphasis on capital regulation to counter incremental safety and soundness risks the changes may have introduced.[23] Prior to the 1980s, capital ratios in the United States usually only came up in examinations, rather than because of specific laws and regulations. In 1983, Congress passed legislation that specifically required the federal banking agencies to establish minimum capital levels for banks and bank holding companies.[24]

The 1983 legislation also pushed the Federal Reserve Board and Treasury Department to seek an international agreement on capital standards. U.S. banks had raised concerns that the new capital requirements introduced by the legislation would make it difficult for U.S. banks to compete with international banks. As Governor Tarullo explains, "[t]he banks could argue, with some justification, that explicit or implicit government safety nets in other countries allowed foreign banks to maintain lower capital levels than comparable U.S. banks."[25] This was, in part, because banks in the other Basel countries generally didn't have to grapple with the combination

[20] *Id.*
[21] TARULLO, BANKING ON BASEL, Chapter 2.
[22] *Id.*
[23] *Id.*
[24] U.S. banking regulators started the process of formalizing risk-weighted capital requirements in 1981.
[25] TARULLO, BANKING ON BASEL, Chapter 3.

of (1) competition from a robust market of non-bank financial service providers and (2) the restrictions on business activities that banks faced in the United States.[26]

Per Governor Tarullo, the pace of asset accumulation by Japanese banks, in particular, was "astonishing":

> Notably, the capital ratios of both Japanese and American banks had moved inversely to their market shares. . . . [W]hile the market rank of the top five Japanese banks rose from between 8th to 17th worldwide in 1981 to first through fifth in 1988, their capital ratios all declined from well over 3 percent to roughly 2 ½ percent. Meanwhile, the capital ratios of the largest U.S., French, British, and German banks all increased during this same period, as their market shares all fell.[27]

Accordingly, the 1988 Basel Accord highlighted "two fundamental objectives": (1) strengthening the "soundness and stability of the international banking system" and (2) "diminishing an existing source of competitive inequality among international banks."[28]

Basel's risk-based capital standards are part of a growing and overlapping set of capital regulations for U.S. banks

Risk-based capital requirements are premised on trying to right-size capital requirements to the assumed riskiness of a bank's activities. The Basel standards do so by imposing different "risk weights" for different types of activities, to ensure that each institution holds appropriate capital for its risk profile.[29] At a basic level, risk weighting is an exercise of

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[26] *Id.*
[27] *Id.*
[28] International Convergence of Capital Measurement and Capital Standards, Basel Capital Accord (July 1988, Updated to April 1998).
[29] The Proposal is, theoretically, the U.S. implementation of Basel III Endgame's efforts to "reduce variability of risk-weighted assets." And for years, U.S. federal banking regulators have emphasized their commitment to "capital neutrality." As discussed in Section 3, however, the Proposal would be a material revision of the capital framework that increases overall bank capital levels well beyond those applicable in peer jurisdictions. In many cases, the new requirements lack empirical support – and are particularly surprising given that, as recently as July, U.S. banking regulators have consistently expressed that the banking system is sound and resilient, with strong levels of capital and liquidity." See, e.g., Federal Reserve Board, "Statement by Chair Jerome H. Powell" (July 27, 2023), *https://www.federalreserve.gov/newsevents/pressreleases/powell-statement-20230727.htm*. And while the Agencies have referenced the 2023 regional bank turmoil in advocating for the Proposal, there is largely no connection between those events and the Proposal (particularly because the international agreement underpinning the proposals were adopted six years prior, in 2017). See, e.g., "Statement by Vice Chair for Supervision Michael S. Barr" (July 27, 2023), *https://www.federalreserve.gov/newsevents/pressreleases/barr-statement-20230727.htm.* The Proposal does not justify this abrupt change in course. Indeed, the Agencies have cited the 2023 regional bank turmoil as motivating the Proposal. But in fact, there is no connection between most of the Proposal, which implements a capital framework adopted in 2017, and those events.

multiplying, for each bank asset (or certain off-balance-sheet items), (1) a baseline measure of exposure by (2) a percentage, set by regulation, that seeks to reflect the riskiness of the asset.

Accordingly, risk-weighting assets comes down to a math problem in which each bank must balance four variables:

- **Capital Ratio Requirements** are set by regulators as threshold requirements for different levels of safety and soundness. Usually the "ratios" are expressed as percentages. And, for practical purposes, these are the goals that banks attempt to reach by adjusting their Asset mix and Capital.[30]
- The **Capital** of a financial institution. If the Capital Ratio Requirement was expressed as a fraction, the Capital would be the numerator (see the text box, below).[31]
- And the denominator of the fraction would be the sum of:
  - Each of the bank's **Assets** (e.g., the bank's various loans and investments) multiplied by
  - The **Risk Weights** for those assets, which are set by regulators – and are at the heart of much of the discussion around the current Proposal. Standardized risk weights range from 0 percent to 1250 percent, with lower risk weights corresponding to lower perceived risk.[32]

Capital Ratio Requirement	=	**Capital** The sum of the banks' **Assets** multiplied by each asset's **Risk Weight**[33]

Leverage requirements are, by contrast, not risk-based and are generally intended to serve as a backstop to risk-based requirements. Federal Reserve Vice Chair for Supervision Barr

[30] So, for instance, the Federal Deposit Insurance Corporation has a "Prompt Corrective Action Framework" that sets out a range of Capital Ratio Requirements for commercial banks. For a bank to qualify as "Well Capitalized," for instance, the FDIC would require that its "Total Risk-Based Capital Ratio) be equal to or higher than 10.0 percent; its Tier 1 Risk-Based Capital Ratio be equal to or higher than 8.0 percent; its Common Equity Tier 1 Capital Ratio be equal to or higher than 6.5 percent; and its Leverage Ratio be equal to or higher than 5.0 percent. The FDIC sets a range of other Capital Ratios for "Adequately Capitalized," "Undercapitalized," "Significantly Undercapitalized," and "Critically Undercapitalized" financial institutions. Capital Adequacy of FDIC-Supervised Institutions 12 C.F.R. Part 324. Formal and Informal Enforcement Actions Manual.

[31] Banks are subject to multiple, different Capital Ratio Requirements at the same time. This is usually because each Capital Ratio Requirement calls for a specific type (or quality) of Capital in the numerator.

[32] Under current rules, very large banking organizations can also determine capital requirements based on models that consider such factors as the probability of default and expected loss due to a default.

[33] For example, a first-lien residential mortgage has a Risk Weight of 50 percent. If a Bank has a residential mortgage valued at $100 (the Asset), in order to meet an 8 percent minimum Capital Ratio Requirement, before applicable buffer and/or surcharge requirements, the bank would need to hold $4 of Capital.

notes that risk-based capital requirements are important, but are "complex, underinclusive under some conditions, and like all capital requirements, can be gamed."[1] The leverage ratio is the ratio of "tier 1 capital" (with certain adjustments) to consolidated assets.

Stress tests, capital planning, and the *stress capital buffer* work together to ensure that large banks can weather crisis conditions. Banks with more than $250 billion in assets (with discretion by the Federal Reserve Board for banks of $100 to $250 billion in assets) are required to undertake company-run stress tests. Further, the Federal Reserve Board runs "supervisory" stress tests for any bank holding company or systemically important financial institution with more than $100 billion in assets. The stress testing exercises gauge banks' ability to weather new and diverse sets of financial and economic conditions hypothesized by the Federal Reserve Board. Vice Chair for Supervision Barr has described the stress tests as "potentially counteract[ing] actions by a bank to 'optimize' against the capital regime – for instance lowering its risk-weighted assets without reducing its risk."[34] Per Vice Chair for Supervision Barr, "[t]he stress test results feed directly into the capital buffer for large firms. The stress capital buffer is floored at 2.5 percent, which aligns with the capital conservation buffer applicable to smaller firms."[35]

Finally, as Vice Chair for Supervision Barr explains, the *long-term debt requirement* "complements the regulatory capital regime. [36] Unlike regulatory capital—which helps a firm absorb losses as it continues operations through times of stress—long-term debt becomes especially relevant once a firm has already entered bankruptcy or resolution."[37]

These are just broad descriptions of each of these tools. But as the Congressional Research Service helpfully sets out in a table replicated below, a range of different capital-related requirements apply to banks, depending on their asset size.[38]

[34] Michael S. Barr, Why Bank Capital Matters, Federal Reserve Board (Dec. 1, 2022), https://www.federalreserve.gov/newsevents/speech/barr20221201a.htm.
[35] *Id.*
[36] *Id.*
[37] Currently, banking organizations with $750 billion or more are required to issue long-term debt that is subordinated to depositors and general creditors. The agencies have proposed to extend the long-term debt mandate to banking organizations with $100 billion or more in assets.
[38] Congressional Research Service, Bank Capital Requirements: A Primer and Policy Issues Appendix. Historical Capital Frameworks (Mar. 2023), https://crsreports.congress.gov/product/pdf/R/R47447.

Summary of Large Bank Capital Requirements

Table 7 summarizes the applicability of the EPR requirements discussed in this section of the report.

Table 7. EPR Capital-Related Requirements

Requirement	Category I (G-SIBs)	Category II (>$700B assets or see notes)	Category III (>$250B or see notes)	Category IV (other $100B-$250B)
Company-run stress tests	annual	annual	biannual	none
Fed-run stress tests	annual	annual	annual	biannual
Capital plan	annual	annual	annual	annual
Emergency 15-to-1 debt-to-equity ratio	applies	applies	applies	none
Stress capital buffer	applies	applies	applies	applies
SLR	more stringent eSLR applies	applies	applies	not required
Advanced approaches	applies	applies	not required	not required
Countercyclical capital buffer	applies	applies	applies	none
Total Loss Absorbency Capacity	applies	none	none	none
G-SIB capital surcharge	applies	none	none	none

Source: CRS.

Notes: SLR = Supplementary Leverage Ratio, eSLR = enhanced Supplementary Leverage Ratio, G-SIB = Global Systemically Important Bank. Banks under $700 billion in assets are ranked as Category II if they have over $75 billion in cross-jurisdictional activity. Banks under $250 billion in assets are ranked as Category III if they have more than $75 billion in nonbank assets, weighted short-term wholesale funding, or off-balance-sheet exposure. For brevity, this table does not specify whether each requirement is applied to a foreign bank's intermediate holding company or total U.S. operations.

Section 2: How would the Proposal impact retail lending?

If adopted as proposed, the Proposal would create changes that would impact the entire banking industry. Below, we walk through a few aspects of the proposal that would have particular impacts on retail banking[39] and, in doing so, negatively impact consumers' financial lives.[40]

The Proposal would increase the risk weights associated with retail lending relative to the Basel III framework

As described above, modern capital regulation is increasingly focused on finding the right "calibration" for "risk-weighting" bank assets.

The changes set forth in the Proposal would significantly increase the amount of capital banks are required to hold. The Proposal does this in part by adjusting the risk weights used to determine risk-weighted amounts, including for assets associated with retail banking, like car loans and mortgages. Under the Proposal, for instance, the capital charge for a mortgage with a low down payment that is protected by mortgage insurance would be materially increased, in some cases by as much as 80 percent over current rules.[41]

Based on the Agencies' estimates, the Proposal would increase overall Common Equity Tier 1 Capital requirements (the highest quality of bank capital) by at least 16 percent. The Agencies conclude that this significant increase is justified based on a review of academic literature, which they read to "conclude[] that there is room to increase capital requirements from their current levels while still yielding positive net benefits."[42] Beyond references to academic literature, however, the Agencies do not present the actual economic analysis for why they believe the Proposal's increases will yield positive net benefits, given the potential consumer impact.

