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OCC: Docket ID OCC-2023-0008
FDIC: RIN 3064–AF29
FED: Docket No. R–1813, RIN 7100–AG64

Regulatory Capital Rule: Amendments Applicable to Large Banking Organizations and to Banking Organizations With Significant Trading Activity

OCC: Docket ID OCC-2023-0011
FDIC: RIN 3064-AF86

Long-term Debt Requirements for Large Bank Holding Companies

FED: Docket No. R–1814, RIN 7100–AG65

Regulatory Capital Rule: Risk-Based Capital Surcharges for Global Systemically Important Bank Holding Companies; Systemic Risk Report (FR Y-15)

Dear Chair Gruenberg, Comptroller Hsu, and Vice Chair Barr,

On behalf of more than 500,000 members and supporters of Public Citizen, we provide the following comment on two rules proposed by the Federal Reserve Board (Board), the Federal Deposit Insurance Corp (FDIC), and the Office of the Comptroller of the Currency (OCC) (hereafter "the agencies"): "Regulatory capital rule: Amendments Applicable To Large Banking Organizations And To Banking Organizations With Significant Trading Activity;" and "Long-term Debt Requirements for Large Bank Holding Companies;" and on the Board's notice of proposed rulemaking for "Regulatory Capital Rule: Risk-Based Capital Surcharges for Global Systemically Important Bank Holding Companies; Systemic Risk Report (FR Y-15)."

These are significant proposals for the large banking institutions that dominate the financial industry. All in all, the proposals cover the 31 largest banks, namely those with more than $100 billion in assets. If implemented as proposed, we believe that the banking system will be safer. Capital becomes stronger and greater long-term debt (relative to short-term debt) provides additional stability. At the same time, Public Citizen believes that genuine financial stability will not be achieved until regulators require a substantial increase in capital. This means less overall reliance on debt, an end to risk weighting—which is overly complex and effectively a device for banks to evade robust capital requirements, and greater attention to highly uncertain and significant risks such as artificial intelligence (AI) and climate-related financial risk (climate risk).

In the capital rule, the bank regulatory agencies propose to modify large bank capital requirements that will better reflect underlying risks. Further, the agencies propose to increase the consistency of how banks measure their risks with the use of standard, as opposed to bank-devised internal models. These changes implement the final components of the Basel III agreement, an international accord regarding bank safety. In the parlance of the financial regulatory community, this is known as the "Basel III endgame."

In the debt proposal, the agencies propose to require that large banks hold a greater level of long-term debt, reducing dependence on less stable deposits, which, if uninsured, are prone to runs when a bank begins to falter.

In the surcharge proposal, the Board proposes to better align the capital surcharge for the largest and most complex banks to each bank's systemic risk profile.

These proposals follow the failure of four regional banks in the spring of 2023. In the case of Silicon Valley Bank (SVB), Congress' misguided 2018 law S. 2155 eliminated "enhanced supervision" for banks as large as $250 billion in assets. This prompted SVB and several other regionals to grow recklessly; in SVB's case, the bank doubled its size each year following

passage of the law. The bank then bet disastrously that interest rates would not rise and invested in low-returning long-term Treasury bonds. These bonds declined in value as interest rates, in fact, rose, which the Federal Reserve had publicly and conspicuously warned. Market value losses in this portfolio quickly eviscerated the thin amount of equity capital (assets minus liabilities) that regulators required. Uninsured depositors, which accounted for the lion's share of SVB's deposits, understandably withdrew their funds, culminating in a run. This forced regulators to seize the institution. Public Citizen explored the collapse of SVB in a submission before the Senate Banking Committee.[1]

Well before these failures, the agencies have been working toward a Basel Endgame capital rule. Agency leaders, economists and other staff have labored on the proposal for more than a decade. The proposal would generally apply to banks with $100 billion or more in total assets, of which there are 31 in number. Community banks would not be impacted by this proposal.
In particular, the proposal would standardize aspects of the capital framework related to credit risk, market risk, operational risk, and financial derivative risk. Additionally, the proposal would require banks to include unrealized gains and losses from certain securities in their capital ratios. This addresses the problem of SVB, which held its long-term Treasuries in a manner known as hold-to-maturity, or HTM. This allowed the bank (and others similarly situated) to account for the bonds as if they had not lost value. These banks would also be subject to the supplementary leverage ratio and the countercyclical capital buffer, if activated.

The proposed improvements to strengthen the banking system are estimated to result in an aggregate 16 percent increase in common equity, with the increase principally affecting the largest and most complex banks. The effects would vary for each bank based on activities and risk profile. Most banks currently would have enough capital to meet the proposed requirements. The proposal includes transition provisions to give banks sufficient time to adapt to the changes while minimizing any potential adverse impact. During the comment period, the agencies will collect data to further refine their estimate of the proposal's impact. Under the proposal, large banks would begin transitioning to the new framework on July 1, 2025, with full compliance starting July 1, 2028.

Separately, the Federal Reserve Board today also requested comment on a proposal that would make certain adjustments to the calculation of the capital surcharge for the largest and most complex banks. The changes would better align the surcharge to each bank's systemic risk profile, in particular by measuring a bank's systemic importance averaged over the entire year, instead of only at the year–end value.

Public Citizen supports greater capital for banks. We express concern that the Basel Endgame proposal perpetuates reliance on risk weighting, which we believe is unwise, unsound, and discriminatory. We are also concerned that the proposal calling for greater long-term debt compounds the problem that banks already operate with too much debt. Public Citizen believes that greater equity capital, not greater debt, will improve the safety and soundness of our largest financial institutions.