Despite this lack of empirical justification, the Proposal would set risk weights for American banks that are 20 percent higher for residential mortgages than under internationally agreed-upon standards adopted by regulators in other jurisdictions. The Proposal would similarly set risk weights that are 22 percent higher for credit card loans for transactor loans and 10 percent higher for other retail loans (like revolving credit cards, auto loans, private student loans, and overdraft services).[43]

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[39] Typically, "retail" lending is a technical and defined term of art in capital regulation. Throughout this white paper, however, unless we are explicit that we are using a defined term, we mean "retail lending" to refer more generally to mean lending to consumers, as well as small and medium-sized enterprises.
[40] In some cases, the changes we discuss are not specific to retail lending and, accordingly, will impact other types of banking activities as well.
[41] 88 Fed. Reg. at 64048.
[42] 88 Fed. Reg. at 64169.
[43] 88 Fed. Reg. at 64053; Bank of England, CP16/22 – Implementation of the Basel 3.1 standards, Consultation Paper 16/22 at 3.139 (Nov. 30, 2022), https://www.bankofengland.co.uk/prudential-

The Proposal asserts that subjecting U.S. banks to higher retail capital risk weights than the international agreement is necessary to ensure that small banks can compete with large banks in the marketplace.[44] However, the Proposal provides little evidence to justify this reasoning. The lack of analysis is particularly concerning because, as discussed below, the Proposal contains a number of other requirements, outside of the increased risk-weights, that will only apply to large banks.[45]

The Proposal would introduce a new "Credit Conversion Factor," which would require banks to hold capital for lines of credit that are not yet drawn

The Proposal would newly require banks to hold capital against the *unused* portions of credit lines that can be unilaterally cancelled by the bank.[46] The Proposal does this by setting a "Credit Conversion Factor" of 10 percent, representing the likelihood that a consumer taps the unused credit portion of her credit line (an "off-balance sheet asset" of the bank) and uses it for credit (making it an "on-balance sheet" asset of the bank). Currently, banks are not required to hold capital against these unused portions of credit lines.

Imagine that a consumer, Charlotte, keeps a backup credit card at home, in case she ever needs emergency expenses. If the emergency credit card had a $10,000 credit limit, the bank would now need to keep capital against 10 percent of the unused credit line – even if Charlotte has never used the credit card and the bank can cancel it at any time.

As with its approach to increasing risk weights beyond international standards, the Proposal provides little empirical evidence to justify the need for this new requirement. Banks can, by definition, always unconditionally cancel these commitments and eliminate any potential credit risk.

The Proposal similarly provides little data explaining how it arrived at the specific 10 percent numbers for the Credit Conversion Factor.[47] For instance, a 2016 empirical analysis by

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regulation/publication/2022/november/implementation-of-the-basel-3-1-standards. Proposal for amending Regulation (EU) No 575/2013 as regards requirements for credit risk, credit valuation adjustment risk, operational risk, market risk and the output floor, COM (2021)/664 (Oct. 27, 2021) at Article 123. As discussed further below, bank exposures to small and medium-sized enterprises that meet certain additional requirements would qualify as "regulatory retail" exposures.

[44] Thus, the Proposal recognizes the impact of capital requirements on loan pricing and market share. 88 Fed. Reg. at 64170.

[45] Further, under the Proposal, large banks are subject to a floor requirement, whereby they would compute their capital requirements both under the new requirements of the Proposal and under the current approach, with their ultimate capital requirements being the more stringent of the two calculations.

[46] For charge cards with no set credit limit, the Proposal also would establish a methodology for calculating the off-balance-sheet notional exposure amount based on the average amount of credit drawn over the previous eight quarters and a multiplier of 10. As described above, the multiplier appears to be set arbitrarily without any supporting empirical evidence.

[47] Similarly, in proposing its methodology for calculating the off-balance-sheet notional exposure amount for charge cards, the Agencies provide no justification for the calibration of any of its parameters.

the Bank Policy Institute demonstrated that the Credit Conversion Factor could be more appropriately set at 6.5 percent.[48]

The Proposal would create a new, untested, standardized approach for holding capital for operational risk

The Proposal would introduce a new, untested, standardized approach for holding capital to account for operational risk.[49] Under the Proposal, capital would need to be maintained against operational risk for virtually all banking activities, like credit card lending, business lending, and mortgage lending.

At a high level, how much operational risk capital charge a bank is required to hold is a function of the bank's income. For credit card issuers, both the interest income and fee income earned from credit cards would be separately accounted for under two different categories of the operational risk requirement (interest income category and the fee income category). The calibration for the fee income category is particularly punitive, resulting in excessive operational capital charges for credit and fee-income businesses. Critics of the new standardized operational risk requirement have raised concerns that the risk weights applicable to the fee income category (more commonly known as the "services component"), including credit card fee income, are excessively high and not well calibrated.

In particular, the interest income category and the fee income category are calibrated differently. Most notably, the interest income category is calibrated on a net basis (net of expenses) and has a cap (recognizing that operational risk does not necessarily increase proportionally to increases in net interest income).[50] The fee income category (or the "services component"), however, is calibrated on a gross basis and does not have a cap. This means that operational risk capital charges for fee-generating activities could grow endlessly as fee income grows. There is no apparent reason for these different categories to be calibrated differently. And the calibration for the fee income category penalizes banks with high fee income. These flaws in the "services component" were recognized by the Basel Committee itself.[51] Unfortunately, the Proposal does not address these flaws.

Given the breadth of its scope, the new operational risk requirement represents the bulk of the Proposal's overall increase in capital requirements for banks. The Proposal itself estimates

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[48] The Clearing House, Empirical Analysis of BCBS-Proposed Revisions to the Standardized Approach for Credit Risk (May 2016), https://bpi.com/wp-content/uploads/2018/07/20160519_tch_study_bcbs_standardized_approach_for_credit_risk.pdf.

[49] Operational risk refers to the risk of loss from inadequate or failed internal processes, people, and systems, or from external events. This includes everything from internal/external fraud and fines resulting from compliance violations. Large banks already hold capital for operational risk – the stress test they go through includes an "operational risk" component. And the stress test results are used to calibrate large banks' unique "stress capital buffer" requirements, discussed in Section 1.

[50] 88 Fed. Reg. at 64084.

[51] Basel Committee on Banking Supervision, Operational risk – Revisions to the simpler approaches at 16 (Oct. 2014), https://www.bis.org/publ/bcbs291.pdf.

that its new operational risk requirement will increase banks' collective estimated capital ratio denominator by almost $2 trillion.[52]

The Proposal would raise effective risk weights for bank lending to small and medium-sized enterprises, as well as bank investments in such companies

The Proposal would curtail banks' ability to work with small and medium-sized enterprises in a number of ways, in addition to the increased risk weights for retail lending. It includes a number of definitional changes that would make it harder to classify small and medium-sized enterprise lending as retail. But then, once a loan falls outside the retail lending classification, the Proposal would effectively penalize banks for lending to small and medium-sized enterprises. Furthermore, the Proposal would make it harder for banks to provide *non*-lending alternatives for small and medium-sized enterprises, by making it more expensive for banks to invest in such companies.

- To begin with, lending to small and medium-sized enterprises can be classified as retail lending in some cases and, accordingly, be subject to the new risk weights for retail lending.

- If a small or medium-sized enterprise misses even a single payment over a 12-month period, the loan could no longer qualify under the definition of a "transactor exposure."[53] This would mean that it no longer would qualify for a lower risk weight of 55 percent and instead would be subject to an 85 percent risk weight.

- The Proposal includes two changes that would each push lending to small and medium-sized enterprises out of the retail lending category, so that such loans would be subject to even higher risk weights.

  First, under the Proposal's definition of "regulatory retail exposure," any exposures where the aggregate regulatory retail exposure to an obligor (a business) and its affiliates exceeds $1 million would no longer be treated as retail lending.[54] At that point, the cost of credit would likely increase.

[52] 88 Fed. Reg. at 64168.
[53] 88 Fed. Reg. at 64052. Under the Proposal, a Transactor Exposure would be defined as a regulatory retail exposure that is either a credit facility (e.g., a credit card) where the balance has been repaid in full at each scheduled repayment date for the previous 12 months or an overdraft line where there has been no drawdown over the previous 12 months.
[54] *Id.*

Second, the Proposal sets a "granularity limit," so that any regulatory retail exposure that exceeds 0.2 percent of a banking organization's total regulatory retail exposure would not be treated as a regulatory retail exposure.[55]

- Further, the internationally agreed-upon standards include a separate 85 percent risk weight for loans to small and medium-sized enterprises, which the Proposal did not adopt.[56]

- Outside of lending, the Proposal's changes to risk weights constrains banks' ability to make equity investments in small and medium-sized businesses.

  When seeking to finance their companies, business owners can opt to sell partial ownership in their companies, as opposed to taking on more debt. In certain situations, banks can make equity investments in these smaller businesses, such as when the small businesses are generating tax credits, are engaged in historic revitalization work, or are a minority-owned business. The Proposal, however, would make this more challenging by significantly increasing the risk weighting of such specialized equity investments in small businesses.[57] Currently, banks are subject to a 100 percent risk weight for nonsignificant equity investments of up to 10 percent of the bank's capital. The Proposal would eliminate this provision, resulting in most such equity exposures being assigned a 400 percent risk weight.[58] The Proposal similarly disallows 100 percent risk weight treatment for venture capital funds.[59]

The Proposal would reduce the deferred tax asset deduction limit for all banks with $100 billion or more in total assets[60]

As a general matter, banks that make loans are required to hold allowances for loan losses. Due to timing differences in the tax deduction for such allowances, deferred tax assets are created, which banks hold on their books. As allowances for loan losses increase, deferred tax assets also usually increase, as the allowance for loan losses is the largest component of deferred taxes for consumer-focused banks.

The Proposal makes a change in the treatment of deferred tax assets for Category III and IV banks, so that when a bank holds deferred tax assets in excess of 10 percent of its capital base (as opposed to 25 percent, the current threshold), the bank would have to deduct such excess amount from its capital. This effectively reduces the amount of capital the bank can count

[55] 88 Fed. Reg. at 64052.
[56] 88 Fed. Reg. at 64051.
[57] The Proposal contains carve-outs for Community Development Investments and Small Business Investment Companies. But because of the qualifying criteria for "community development" under related regulations, many of these specialized investment opportunities would not qualify.
[58] 88 Fed. Reg. at 64077.
[59] *Id.*
[60] 88 Fed. Reg. at 64036-64037.

towards the satisfaction of the various capital requirements. Notably, this change would impact banks with $100 billion or more in total assets – not just the largest banks subject to the Proposal. In particular, banks that focus more heavily on consumer lending generally have larger allowances for loan losses and therefore have larger deferred tax assets – and their consumer-focused businesses have fewer opportunities to generate deferred tax liabilities that could be used to offset those deferred tax assets.

The Proposal would not recognize banks' restructuring agreements with consumers that default on their mortgages

As part of the Proposal, the definition of "defaulted real estate exposure" would not align with that of "defaulted exposure" producing a perverse outcome for residential real estate exposures for which there has been an agreed-upon distressed restructuring.[61] A distressed restructuring occurs when a borrower has insufficient income and other resources to repay his debts and, as a result, the creditor agrees to change the terms of the loan in order to enable the borrower to continue to pay off the loan.[62] Unlike with other defaulted exposures, defaulted residential real estate exposures have no possibility of reclassification and would always be considered to be in default, regardless of future performance.

The Agencies do not explain the purpose for this deviation, and there is no apparent justification for why modifications of residential real estate exposures should be regarded as permanently in default. That being said, not allowing residential mortgage loan modifications to be "cured" may discourage banks from working with borrowers to equitably resolve issues, and instead encourage banks to move directly to foreclosing on homeowners.

[61] 88 Fed. Reg. at 64049-64050.
[62] For example, a creditor offering a distressed restructuring may reduce the interest rate, extend the term of the loan, or forgive part of the principal owed by a borrower.

Section 3: How would the Proposal impact consumers?

Given the aforementioned impacts to retail banking, the Proposal creates a number of conflicts with policy goals of protecting consumers and ensuring they have good and equitable access to credit.

The Proposal would reduce consumers' access to credit, resulting in higher retail interest rates and fees

The Proposal would include a number of changes that would make it more expensive for banks to lend to retail consumers.

The primary driver for the increases in the cost of credit is the most straightforward and intentional: the Proposal would set risk weights for retail lending higher than those agreed to internationally or that have been justified by data.

Assume that local consumers have deposited $1,000 in Bank of the Local for safekeeping in savings accounts. Bank of the Local lends those deposits out to borrowers, earning interest income for itself while generating credit for the local economy. Under the Proposal, if Bank of the Local wanted to make retail loans (for example, by offering credit cards, auto loans, or mortgages to consumers in its community), it would have to hold more capital against those loans. This means that the bank would have less capacity in its balance sheet to lend to local consumers, meaning the same borrowers must compete for a smaller pool of credit from the bank.[63] The smaller supply of retail loans will drive up the cost of credit for consumers, reflected in increased APRs and fees. The higher cost for bank loans will, in turn, create incentives for consumers to seek credit from less regulated non-bank lenders who are not subject to the same regulatory capital requirements as banks.

The Proposal's setting retail risk weights higher than the Basel framework represents a marked departure from the United States' reasoning for joining the accords in the 1980s. As Governor Tarullo's "*Banking on Basel*" explained, Congress instructed U.S. regulators to seek international coordination on capital regulation to ensure that U.S. banks were not disadvantaged by having to compete with banks from countries that may have lower capital requirements.

These impacts on the cost and availability of retail credit are further exacerbated by the Proposal's standardized approach to operational risk and the more restrictive treatment of deferred tax assets in regulatory capital, which have cumulative and outsized impacts on retail banking. As discussed above, the Proposal's standardized operational risk framework penalizes credit card issuers, who would need to hold capital against both interest and fee income, and the calibration for the fee income category is unjustifiably high. Likewise, as discussed above, retail

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[63] As an alternative, Bank of the Local could raise more equity capital without reducing its lending. But the bank ultimately may still be forced to increase interest and fees in order to offer equity investors a sufficiently attractive return to raise capital.

banks typically carry larger deferred tax assets, and a much lower limit under the Proposal (10 percent, as compared to the current 25 percent limit) would increase the capital requirement for these banks. Although these changes are different in many ways from straightforward increases to retail risk weights, ultimately the impact on retail credit is the same – more capital for retail loans – resulting in fewer dollars to lend to consumers and small businesses.

The Proposal's increases in the "Credit Conversion Factor" are another significant driver in the cost of retail credit. Simply put, a credit conversion factor is a way to assign regulatory capital requirements to credit products (like credit cards and other lines of credit) that represent borrowing capacity. Increases in credit conversion factors could mean increases in credit card fees or decreases in available credit lines.

Assume that one of Bank of the Local's retail customers, Charlotte, has an emergency credit card with a $1,000 line of credit. This line of credit currently is not subject to any capital requirement because it has not yet been used and because the bank can choose to deny the charge when it is made. If the Proposal is adopted, however, Bank of the Local would have to hold capital against such an open line of credit. Accordingly, as discussed above, the Proposal creates a powerful incentive for Bank of the Local to increase the fees associated with maintaining the credit card or simply reduce the credit line on Charlotte's emergency credit card (and Bank of the Local's other credit card customers).

In each case, beyond impacts on existing customers, increased capital requirements for retail loans and lines of credit would impact *potential* consumers and small businesses. Prior to the Proposal, if Bank of the Local wanted to offer credit to a consumer with a limited credit history, Bank of the Local could offer a credit card with a small credit line and monitor how the consumer manages his credit. If the consumer, for instance, failed to pay his credit card bills (or even other bills that show up on his credit report), Bank of the Local could lower or even cancel the credit line. Under the Proposal, however, Bank of the Local would need to hold capital against the open line of credit, even though Bank of the Local could adjust or eliminate the line of credit in response to potential credit risks. Accordingly, given the opportunity cost of each dollar of capital, Bank of the Local will have a diminished incentive to offer credit to new-to-credit consumers, directly impacting financial inclusion.

Opportunity cost isn't limited to capital, though. Because the Proposal's approach to operational risk is so new, while also being incredibly broad, the Proposal creates significant burdens on banks across the marketplace by requiring costly buildouts to their operational risk frameworks.

The Proposal would create incentives for consumers to seek credit access outside the banking system

Despite the sweeping breadth and enormous impact of the Proposal, it's important to keep in mind that the Proposal would directly impact only banking organizations.[64] This means that, under the Proposal, less regulated or unregulated non-bank competitors would be able to offer similar products and services at a lower price than banks. This, in turn, could drive consumers to non-bank financial institutions that are not subject to the Proposal.

This shift away from the banking sector has already begun to happen on a global scale. According to data collected by the Financial Stability Board, in 2008, non-bank financial institutions owned or controlled roughly 42 percent of global financial assets.[65] By 2021 that proportion had grown to roughly 47 percent. A "Global Banking Annual Review" by McKinsey & Company echoed these findings, while highlighting the accelerated transition from banks to non-bank financial institutions in the United States, as compared to other countries. In a 2023 overview titled "The Great Banking Transition," McKinsey explains that:

> [B]etween 2015 and 2022, more than 70 percent of the net increase of financial funds ended up off banking balance sheets, held by insurance and pension funds, sovereign wealth funds and public pension funds, private capital, and other alternative investments, as well as retail and institutional investors
>
> The shift off the balance sheet is a global phenomenon. In the United States, 75 percent of the net increase in financial funds ended up off banking balance sheets, while the figure in Europe is about 55 percent.[66]

Mortgage servicing provides a good example of how this shift to non-bank financial institutions plays out across retail products. Mortgage servicing is the business of collecting mortgage payments, escrowing tax and insurance, maintaining accurate books and records, and working with homeowners who have fallen behind on their mortgage payments, and if necessary, taking foreclosure actions. When the regulatory agencies significantly increased the capital charge associated with this service,[67] the relative amount of servicing conducted by banks dropped precipitously. As Federal Deposit Insurance Corporation Chairman Martin J.

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[64] Specifically, only banks and savings and loan holding companies and insured depository institutions are subject to the Proposal.

[65] Financial Stability Board, Global Monitoring Report on Non-Bank Financial Intermediation 2023 (Dec. 18, 2023) https://www.fsb.org/2023/12/global-monitoring-report-on-non-bank-financial-intermediation-2023.

[66] McKinsey & Company Global Banking Annual 2023: The Great Banking Transition (Oct. 2023) https://www.mckinsey.com/industries/financial-services/our-insights/global-banking-annual-review.

[67] Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Capital Adequacy, Transition Provisions, Prompt Corrective Action, Standardized Approach for Risk-weighted Assets, Market Discipline and Disclosure Requirements, Advanced Approaches Risk-Based Capital Rule, and Market Risk Capital Rule,78 Fed. Reg. 62018, 62069 (Oct. 11, 2013).

Gruenberg has noted, most mortgage lending and servicing now takes place outside of the banking system.[68] Non-bank financial institutions account for almost two-thirds of mortgage originations.[69]

After the financial crisis of 2008, Congress and regulators worked to close many of the regulatory differences between banks and non-bank financial institutions in the mortgage space. The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 created the Consumer Financial Protection Bureau (the "CFPB"), consolidating authority over the mortgage market, which had previously been split across nine different federal agencies and the 50 different states.[70]

The mortgage market is a rare example of Congress and regulators working to close the gaps between regulation and examination of banks and non-bank financial institutions. Retail products from non-bank financial institutions frequently are not subject to the same substantive consumer protection requirements as mainstream consumer products offered by banks and, accordingly, may expose consumers to risks that they haven't accounted for.

The Proposal would expose consumers to non-bank products with fewer consumer protections than bank products

Comparing credit cards and non-bank Buy Now, Pay Later products provides a useful example of the types of consumer protections that consumers may forgo when they opt for a non-bank financial product.[71]

In 2022, the CFPB published a report based on data from five non-bank Buy Now, Pay Later providers showing their rapid growth, but also highlighting a number of the risks they pose to consumers.[72] The CFPB found that the five firms originated 180 million total loans totaling $24 billion in 2021 – a near tenfold increase in just two years. McKinsey & Company estimates that by 2025, American banks could lose as much as 15 percent of their incremental

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[68] Remarks by FDIC Chairman Martin J. Gruenberg at the Exchequer Club on the Financial Stability Risks of Non-bank Financial Institutions (Sept. 20, 2023) https://www.fdic.gov/news/speeches/2023/spsept2023.html (citing the 2022 FSOC annual report and CFPB data).

[69] This is a 27 percent increase since 2017.

[70] William W. Bratton Adam J. Levitin, A Tale of Two Markets: Regulation and Innovation in Post-Crisis Mortgage and Structured Finance Markets, UNIVERSITY OF ILLINOIS LAW REVIEW Vol. 2020 No. 1 (2020), https://scholarship.law.upenn.edu/cgi/viewcontent.cgi?article=3098&context=faculty_scholarship.

[71] Buy Now, Pay Later products have a wide range of product features, but are frequently marketed as non-bank substitutes for credit cards, because they usually offer short-term liquidity without having to pay interest or fees (assuming consumers pay their loans on time). See, e.g., Consumer Financial Protection Bureau, Buy Now, Pay Later: Market trends and consumer impacts (Sept. 2022), https://files.consumerfinance.gov/f/documents/cfpb_buy-now-pay-later-market-trends-consumer-impacts_report_2022-09.pdf.

[72] *See, e.g.*, Consumer Financial Protection Bureau Buy Now, Pay Later: Market trends and (consumer impacts (Sept. 2022) https://files.consumerfinance.gov/f/documents/cfpb_buy-now-pay-later-market-trends-consumer-impacts_report_2022-09.pdf.

credit card profits to new competitors, like Buy Now, Pay Later firms.[73] As the Wall Street Journal recently noted, much of the growth in Buy Now, Pay Later market share comes as banks are "forced to offload or curtail some of their consumer lending as capital requirements rise."[74]

Consumers may feel that they get short-term benefits by turning to non-bank credit options like Buy Now, Pay Later products, but they may not realize that the non-bank products lack important consumer protections that only apply to credit cards:

- That lack of consumer awareness is, arguably, by design. Many non-bank Buy Now, Pay Later products are specifically structured as "Pay-in-Four" loans, so that they can avoid compliance with the Truth in Lending Act.[75]

  In contrast, banks offering credit cards are required to provide consumers a clear and conspicuous cost-of-credit disclosure *before* the consumer agrees to the loan. The disclosures cover issues like the amount financed, total number of payments, finance charge and annual percentage rate, and potential late fee disclosures.[76]

- With the passage of the Credit Card Accountability Responsibility and Disclosure Act of 2009 (the "CARD Act"), credit cards are generally only available to consumers that are 21 years of age or older, unless the consumer shows a source of independent income or cosigns with another borrower.

  Non-bank Buy Now, Pay Later firms, by contrast, "have traditionally relied on younger consumers as a source of growth," reports McKinsey. They note that Buy Now, Pay Later usage is at 37 percent amongst Generation Z, as compared to 30 with millennials and 17 percent with Generation X.[77]

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[73]Amit Gang, Diana Goldstein, Udal Kaura, and Roshan Varadarajan Reinventing credit cards: Responses to new lending models in the US, McKinsey & Company (June 2022) https://www.mckinsey.com/industries/financial-services/our-insights/reinventing-credit-cards-responses-to-new-lending-models-in-the-us. McKinsey noted that although 62 percent of users expressed the belief that Buy Now, Pay Later *could* replace their credit card, 75 percent did not express that they wanted it to.

[74] Telis Demos, Wall Street Journal, Buy Now, Pay Later Lender Is Surfing the Private Credit Wave (Nov. 9, 2023), https://www.wsj.com/finance/investing/buy-now-pay-later-is-surfing-the-private-credit-wave-5548a37a?mod=finance_lead_pos3.

[75] See, e.g., Chuck Bell, Consumer Reports, Consumer Protections Needed for the Popular New Way to Pay (Nov. 21, 2022), https://advocacy.consumerreports.org/wp-content/uploads/2022/11/FINAL-Buy-Now-Pay-Later_-Consumer-Protections-Needed-for-the-Popular-New-Way-To-Pay-White-Paper.pdf.

[76] Reg. Z, 12 C.F.R 1026.18. Credit card issuers provide a range of other disclosures to consumers, such as information about penalty rates, minimum interest charges, transaction charges, and grace periods, as well as periodic disclosures.

[77] Amit Gang, Diana Goldstein, Udal Kaura, and Roshan Varadarajan Reinventing credit cards: Responses to new lending models in the US, McKinsey & Company (June 2022) https://www.mckinsey.com/industries/financial-services/our-insights/reinventing-credit-cards-responses-to-new-lending-models-in-the-us. *See, e.g.*, Erin Lowry *Gen Z Could Pay a Steep Price for Buy Now, Pay Later Services* WASHINGTON POST, BLOOMBERG (Oct. 2023)

- Similarly, credit card companies can only offer a consumer credit if the credit card issuer has considered whether the borrower actually has the ability to repay the debt.[78]

  In contrast, as nearly two dozen state Attorneys General have raised concerns with the CFPB, non-bank Buy Now, Pay Later firms are not subject to comparable requirements. They explained that "[a] lack of robust underwriting coupled with marketing that touts the ease of splitting the cost of goods or services into multiple payments without interest or fees, provides little protection against an unsustainable accumulation of debt – particularly for younger borrowers and consumers who already struggle to make ends meet or owe on other debts."[79]

- The CARD Act also includes a range of important protections regarding the interest rates and fees that a credit card issuer can charge a consumer.[80] The CARD Act also includes a number of protections to lessen the chance that a borrower is surprised when a payment is due.[81]

- And as the CFPB has noted, Buy Now, Pay Later products frequently are structured with operational hurdles that create challenges for consumers filing and resolving

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https://www.washingtonpost.com/business/2023/10/23/gen-z-could-pay-a-steep-price-for-buy-now-pay-later-services/325537f4-71a4-11ee-936d-7a16ee667359_story.html ("Unfortunately, for now no laws protect young buy now, pay later users from getting in over their head financially. And buy now, pay later options don't come with the perk of helping young adults build a credit history when they use the cards responsibly."); Cora Lewis *More Americans are expected to "buy now, pay later" for the holidays. Analysts see a growing risk* INDEPENDENT (Nov. 2023) https://www.independent.co.uk/news/ap-consumers-americans-fed-data-b2451632.html ("Data shows younger consumers and those with difficulty accessing credit use the loans most frequently.").

[78] 15 U.S.C. 1665e, 12 C.F.R. 1026.51(a)(2).

[79] Letter from State Attorneys General from Illinois, California, Colorado, Connecticut, Delaware, Hawaii, Iowa, Maine, Maryland, Massachusetts, Michigan, Minnesota, Nevada, New Jersey, New York, North Carolina, Oregon, Pennsylvania, Rhode Island, Vermont, and Washington, as well as the Hawaii Office of Consumer Protection to Consumer Financial Protection Bureau (2022), CFPB-2022-002; 87 Fed. Reg. 3511 State Attorneys General Comment Letter (Mar. 25, 2022), https://www.regulations.gov/comment/CFPB-2022-0002-0025 ("There is also no guarantee that BNPL providers are able to track when consumers have BNPL loans from multiple providers.").

[80] Many of these protections are not applicable to certain kinds of Buy Now, Pay Later products (e.g., limits on card issuers' ability to make changes to interest rates and fees in the first year; limits on card issuers' ability to change terms on existing balances; a 6-month lookback for unwinding rate increases). But card issuers are required to ensure that any penalty fees are reasonable and proportional to the consumers' violation. Likewise, credit cards must cap any first-year fees at 25 percent of the available credit line.

[81] Payments must always be due on the same numerical date or the last day of the month; the periodic statement must be mailed no less than 21 days before a payment is due; and the consumer must receive a grace period of at least 21 days.

disputes.[82] In contrast, many credit card products offer consumers chargeback rights,[83] satisfaction guarantees,[84] and even protections against theft or damage of recent purchases.[85]

Even if non-bank financial institutions were subject to the same rules as banks, they are generally not examined for compliance with those regulations. While all banks are regularly examined for compliance with consumer compliance regulations, the CFPB has limited supervisory jurisdiction over non-banks. It has statutory authority to examine mortgage originators and servicers, payday lenders, and student lenders of all sizes. But for other non-bank financial institutions, the CFPB has to write special "larger participant" rules that allow it to examine only the largest entities in different products.[86] Banking trade associations and consumer activists (including in a joint letter from Consumer Bankers Association and the Center for Responsible Lending) have called for the CFPB to draft a larger participant rule that would allow it to examine non-bank financial institutions providing loans to consumers, like Buy Now, Pay Later firms.[87] However, the CFPB has not prioritized finalizing any such larger participant rulemaking.[88]

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[82] All five non-bank providers in the CFPB's survey required consumers to contact the merchant that sold the product; if the merchant refuses, consumers "may be required to make additional payments under the loan contract until the investigation is concluded." Consumer Financial Protection Bureau Buy Now, Pay Later: Market trends and consumer impacts (Sept. 2022) https://files.consumerfinance.gov/f/documents/cfpb_buy-now-pay-later-market-trends-consumer-impacts_report_2022-09.pdf.

[83] See, e.g., Gregory Karp, Nerdwallet, Credit Card Chargebacks Can Be a Powerful Tool for Consumers (June 26, 2023) https://www.nerdwallet.com/article/credit-cards/credit-card-chargebacks ("Disputing a charge allows consumers to at least temporarily avoid paying without risking damage to their credit. They can also dispute paid charges from previous billing cycles. And the process has become as simple as making a few clicks from an online bank statement or taps in a bank smartphone app.").

[84] Mastercard, Guide to Benefits for MasterCard Cardholders, Satisfaction Guarantee (last visited Jan. 5, 2025), https://www.mastercard.us/content/dam/mccom/en-us/documents/Cardholder%20Benefits/GTB-Satisfaction_Guarantee_Std_MC_Cov_012715.pdf.

[85] Visa, Purchase Security Terms and Conditions (Effective April 15, 2021), https://usa.visa.com/content/dam/VCOM/regional/na/us/pay-with-visa/documents/purchase-security-infinite.pdf.

[86] The CFPB has written such "larger participant" rules for the consumer reporting, consumer debt collection, student loan servicing, international money transfer, and automobile financing markets. An additional rulemaking that would allow it to examine domestic payment companies is currently being finalized.

[87] Center for Responsible Lending, Consumer Bankers Association and Center for Responsible Lending File Petition to CFPB for Oversight of "Buy Now, Pay Later," "Fintech," and Finance Company Personal Loans (Sept. 15, 2022), https://www.responsiblelending.org/media/consumer-bankers-association-and-center-responsible-lending-file-petition-cfpb-oversight-buy ("The market for personal loans is massive and growing, yet the fintechs and other non-bank lenders who make such loans are not subject to regular oversight by the Consumer Financial Protection Bureau (CFPB), which has "created an unlevel playing field and a large risk to consumers," write the Consumer Bankers Association (CBA) and the Center for Responsible Lending (CRL).").

[88] The CFPB does have a separate authority to sporadically examine individual non-banks that pose risks to consumers, but the CFPB uses the authority so rarely that its own press releases describe it as a "dormant authority" that has been "largely unused." Consumer Financial Protection Bureau, CFPB

Non-bank financial institutions are not examined for safety and soundness regulations at the federal level, either. Non-bank financial institutions are similarly not comprehensively regulated on a "top of house" overall basis.[89]

The Proposal would inhibit consumers' ability to grow their credit scores and build their credit histories

By making it comparatively cheaper for consumers to obtain credit with non-bank financial institutions, rather than with banks, the Proposal potentially creates longer-term impacts that are net harmful to consumers' long-term financial health. In particular, increased use of non-bank financial products by consumers may have damaging impacts to their ability to develop and grow their credit scores, which can have stubborn and broad consequences over their financial lives. Further, relying too heavily on non-bank financial products can impact consumer credit scores in ways that impact key opportunities outside of just borrowing money, like renting a home, getting a job, paying utility bills, or even getting medical treatment.

The National Consumer Law Center explains that "[c]redit reports and scores are critical to the economic health of over 200 million Americans. They are a consumer's financial report card, used by employers, landlords, insurers, and lenders."[90] Chi Chi Wu, Staff Attorney at the National Consumer Law Center recently testified before Congress, emphasizing the following:

> Credit reports and credit scores play a crucial role in consumers' lives, and their importance has only grown in recent years. Of course, credit reports and scores can determine a consumer's ability to obtain credit and the amount they have to pay for it, which affects their ability to purchase a home – the pathway to establishing

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Invokes Dormant Authority to Examine Nonbank Companies Posing Risks to Consumers (April 25, 2022), https://www.consumerfinance.gov/about-us/newsroom/cfpb-invokes-dormant-authority-to-examine-nonbank-companies-posing-risks-to-consumers/#:~:text=CFPB%20Invokes%20Dormant%20Authority%20to%20Examine%20Nonbank%20Companies%20Posing%20Risks%20to%20Consumers,-Bureau%20Seeks%20Comment&text=Washington%2C%20D.C.%20%E2%80%93%20The%20Consumer%20Financial,that%20pose%20risks%20to%20consumers.

[89] Further, a larger non-bank financial institutional footprint outside of the regulated bank perimeter carries greater risks to financial stability. FDIC Chairman Gruenberg recently sounded alarm bells regarding the growing role non-bank financial institutions play in the U.S. economy by discussing the role non-bank financial institutions played in the 2008 financial crisis. FDIC Chairman Gruenberg further expressed concern about non-bank financial institutions' increasingly high levels of leverage. Financial Stability Board, "The Financial Stability Implications of Leverage in Non-Bank Financial Intermediation" (Sep. 6, 2023). This concern is borne out by data collected by the Financial Stability Board, which noted that non-bank financial institution leverage was both at near-peak levels and incredibly concentrated. As Federal Reserve Board Governor Christopher J. Waller said, "a safe but needlessly narrow banking system doesn't necessarily result in a safe financial system and vibrant economy." Board of Governors of the Federal Reserve System, "Statement by Governor Christopher J. Waller", https://www.federalreserve.gov/newsevents/pressreleases/waller-statement-20230727.htm (July 27, 2023).

[90]National Consumer Law Center Credit Reporting & Scores, https://www.nclc.org/topic/credit-reporting-and-scores/ (last visited Jan. 5, 2024).

> middle class wealth for most consumers But even for renters, 90% of landlords use credit reports and scores, which means a bad score could shut out a renter out of apartments in a decent school district or even permanent housing.[91]

Wu goes on to reference research highlighting "how much a bad credit score can hurt the ability of many Americans to simply find a stable roof over their heads."

> A survey conducted in the fall of 2018 in Norcross, Ga., a city of about 17,000 outside Atlanta, concluded that nine of the city's 14 hotels, motels and extended stays had become "primarily residential facilities." When the respondents — 70 percent of whom were Black — were asked to name the biggest barrier to more permanent housing, one person after another cited bad credit.[92]

Wu adds that:

> In addition, credit reports and scores can affect whether and at what price Americans can obtain insurance and hence their ability to own a car. Some employers use credit reports, affecting a consumer's ability to find a job. Even hospitals have been known to pull a credit report before offering medical services and the Department of Homeland Security had included a credit score check in its now-vacated Public Charge Rule. It's essentially the report card for a consumer's financial life.[93]

In 2015, the CFPB found that 26 million Americans are "credit invisible," in that they do not have any credit records.[94] Another 19 million Americans have credit records that are considered "unscoreable" by traditional credit scores because they either had insufficient credit history or lacked a recent credit history. This means that nearly one in five Americans lack a conventional credit score.

Revisiting the issue of credit invisibles two years later, the CFPB found that bank products offer a key on-ramp for credit invisibles to become "credit visible" and, therefore, start

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[91] Chi Chi Wu Staff Attorney National Consumer Law Center Testimony before the U.S. House of Representatives Committee on Financial Services subcommittee on Oversight and Investigations Regarding Consumer Credit Reporting: Assessing Accuracy and Compliance (May 2021) https://www.nclc.org/wp-content/uploads/2022/08/Testimony_HFSC_OI_credit_reporting-1.pdf (internal citations omitted).

[92] *Id.* (internal citations omitted).

[93] *Id.* (internal citations omitted). *See also*, National Urban League Your Credit: Why Credit Reports and Scores Matter to your Financial Health (Jan. 2024) https://nul.org/blog/your-credit-why-credit-reports-and-scores-matter-your-financial-health.

[94] Consumer Financial Protection Bureau, CFPB Report Finds 26 Million Consumers Are Credit Invisible (May 2015)https://www.consumerfinance.gov/about-us/newsroom/cfpb-report-finds-26-million-consumers-are-credit-invisible/.

building their financial lives.[95] In particular, the CFPB found that "[a]cross all age groups and income levels, credit cards trigger the creation of consumer credit records more frequently than any other product." Student loans were a distant second, but that was driven almost entirely by consumers under the age of 25. Debt collection for unpaid medical and cell phone bills were third – but as the CFPB points out, any credit visibility caused by such reporting was likely to only diminish a consumers' future access to credit.

Unfortunately, the Proposal works in a number of ways to reduce consumers' access to credit cards. The Proposal increases the capital needed to support credit card lending, especially through the Proposal's new Credit Conversion Factor. The Proposal's new operational risk charges would force banks to hold capital for both interest and fee revenue from their credit card portfolios. And because the fee revenue calibration is flawed, it would result in excessively high operational risk capital charges to credit cards. And then the Proposal's changes to the treatment of deferred tax assets will effectively penalize retail lenders like credit card issuers disproportionately compared to banks that concentrate more in lending to commercial entities.

Reducing credit lines will almost inevitably have a direct impact on consumer credit scores. As the CFPB advises consumers, "[c]redit scoring models look at how close you are to being "maxed out," so try to keep your balances low in proportion to your overall credit limit. Experts advise keeping your use of credit at no more than 30 percent of your total credit limit."[96]

Consumer usage within the United States of non-bank financial institutions to meet their personal credit needs already mirrors the global shift away from banking documented by the Financial Stability Board and McKinsey & Company. TransUnion reports that banks and credit unions originated only 37.5 percent of unsecured personal loans in the United States in the fourth quarter of 2022.[97] Adobe similarly noted that consumers are increasingly turning to non-bank financial products for day-to-day purchases when making ends meet. In a recent report, Adobe notes that "[i]n the first two months of 2023, groceries' share of [Buy Now, Pay Later] orders grew a staggering 40 percent, while home furnishings grew by 38 percent."[98]

When consumers turn to non-bank financial institutions like Buy Now, Pay Later providers to meet their credit needs, they may benefit from short-term benefits in the cost of credit. But non-bank products can create important long-term trade-offs for consumers, because non-bank financial products may not help consumers build their credit histories. This is

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[95] Consumer Financial Protection Bureau Office of Research, CFPB Data Point: Becoming Credit Visible (June 2017) https://files.consumerfinance.gov/f/documents/BecomingCreditVisible_Data_Point_Final.pdf.
[96] Consumer Financial Protection Bureau , Understanding Your Credit Score (July 2020) https://files.consumerfinance.gov/f/documents/cfpb_adult-fin-ed_understand-your-credit-score.pdf.
[97] TransUnion, TransUnion Unsecured Personal Lending Industry Insights report (Q1 2023) https://www.transunion.com/content/dam/transunion/global/business/documents/fs2023/unsecured-personal-lending-industry-insights-report.pdf.
[98] Adobe Communications Team, Adobe Analytics – buy now, pay later usage driven by home furnishings and groceries (Mar. 2023) https://business.adobe.com/blog/the-latest/adobe-analytics-buy-now-pay-later-usage-driven-by-home-furnishings-and-groceries.

particularly the case for non-bank credit card substitutes marketed to consumers with low credit scores or limited credit histories.

Further, while non-bank financial products offer limited to no *upside* benefits to consumers' credit scores, non-bank financial products can frequently have *downside* impacts on consumers' credit scores. For instance, the CFPB warns that when consumers turn to storefront payday lenders for emergency credit, the non-bank lenders "do not generally report any information about payday loan borrowing history to the nationwide credit reporting companies."

> However, if you don't pay your loan back and your lender sends or sells your payday loan debt to a debt collector, it is possible the debt collector might report this debt to one of the major national credit reporting companies. Debts in collection could hurt your credit scores. Likewise, some payday lenders bring lawsuits to collect unpaid payday loans. If you lose a court case related to your payday loan, that information could appear on your credit reports and may lower your credit scores.[99]

Similarly, in discussing Buy Now, Pay Later products, the CFPB explains that:

> Until recently, few BNPL lenders furnished information about consumers to the nationwide consumer reporting companies (NCRCs). This lack of furnishing could have downstream effects on consumers and the credit reporting system. It could be bad for BNPL borrowers who pay on time and may be seeking to build credit, since they may not benefit from the impact that timely payments may have on credit reports and credit scores. It may also impact both BNPL lenders and non-BNPL lenders seeking to understand how much debt a prospective borrower is carrying.[100]

The Proposal would disproportionately impact consumers on the margins

Vice Chair for Supervision Barr has suggested that the Proposal be thought of as an increase of capital requirements by 2 percentage points (essentially requiring that banks hold an additional $2 in capital for every $100 in risk-weighted assets).[101] A recent metastudy by the Financial Services Forum reviewed over a dozen efforts to quantitatively estimate the

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[99] Consumer Financial Production Bureau, "I heard that taking out a payday loan help rebuild my credit or improve my credit score. Is that true?", Ask CFPB (Sept. 2020) https://www.consumerfinance.gov/ask-cfpb/i-heard-that-taking-out-a-payday-loan-can-help-rebuild-my-credit-or-improve-my-credit-score-is-this-true-en-1611/.
[100] Martin Kleinbard and Laura Udis, Consumer Financial Protection Bureau, Buy Now, Pay Later and Credit Reporting (June 15, 2022), https://www.consumerfinance.gov/about-us/blog/by-now-pay-later-and-credit-reporting/.
[101] Vice Chairman Michael S. Barr, speech "Holistic Capital Review" Board of Governors of the Federal Reserve System (July 2023) https://www.federalreserve.gov/newsevents/speech/barr20230710a.htm.

relationship between capital requirements and higher costs of bank credit. Projecting from the different studies' estimates results in estimates for the average cost of bank credit increasing anywhere from 8 to 34 basis points more.[102] Given the important role that bank lending plays in our economy, the additional costs quickly add up – making borrowing from banks $38-158 billion more expensive a year.

When economists and policymakers talk about the Proposal's *average* impact on the cost of credit, a wide range of lending is swept into that math. An old data science joke warns about the statistician that drowned trying to walk across a river that was, on average, two feet deep. Estimates about the average increased cost of credit may similarly hide important variance in impacts to the cost of credit across commercial borrowers and retail borrowers. Within the retail sector, the averages may hide variance that is spread across a wide range of products, from credit cards, to auto loans, to small business loans, to mortgages.

Further, focusing on averages runs the risk of losing sight of the important variance experienced by consumers on the margins of our financial system. For instance, the Census Bureau's American Community Survey reports that the average 12-month income in 2022 was $105,555.[103] But those averages were skewed by a disproportionate amount of income going to the highest earners. Median income, meaning the income earned by consumers at the midpoint of the distribution, was nearly 30 percent lower than the average income – $74,755. Median incomes for respondents with a Black head of household were 50 percent lower than the average income, at $52,860.[104] And the median income for respondents where the head of household did not have a high school education were 67 percent lower than the average income, at $34,850.[105]

<u>The Proposal would disproportionately impact low- and moderate-income and minority consumers in the credit card market</u>

These disparities are particularly pronounced for consumers that are newest to the credit ecosystem, where access to bank products is most critical. Recall that in 2015, the CFPB reported on the 45 million Americans that were either credit invisible or had credit reports that were "unscoreable" by traditional credit scores.[106] These one-in-five Americans overlapped heavily with consumers that have traditionally needed access to well-regulated banking services

[102] Sean Campbell, Financial Services Forum, Fixing What Ain't Broken: The Real and Hidden Costs of Excessive Bank Capital Regulation (Jan. 29, 2023), https://fsforum.com/news/fixing-what-ain-t-broken-the-real-and-hidden-costs-of-excessive-bank-capital-regulation.
[103]United States Census Bureau Data Tables (last visited Jan. 4, 2024) https://data.census.gov/table/ACSST1Y2022.S1901?g=010XX00US$0400000.
[104] Peter G. Peterson Foundation, Income and Wealth in the United States: an Overview of Recent Data (Nov. 2023) https://www.pgpf.org/blog/2023/11/income-and-wealth-in-the-united-states-an-overview-of-recent-data. Median incomes for respondents with a Hispanic head of household were 41 percent lower than the average income, at $62,800.
[105] Peter G. Peterson Foundation, Income and Wealth in the United States: an Overview of Recent Data (Nov. 2023) https://www.pgpf.org/blog/2023/11/income-and-wealth-in-the-united-states-an-overview-of-recent-data.
[106] Consumer Financial Protection Bureau Office of Research, Data Point: Credit Invisibles (May 2015) https://files.consumerfinance.gov/f/201505_cfpb_data-point-credit-invisibles.pdf.

the most. For instance, the CFPB found that 45 percent of consumers in low-income neighborhoods lacked credit scores, compared to just 9 percent of consumers in upper-income neighborhoods. Likewise, Black and Hispanic consumers are considerably more likely to be credit invisible or have unscored credit records (27-28 percent) than White or Asian consumers (16 percent).[107] Importantly, the CFPB explained that their "analysis suggests that these differences across racial and ethnic groups materialize early in the adult lives of these consumers and persist thereafter."

Earlier, we discussed the different ways that the Proposal would make it harder for banks to offer credit card loans: retail risk weights that exceed international standards by 10 percent; the Proposal's Credit Conversion Factor; new standardized operational risk capital charges, including the excessively high capital charge for fee income; and the disproportionate impacts of the changes to deferred tax assets for retail banks. The important and unique role that credit cards serve as on-ramps to credit visibility for consumers, combined with the particular populations impacted by credit invisibility, means that the Proposal would likely disproportionately impact low-income, Black, and Hispanic consumers that are trying to get their first footholds in the credit system.

Some customers may find ways to mitigate the impact of the Proposal on the supply and cost of retail credit – for example, by getting a first loan with a co-borrower or by building an initial credit history by becoming an authorized user on someone else's credit card. But the CFPB found in 2017 that these avenues are disproportionately available to consumers in upper-income neighborhoods, where consumers were twice as likely as consumers from low-income neighborhoods to transition out of credit invisibility by relying in whole or in part on the credit worthiness of others (30.3 percent vs. 14.9 percent).[108]

The lack of credit card access has critically different impacts on low- and moderate-income consumers, as compared to high-income consumers. For instance, a working paper by economists at the Federal Reserve Bank of Boston found that access to credit cards had a

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[107] Setting aside credit invisibility, the Proposal may disproportionately impact non-White households because they may be more likely to need access to credit to begin with. For instance, 34.3 percent of non-Hispanic White respondents to the CFPB's 2023 Making Ends Meet survey reported that they had difficulty paying all of their bills and expenses from time to time. In contrast, 54.6 percent and 46.0 percent of Black and Hispanic respondents reported that they had experienced such issues, respectively. Consumer Financial Protection Bureau Office of Research, Making Ends Meet in 2023 Publication No. 2023-8 (Dec. 2023) https://files.consumerfinance.gov/f/documents/cfpb_making-ends-meet-in-2023_report_2023-12.pdf.

[108] Consumer Financial Protection Bureau Office of Research, CFPB Data Point: Credit Invisibles (May 2015) https://files.consumerfinance.gov/f/201505_cfpb_data-point-credit-invisibles.pdf.

[108] Consumer Financial Protection Bureau Office of Research, CFPB Data Point: Becoming Credit Visible (June 2017) https://files.consumerfinance.gov/f/documents/BecomingCreditVisible_Data_Point_Final.pdf.

material impact on working college students' ability to stay in school after losing a job – but the effect was confined to students with demonstrated financial needs.[109]

It then shouldn't be a surprise that the Federal Reserve Board's Survey of Household Economics and Decisionmaking found that Black respondents reported using Buy Now, Pay Later products (21 percent) at twice the rate of White respondents (9 percent).[110] The Federal Reserve Bank of New York, in an overview of "Who uses Buy Now, Pay Later?" found that "both the availability and use of [Buy Now, Pay Later] to be fairly widespread but see disproportionate take-up among consumers with unmet credit needs, limited credit access, and greater financial fragility."[111] Likewise, Black respondents to the Federal Reserve survey reported using non-bank payday, pawn, auto title, and refund anticipation loans at *three times* the rate as White respondents (9 percent vs. 3 percent). The ratios were even more pronounced when comparing disabled to non-disabled respondents (10 percent vs. 3 percent). And as discussed earlier, with each of the products the consumer is likely only introducing downside risk to her credit reports, rather than building a credit history.

Even when considering consumers that already have credit cards, the Proposal may have disproportionate impacts on particular populations. For instance, distinct from the Credit Conversion Factor, the Proposal would impose a higher capital charge for credit cards if the consumer does not repay the balance in full every month, as compared to transactors.[112] According to the Federal Reserve Board's Survey of Household Economics and Decisionmaking, 78 percent of Black credit cardholders reported carrying a balance on their credit card, as compared to just 42 percent of White credit cardholders.[113] Likewise, 57 percent of disabled cardholders reported carrying a balance, as opposed to 46 percent of non-disabled cardholders. Accordingly, the increased cost of credit posed by these new capital charges will be disproportionately borne by these communities.

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[109] Pinghui Wu and Lucy McMillan, Federal Reserve Bank of Boston, Job Loss, Credit Card Loans, and the College-persistence Decision of US Working Students (Oct. 2023), https://www.bostonfed.org/publications/research-department-working-paper/2023/job-loss-credit-card-loans-and-the-college-persistence-decision-of-us-working-students.aspx. ("These working college students represent 57 percent of the 18- to 24-year old US undergraduate population. On average, compared with their non-working peers, they have lower family income and receive less parental support, and more than half depend on their own earned income to pay for their college education.")

[110] Board of Governors of the Federal Reserve System, Report on the Economic Well-Being of U.S. Households in 2022 (May 2023), https://www.federalreserve.gov/publications/2023-economic-well-being-of-us-households-in-2022-banking-credit.htm.

[111] Felix Aidala, Daniel Mangrum, and Wilbert van der Klaaw, Who Uses 'Buy Now, Pay Later?,' Federal Reserve Bank of New York, Liberty Street Economics (Sept. 2023) https://libertystreeteconomics.newyorkfed.org/2023/09/who-uses-buy-now-pay-later/.

[112] 88 Fed. Reg. at 64053.

[113] Board of Governors of the Federal Reserve System, Report on the Economic Well-Being of U.S. Households in 2022 (May 2023), https://www.federalreserve.gov/publications/2023-economic-well-being-of-us-households-in-2022-banking-credit.htm.

The Proposal would disproportionately impact low- and moderate-income and minority consumers working to build their small businesses

The Proposal would also make it more expensive for entrepreneurs to obtain credit (particularly non-revolving credit) to start a business and for small businesses to get bank loans they need to operate. This will almost certainly impact the growth and development of small and medium-sized enterprises, which are critical to fueling the innovation that drives the engine of the American economy.

Additionally, these changes could lead these small and medium-sized enterprises to borrow from largely unregulated non-bank financial institutions instead of borrowing from banks, encouraging the buildup of leverage outside of the regulated financial sector. This will present a variety of dangers to small business owners, as they will be working with lenders that are subject to less regulation and federal oversight.

For instance, the government similarly empowered non-bank financial institutions during the pandemic, enabling non-banks to administer pandemic relief funds alongside banks. A subsequent Congressional investigation found that many non-bank fintech firms "failed to stop obvious and preventable fraud because they had little to no fraud prevention efforts in place."[114] Non-bank fintechs were almost five times more likely than traditional lenders to be involved with suspicious loans.[115] Indeed, researchers at the University of Texas ultimately determined that nine of the top ten issuers involved with Paycheck Protection Program fraud were non-bank fintech firms.[116] The fraud cost American taxpayers an estimated $64 billion.[117] But perhaps even worse, many non-bank financial institutions simply opted to not serve smaller loans, because they could earn more revenue focusing on large borrowers. Congressional investigators, for instance, shared an email exchange from one non-bank financial institution that was alleged to have offered preferential treatment and less scrutiny for large-dollar "VIPPP" loans. The non-bank financial institution's co-founder wrote employees that "Closing these monster loans will get everyone paid," adding that loan reviewers should "delete" certain smaller

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[114] Austin Fast and Sacha Pfeffer, *A Congressional Report Says Financial Technology Companies Fueled Rampant PPP Fraud* NATIONAL PUBLIC RADIO (Dec. 2022) https://www.npr.org/2022/12/06/1140823783/a-congressional-report-says-financial-technology-companies-fueled-rampant-ppp-fr.

[115] John M. Griffin, Samuel Kruger and Prateek Mahajan, *Did FinTech Lenders Facilitate PPP Fraud?* JOURNAL OF FINANCE (Aug. 2021) https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3906395; Katherine Chiglinsky, Fintechs Found to Be Much More Likely to OK Suspicious PPP Loans (Aug. 17, 2021), https://www.bloomberg.com/news/articles/2021-08-17/fintechs-found-to-be-much-more-likely-to-ok-suspicious-ppp-loans.

[116] Consumer Bankers Association, New Study Examining PPP Fraud: Fintechs Represent 90% of Lenders with the highest rates of suspicious loans (Aug. 18, 2021), https://www.consumerbankers.com/cba-media-center/media-releases/new-study-examining-ppp-fraud-fintechs-represent-90-lenders-highest.

[117] Austin Fast and Sacha Pfeffer, *A Congressional Report Says Financial Technology Companies Fueled Rampant PPP Fraud* NATIONAL PUBLIC RADIO (Dec. 2022) https://www.npr.org/2022/12/06/1140823783/a-congressional-report-says-financial-technology-companies-fueled-rampant-ppp-fr.

loans. "Who f***ing cares?" she allegedly wrote. "We're not the first [] to decline borrowers who deserve to be funded."[118]

The Proposal's changes are being added on top of an already difficult landscape for small business financing. A recent Federal Reserve Senior Loan Officer Opinion Survey on Bank Lending Practices[119] found that more than 50 percent of banks have tightened their credit standards for small businesses with annual sales of less than $50 million.

The recent National Federation of Independent Businesses September 2023 Optimism Index highlighted that small businesses face rising costs of credit, stating, "A net 26 percent of owners reported paying a higher rate on their most recent loan, up 2 points from August. The average rate paid on short maturity loans was 9.8 percent, 0.8 of a percentage point above last month. Thirty-one percent of all owners reported borrowing on a regular basis (up 3 points)."[120] Furthermore, according to the 10,000 Small Businesses Voices Survey in September 2023, 78 percent of the small business respondents fear that the Proposal will exacerbate credit access challenges.[121]

<u>The Proposal would disproportionately impact low- and moderate-income and minority consumers in the mortgage market</u>

The Proposal asserts that regulators "are supportive of home ownership and do not intend the proposal to diminish home affordability or homeownership opportunities, including for low- and medium-income home buyers or other historically underserved markets."[122] Yet, the Proposal's increased risk weights will increase costs to consumers that need to borrow to purchase their homes. Further, the Proposal creates a number of other important changes to how other mortgage-related commitments and pertinent hedging activities are treated that will disproportionately impact low- and moderate-income borrowers.

To begin with, the Proposal would materially increase the capital charge for low down payment mortgages that are protected by mortgage insurance. In some cases, the increase could be as much as 80 percent, due to the Proposal's 20 percent risk weight add-on to internationally

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[118] Austin Fast and Sacha Pfeffer, *A Congressional Report Says Financial Technology Companies Fueled Rampant PPP Fraud* NATIONAL PUBLIC RADIO (Dec. 2022) https://www.npr.org/2022/12/06/1140823783/a-congressional-report-says-financial-technology-companies-fueled-rampant-ppp-fr. Blueacorn's Stephanie Hockridge actually wrote, "We're not the first bank to decline borrowers who deserve to be funded." But Blueacorn is not a bank but rather a non-bank financial institution.
[119] Board of Governors of the Federal Reserve System, The July 2023 Senior Loan Officer Opinion Survey on Bank Lending Practices (July 31, 2023), https://www.federalreserve.gov/data/sloos/sloos-202307.htm.
[120] William C. Dunkleberg and Holly Wade, National Federation of Independent Business, "September 2023 Small Business Economic Trends (Oct. 17, 2023), https://strgnfibcom.blob.core.windows.net/nfibcom/SBET-September-2023.pdf.
[121] Goldman Sachs, "Small Businesses Continue to Face Capital Crunch" (Oct, 20, 2023), https://www.goldmansachs.com/citizenship/10000-small-businesses/US/infographics/small-businesses-continue-to-face-capital-crunch/index.html
[122] 88 Fed. Reg. at 64048.

agreed-upon standards.[123] As a result, consumers who are not able to afford significant cash down payments of 20 percent, including many first-time homebuyers, and who need mortgages with greater than 80 percent loan-to-value ratios will find reduced availability of mortgages and higher costs for the mortgages that are available. Home Mortgage Disclosure Act data from 2022 show that median combined loan-to-value ratios for African American; American Indian or Alaska Native; and Hispanic borrowers are higher than the median ratios for non-Hispanic White, Asian, or Hawaiian and Pacific-Islander borrowers.[124]

Further, the Proposal would not just increase the costs for bank mortgages; it adds stress to every part of the mortgage industry. Currently, over 60 percent of all single-family mortgage originations are originated by non-bank financial institutions called independent mortgage banks, or "IMBs." IMBs originate 85-90 percent of all Federal Housing Administration, Veterans Affairs, and United States Department of Agriculture/Rural Housing Service mortgage loans, which are all critically important loan programs for low- and moderate-income and minority borrowers and communities.[125] IMBs rely heavily on banks to provide them with the credit to help them fund their loan originations. However, the Proposal would *double* the capital required to be held by banks when extending these lines of credit.[126] The Proposal would therefore strain the economics of lending to IMBs, making it more challenging for many IMBs to provide cost-effective loans to low- and moderate-income consumers.

The Proposal would interfere with banks' compliance with the Community Reinvestment Act

By limiting the ability for banks to provide low down payment mortgages, the 20 percent risk weight add-on would also make it more challenging for banks to fulfill their obligations under the Community Reinvestment Act. The Community Reinvestment Act was amended just three months after the release of the Proposal, specifically for the purpose of encouraging "banks to expand access to credit, investment, and banking services in low- and moderate-income communities."[127] As the Urban Institute observes, providing low down payment mortgages is

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[123] *Id.*
[124] Federal Financial Institutions Examination Council, Home Mortgage Disclosure Act Snapshot Loan Level Dataset (2022), https://ffiec.cfpb.gov/data-publication/snapshot-national-loan-level-dataset/2022 (last visited Jan. 5, 2024).
[125] Community Home Lenders of America, 2023 Report on Independent Mortgage Banks (Jan. 2024), https://www.communitylender.org/wp-content/uploads/2024/01/CHLA-2023-IMB-Report-FINAL-combined.pdf.
[126] 88 Fed. Reg. at 64056. See Jim Parrott and Laurie Goodman, Bank Regulators Are Taking Too Narrow a View of Mortgage Risk, Urban Wire (Sep. 18, 2023), https://www.urban.org/urban-wire/bank-regulators-are-taking-too-narrow-view-mortgage-risk.
[127] Board of Governors of the Federal Reserve System "Statement on the Community Reinvestment Act Final Rule by Vice Chair for Supervision Michael S. Barr" (Oct. 24, 2023), https://www.federalreserve.gov/newsevents/pressreleases/barr-statement-20231024.htm.

"the type of lending banks are encouraged to do under the CRA, enabling them to make a disproportionate number of loans to LMI borrowers and borrowers in LMI communities."[128]

These loans tend to help to facilitate first-time home ownership especially with respect to Black and Hispanic borrowers. Other organizations have echoed similar concerns, particularly as to Black home ownership.[129]

The Proposal would impact consumers across products and across time, at each stage of their financial lives

Throughout this discussion of the Proposal's impacts on consumers, we have necessarily zeroed in on its impacts to specific products and services. But consumers lead complex financial lives and often rely on a range of financial products and services to make ends meet.

When studying credit invisibility, the CFPB noted that the differences materialize early across racial and ethnic groups and stubbornly persist thereafter. The Proposal would similarly make it harder for consumers to close those gaps at almost every step in their financial lives. Every time the consumer seeks a loan, the Proposal would increase the cost of credit bank products considered by the consumer in ways that would not apply to non-bank products.

If the consumer opts for a *bank* product to meet her needs, the consumer pays a higher cost of credit as long as the consumer uses that product – for instance as long as she keeps her mortgage with the bank. The Proposal would effectively turn the "Miracle of Compound Interest" on its head, as the additional cost of credit that the Proposal causes would compound each year, growing the consumer's interest obligations.

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[128] Laurie Goodman and Jun Zhu, Urban Institute, Bank Capital Notice of Proposed Rulemaking (Sept. 2023), https://www.urban.org/sites/default/files/2023-09/Bank%20Capital%20Notice%20of%20Proposed%20Rulemaking.pdf ("Raising the capital charges undercuts other federal efforts, including those to put more teeth in the CRA, as well as those encouraging lenders to develop special purpose credit programs. Moreover, it will accelerate a broader retreat by banks from the mortgage business.")

[129] *See, e.g.*, Letter from Nat'l Hous. Conf., Mortg. Bankers Ass'n, NAACP, Nat'l Ass'n Realtors & Nat'l Urb. League, to Hon. Jerome Powell, Chairman, Bd. Gov. Fed. Rsrv. Sys., Hon. Michael Hsu, Comptroller, Off. Comptroller Currency, and Hon. Martin Gruenberg, Chair, Fed. Deposit Ins. Corp. (Jul. 24, 2023), letter hyperlinked in text of, "Housing groups warn proposed capital standards undercut efforts to close racial homeownership gap" (July 25, 2023) https://nhc.org/press-release/housing-groups-warn-proposed-capital-standards-undercut-efforts-to-close-racial-homeownership-gap. ("These standards, if adopted, will have a devastating impact on the groups' efforts to increase Black ownership... These standards, if adopted, will disadvantage all first-time, and, in particular, first-generation homebuyers who do not have the benefit of multi-generational wealth or higher than average incomes"); Angela Lang, Exec. Dir., Black Leaders Org. Communities, Comment Letter on Proposed Regulatory Capital Rule: Amendments Applicable to Large Banking Organizations and to Banking Organizations with Significant Trading Activity (2023), https://www.federalreserve.gov/SECRS/2023/October/20231017/R-1813/R-1813_101023_154739_416882729609_1.pdf; Isaac Russell, Dir. Pub. Pol'y, Ctr. Econ. Inclusion, Comment Letter on Proposed Regulatory Capital Rule: Amendments Applicable to Large Banking Organizations and to Banking Organizations with Significant Trading Activity (2023), https://www.federalreserve.gov/SECRS/2023/October/20231013/R-1813/R-1813_092723_154732_477238732838_1.pdf.

On the other hand, each time the consumer opts for the *non-bank* product, she may face additional consumer protection risks, fraud, or be one step further behind in building her credit history. That, in turn, may have cumulative impacts that make it harder and more expensive for the consumer to qualify for loan products in the future and bring additional complications when the consumer tries to rent, pay utilities, seek employment, or even receive medical treatment.

Section 4: A consumer's financial life under the Proposal

Credit Cards

Consider, as a hypothetical example, the impact of the Proposal on the particular American dream for Charlotte, a 21-year-old senior at a local state university that is majoring in mechanical engineering. Charlotte is a first-generation college student with limited parental support, paying her way through school with a combination of scholarships and part-time jobs. After graduation she plans to move away from her family to a nearby city and begin on a path toward financial self-sufficiency. After a summer internship located an hour away from her hometown, she received an offer to return full time as an engineer at an industrial machinery company and looks forward to starting her career. However, she is concerned about her ability to support herself once she graduates and her scholarship runs out before she starts her full-time job in the fall. Her job has not offered her a signing bonus or salary advance, and she needs to find an apartment, buy a car, move and pay her living expenses for several months until her job starts. Her first thought is to go to a bank that she knows has multiple branches in the nearby city, in hopes of opening a credit card and establishing a line of credit.

Research has shown that establishing a credit score is vital to Charlotte's quest for financial self-sufficiency. Both Charlotte and her parents are among the 45 million Americans that the CFPB has found are either credit invisible or have unscored credit records.[130] While many of Charlotte's friends have become credit visible by having their parents co-sign credit cards, or by simply being added as an authorized user to their parents' credit cards, Charlotte does not have such a luxury and has not had any other opportunity to establish a credit record.

The best way for Charlotte to become credit visible is to visit her local bank branch and open a credit card. As we have discussed, credit cards are by far the most common product used to overcome credit invisibility.[131] The protections provided by banks, because of the CARD Act and the supervision of the CFPB, ensure that Charlotte can obtain credit in a financially responsible manner as she ventures into the world of financial independence.

In the long term, getting a credit card will help start Charlotte on the path towards financial success, but in the short term, having a credit card is simply a way for her to pay rent, buy gas and shop for groceries. Failure to get a credit card now would force her to seek credit from less reliable sources, or otherwise force her to give up her job offer.

However, unfortunately for Charlotte, the increased capital requirements contemplated by the Proposal are likely to put pressure on banks' ability to offer credit cards to consumers,

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[130] Consumer Financial Protection Bureau, CFPB Report Finds 26 Million Consumers Are Credit Invisible (May 2015), https://www.consumerfinance.gov/about-us/newsroom/cfpb-report-finds-26-million-consumers-are-credit-invisible/.
[131] Consumer Financial Protection Bureau Office of Research, CFPB Data Point: Becoming Credit Visible (June 2017), https://files.consumerfinance.gov/f/documents/BecomingCreditVisible_Data_Point_Final.pdf.

particularly to those without any credit history like her. The Proposal's imposition of a capital charge against an undrawn but available line of credit will make it more expensive for a bank to extend Charlotte a line of credit. Charlotte's ability to get approved for a credit card will also be challenged by the Proposal's overall over-calibration, including its excessive operational risk capital charge and its more punitive approach to consumer lending banks with higher deferred tax assets.

Further, even if Charlotte is able to obtain a card, this new requirement would likely mean lower credit limits, which also could mean higher utilization rates that can negatively impact Charlotte's credit score. The aforementioned other aspects of the Proposal and the stress capital buffer that banks are required to hold, would significantly increase the effective risk weight of credit cards. This would also mean it will be significantly more expensive for Charlotte to obtain credit, leaving her with both higher fees and potentially a smaller range of benefits than banks currently offer.[132]

If the Proposal is adopted as currently drafted, Charlotte, unfortunately, may walk out of the bank deflated. With no current income, no credit history and no one to co-sign for her, the Proposal gives Charlotte's credit card application an increased risk of rejection by a bank simply trying to accommodate the lending environment brought about by the new capital rules. Without access to a credit card, Charlotte will need to turn to another means to pay her rent, groceries and other living expenses until her job begins in the fall. It seems likely that Charlotte will turn to non-bank financial products to assist her, particularly Buy Now, Pay Later products.

The use of Buy Now, Pay Later has increased dramatically in recent years, as borrowers, especially during the COVID-19 pandemic, transitioned away from the highly regulated credit card industry towards less regulated credit industries and products such as Buy Now, Pay Later.[133] This transition was particularly acute amongst low- and moderate-income borrowers, like Charlotte.[134] Furthermore, Buy Now, Pay Later borrowers have lower liquidity and savings on average compared to other consumers.[135]

The Proposal's pushing of low- and moderate-income consumers, such as Charlotte, away from credit cards and towards Buy Now, Pay Later carries risk for these consumers. As we have discussed, Buy Now, Pay Later products are often structured in ways that may present borrowers with undesirable operational hurdles that impede their ability to understand the terms of their loan or dispute transactions with merchants.[136] As the various state Attorneys

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[132] Benefits including rewards (cash back, airline miles or points), extended warranty, return and purchase protection, cell phone insurance, and travel-related benefits such as roadside assistance trip insurance and rental car insurance.

[133] The CFPB Office of Research, *Consumer Use of Buy Now, Pay Later: Insights from the CFPB Making Ends Meet Survey* (March 2023), 2, https://files.consumerfinance.gov/f/documents/cfpb_consumer-use-of-buy-now-pay-later_2023-03.pdf.

[134] *Id.*

[135] *Id.*

[136] Consumer Financial Protection Bureau, *Buy Now, Pay Later: Market Trends and Consumer Impacts* (September 2022), 4, https://files.consumerfinance.gov/f/documents/cfpb_buy-now-pay-later-market-trends-consumer-impacts_report_2022-09.pdf.

General have cautioned, the Buy Now, Pay Later business model may encourage overextension, because the providers don't need to consider consumers' ability to pay when offering loans.[137] And lastly, very few Buy Now, Pay Later lenders provide information about consumers to the national consumer reporting companies. This lack of communication could be bad for Buy Now, Pay Later borrowers looking to build credit, particularly those who pay on time and in full, because any record of payment would not be reflected in credit reports or credit scores.[138]

All of these issues represent serious concerns for Charlotte in particular. If forced to use the non-bank Buy Now, Pay Later products to help with her rent, groceries and living expenses, Charlotte may be pushed into a "downside-only" approach to her financial life from the very beginning, when she could otherwise be setting herself up for financial self-sufficiency.

Small Business

Fast forward several years: Charlotte, now in her late-20s and with years of work experience under her belt, is looking to use the skills and expertise she has developed on the job to start her own company. In order to get her small business off the ground, however, Charlotte needs credit. She does not have enough money in her savings to start the small business on her own, so Charlotte goes back to her bank to ask for a loan. Unfortunately, many of the same obstacles that the Proposal put in the way of getting her first credit card would also, if adopted as proposed, make it more difficult for her to get a loan to start her new business.

Small businesses are the lifeblood of the U.S. economy and drive U.S. innovation and competitiveness. Research from the U.S. Small Business Administration shows that small businesses account for over 40 percent of U.S. economic activity.[139] Additionally, small businesses account for almost 60 percent of jobs in the United States and are the country's primary driver of job creation.[140]

However, starting a small business is not easy. Small businesses face a host of legal, technical and, most importantly, financial issues at the outset. Among other things, Charlotte needs to decide on and set up a legal entity, register it with the state and the IRS and obtain the relevant licenses. She needs to hire employees, buy and store materials, set up a website and figure out a marketing strategy. But first, before she can do any of these things, she needs funding.

Like we discussed above, numerous elements of the Proposal make it more difficult for Charlotte to raise the funding she needs for her business. The Proposal would make it more

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[137] *Id.* at 5.
[138] Martin Kleinbard and Laura Udis, Consumer Financial Protection Bureau, *Buy Now, Pay Later and Credit Reporting* (Jun. 15, 2022), https://www.consumerfinance.gov/about-us/blog/by-now-pay-later-and-credit-reporting/.
[139] Kathryn Kobe and Richard Schwinn, *Small Business GDP: 1998–2014* (December 2018), 3, https://advocacy.sba.gov/wp-content/uploads/2018/12/Small-Business-GDP-1998-2014.pdf.
[140] *Id.* at 37.

expensive for Charlotte to obtain credit (particularly non-revolving credit) to start and operate her business.

Further, the Proposal's array of technical, but meaningful, nuances to the "retail" definitions will functionally put an artificial ceiling on how big Charlotte's business can get before it must pay more to access credit, tie her access to credit to how much banks lend to other businesses, and punish her harshly if she misses just one payment as she navigates the process of starting her business.

The Proposal's approach to bank equity investments in small businesses will further obstruct Charlotte as she tries to both maintain the success of her small business and grow it past its liminal phase. Because it limits Charlotte's ability to access certain types of specialty equity financing to grow her business, the Proposal's approach to small business equity investments may push Charlotte to take on a greater debt burden through more debt. Charlotte will have worse access to financing in the short term, which will darken her small businesses' investment outlook in the long term.

Fast forward several more years. After much difficulty, Charlotte was able to obtain credit to start her business, which has grown. Despite her hefty debts, her business grosses over $10 million in revenue per year and employs one hundred workers in well-paying jobs. She has opened up a factory and several warehouses in her hometown, which has seen a small economic revitalization. Now, Charlotte is poised to accelerate her growth and expand her business geographically.

In order to achieve this kind of ambitious growth, Charlotte needs to significantly scale her operations, which means obtaining significant outside investment. Yet even after her tremendous success, she faces many of the same difficulties in accessing financing.

At this stage, Charlotte has to deal with the Proposal's risk weighting for small and medium-sized enterprises that need to borrow more than $1 million to finance their businesses. Unfortunately, the Proposal does not include a separate, 85 percent risk weight for loans to small and medium-sized enterprises that internationally agreed-upon standards had endorsed. Due to these changes, Charlotte's bank partners may be less willing to lend to her small businesses, or she may encounter a higher cost of credit, and Charlotte may find that her only option is to borrow from largely unregulated non-bank financial institutions.

Residential Mortgage

Over the years, in part due to her challenge getting bank financing, Charlotte's business remains a work-in-progress. Charlotte knows that if she continues to work at it, her business will flourish. In the meantime, however, she would like to move out of her crowded apartment and buy a house with more space to accommodate her growing family. After hiring a realtor and searching for months, Charlotte finally finds the house of her dreams. She quickly agrees to a price with the seller and calls her bank to try and work out the details of the mortgage. Because she has put all of her available cash into her business, and only takes a nominal salary, Charlotte

cannot afford a down payment of 20 percent. She hopes her bank will be flexible and will be able to provide her with a mortgage with a 90-95 percent loan-to-value ratio so she only has to pay a 5-10 percent down payment.

Once again, however, the changes to bank regulation initiated by the Proposal provide a stumbling block to Charlotte's ambitions. If adopted as drafted, the rule changes in the Proposal would present serious obstacles to Charlotte's attempt to procure a mortgage from her bank.

In particular, the main challenge Charlotte will face is the Proposal's 20 percent add-on to internationally agreed-upon standards for the risk weight of residential mortgage loans. This 20 percent risk-weight add-on will limit the role banks have in the mortgage industry and therefore make it significantly more difficult for Charlotte to receive a mortgage from her bank.

Without being able to receive a mortgage from her bank, Charlotte may be forced to turn to nonbank mortgage lenders to try and secure the mortgage she needs for her home purchase. Getting a nonbank mortgage is unlikely to be any easier for Charlotte though. The Proposal won't just increase the costs of bank mortgages; it adds stress to every part of the mortgage industry, and the increased costs it will cause throughout the industry may even prevent low- and moderate-income borrowers, such as Charlotte, from being able to afford homes at all. A separate element of the Proposal would double the capital required to be held by banks when extending lines of credit to nonbank mortgage originators.[141] The Proposal would therefore strain the economics of residential mortgage lending on all fronts, making it more challenging for banks and nonbanks to provide cost-effective loans to low- and moderate-income consumers such as Charlotte.

In the end, Charlotte does succeed in getting a mortgage from her bank, though at a higher rate than she had hoped for. In the beginning, she does a good job of keeping up with her mortgage payments, always making them in a timely fashion. However, within one year after Charlotte buys her house, her bank sells the servicing rights of her mortgage due to the pressure placed on it by the amount of capital it needs to hold to maintain her mortgage. Charlotte continues to make her payments in a timely fashion, but she has no relationship with the new mortgage servicer.

In the meantime, Charlotte's small business starts to falter, in part due to lack of financing, and she no longer earns as much money as she needs to support herself and pay for all of her expenses. She begins to fall behind on her mortgage payments. However, Charlotte's attempts to communicate with her mortgage servicer fall flat. Seeing no other options and fearing a foreclosure, Charlotte goes back to her bank in a last-ditch attempt to restructure her mortgage. What Charlotte is not aware of, however, is that the Proposal contains an additional provision that makes it difficult for her bank to help restructure her mortgage. This additional provision, found in the definition of "defaulted real estate exposure," creates a strong disincentive for her bank to work with her to equitably resolve her issues, and, in fact, encourages her bank to move directly to foreclosing on her home. As such, this provision could

[141] 88 Fed. Reg. at 64056.

be incredibly damaging for Charlotte; she could be prevented from keeping her dream house because her bank has no incentive to work with her on a restructuring.

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It is difficult to quantify the cumulative costs, both the monetary costs and the opportunity costs, that the Proposal has caused Charlotte over the course of her financial life. But the regulators advancing the Proposal must, at the very least, make an effort to understand these important impacts on her ability to achieve her version of the American dream.

Section 5: Conclusion and Recommendations

We believe it is necessary and important for banks to be adequately capitalized. However, excessive capital mandates limit growth and raise the cost of loans and other financial products. Inappropriately high capital standards will harm low- and moderate-income consumers and provide a competitive advantage to the less regulated or unregulated shadow banking sector. Regulatory capital standards need to be established with these concerns in mind. Capital is an important tool to enhance bank safety and – along with appropriate macro-economic policies – can reduce the potential for future crises and mitigate their consequences when they occur, but it must be used carefully to avoid unintended consequences that would be harmful to financial inclusion and longer-term consumer financial resilience.

In this white paper, we pointed out some of the changes in the Proposal that will make it more difficult for a consumer like Charlotte to access the capital she needs to improve both her own life and society at large. We emphasize, however, that our primary concern is with the Proposal's overall calibration and cumulative impacts. Even if one, two or several modifications are made, the Proposal still may make it materially more difficult for low- and moderate-income consumers by virtue of its overall impact. In order to simply maintain the current environment for low- and moderate-income consumers, every issue discussed above must be addressed simultaneously, and the Proposal's overall calibration must be addressed.

Accordingly, the following changes to the Proposal may help establish an appropriate balance between ensuring a safe and sound banking system while still freeing up enough capital for banks to maintain their lending to low- and moderate-income consumers, as well as small and medium-sized businesses:

- The Proposal's approach to operational risk capital should be rethought and recalibrated. Once it is adopted, the operational risk component of the Federal Reserve Board's stress test should be eliminated.

- The Proposal's 10 percent Credit Conversion Factor should be lowered. In no case should it be higher than 6.5 percent.

- The Proposal should retain the 25 percent deferred tax asset deduction threshold for large banks.

- The retail risk weights in the Proposal are not based on an empirical assessment of actual risk and significantly overstate that risk, in addition to being 10 percent higher across the board than the retail risk weights of the Basel framework. They require fundamental changes and should be revised downward to reflect actual risk.

- The Proposal should exclude the $1 million cap from the definition of regulatory retail exposure.

- The granularity limit should be eliminated from the definition of regulatory retail exposure.

- The definition of transactor exposure should provide for a 6-month lookback period, as opposed to a 12-month lookback period.

- A separate risk weight of 85 percent should be applied to small and medium-sized enterprises.

- The Proposal should retain the 100 percent risk weight category for non-significant equity exposures; expand the 100 percent risk weight category for equity exposures pursuant to a national legislated program; and allow an exposure to a small business investment company to continue to be treated as such if the small business investment company has voluntarily surrendered its license.

- The risk weight of the residential mortgage exposures category should be redeveloped using a risk-based, empirical analysis to more accurately reflect the risk presented by a mortgage and to avoid unnecessary and potentially harmful impacts on American homeownership, as well as low- and moderate-income and minority borrowers and communities.

- The definition of defaulted real estate exposure should clarify that an exposure that has undergone a distressed restructuring but has resumed performing its payment obligations no longer qualifies as a defaulted real estate exposure.

Ultimately, however, regulators should withdraw the Proposal to study its impacts on consumers, particularly those on the margins of our financial system. Regulators should then re-submit any modified version of the Proposal with that supporting data, so that all stakeholders can appropriately engage on the trade-offs that will ultimately be borne by the people that the Consumer Bankers Association's members and regulators should be most focused on helping.

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