[1] Bartlett Naylor, *Testimony, Senate Banking Committee* CITIZEN.ORG (March 27, 2023) https://www.citizen.org/article/submission-to-banking-housing-and-urban-affairs-committee-re-silicon-valley-bank-compensation/

A Consideration of Capital

On the surface, a bank may appear to be the epitome of safety. Many emphasize this in their names, using words such as "trust" or "security." They occupy large, sturdy buildings in the middle of cities, often defining the skyline.

Yet, as Americans have come to understand, they are, in fact, highly speculative business operations that rely dangerously on debt. Moreover, much of that debt, namely, the debt that comes as deposits, is insured by the federal government. This introduces moral hazard. While the normal lender performs diligence on the borrower lest the money is squandered, the depositor need not worry. If the bank fails, the insured depositor is repaid by the government. This invites a wayward banker to speculate unsafely.

There are three traditional means of controlling moral hazard: 1. examination and supervision; 2 uninsured depositor and creditor discipline; and 3. regulatory capital requirements.

Banks overly reliant on debt risk insolvency. If the value of their assets declines by as little as 10 percent, they become insolvent, as what they owe becomes larger than what they own. At the end of 2022, JP Morgan, America's largest bank, with operations throughout the nation and in dozens of countries, listed $3.66 trillion in assets. That's $3,665 billion. However, it also disclosed $3.373 trillion in debt, or liabilities.[2] The difference between these two mammoth numbers is slim. If the value of its assets declined by a mere 7.9 percent, then the nation's largest bank would be insolvent. By contrast, the average household owns $166,900 worth of assets (equity in a home, savings, stocks, etc).[3] And the average household debt is $101,915.[4] That means the value of average household assets would need to decline by 39 percent before the family is insolvent.

In the somewhat misleading parlance of bank regulation, these percentages are known as capital. Capital is a ratio. Capital is the ratio of the difference between assets and liabilities, which is the numerator, divided by assets, which is the denominator. JP Morgan's capital is 7.9 percent of its assets. The average household's capital is 39 percent of their assets. JPMorgan may have skyscrapers in many American cities and most of the world's capitols, but the average American household is essentially five times safer, financially.

Most businesses operate by developing, making and selling widgets at the least cost and then selling them for the highest price the market will bear. Apple, maker of the iPhone, is the biggest company in the United States, measured by market capitalization (the value of all its stock). Apple disclosed $355 billion worth of assets in its latest annual report, and $302 billion in

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[2] JP Morgan, *Annual Report*, JP MORGAN (Dec. 31, 2022) https://jpmorganchaseco.gcs-web.com/node/525601/html#i71fd3be39cff46d4bfa090c3713c3fa2_139

[3] *The Wealth of Households 2021*, CENSUS BUREAU (June 2023) https://www.census.gov/content/dam/Census/library/publications/2023/demo/p70br-183.pdf

[4] Jack Caporal, *Average American Household Debt in 2023: Facts and Figures*, THEASSENT (Aug 17, 2023) https://www.fool.com/the-ascent/research/average-household-debt/

liabilities. Of these liabilities, only $148 billion is debt.[5] In its history, Apple has operated with debt that is as little as 1.3 times that of its equity. By contrast, large banks operated with debt that is 18 times that of its equity.

The business of JP Morgan is not about developing, making and selling widgets, but borrowing as much money as is allowed, then lending or speculating with it. The business of banking, then, is akin to that of a house flipper. The flipper attempts to buy a house worth $100,000 with as little of his own money as possible, say $5,000, financing as much as possible with a loan, in this case $95,000. A resale at $110,000 would mean a $10,000 profit on the $5,000 investment, or 200 percent. If the flipper put in $100,000 himself, that $10,000 gain would only be 10 percent.

The overriding reason that bankers fund their operations with as much debt and as little equity capital as possible: executive compensation. Banker bonuses largely come in the form of stock grants. The higher the stock price, the richer the compensation. Less equity capital means the profits of the bank are greater for each share. Banker bonuses stem from return on equity, or ROE. The smaller the equity, the greater the return, and the greater the compensation. (The simplest way to boost pay based on ROE, is to reduce E.) The recent Wells Fargo financial maneuver demonstrated this dynamic. On July 25, Wells Fargo announced its board of directors had authorized a $30 billion repurchase plan of its publicly traded common stock.[6]

Public Citizen generally opposes stock repurchases and especially those by bank holding companies. They deprive a company of funds needed to expand and pay fair wages that retain a quality, productive workforce. While typically stock prices can increase temporarily from corporate stock repurchase programs as the number of shares are reduced, the long term benefit to core equity holders is more speculative, and can be dependent on the fundamental underlying value of the common stock at the time of repurchase.[7] Public Citizen wrote previously to the Federal Reserve expressing our concerns that Wells Fargo is repurchasing stock to boost management compensation, which is largely dependent on the price of its stock.[8] Indeed, Wells Fargo stock rose three percent following announcement of the buyback.[9] A mega-bank should not make precipitous decisions to further feather the nest of already well-compensated senior managers at the risk of a foundational bank safety measure. Wells Fargo's notorious fake

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[5] Apple, *Annual Report 2022* APPLE (September 2022)
https://d18rn0p25nwr6d.cloudfront.net/CIK-0000320193/b4266e40-1de6-4a34-9dfb-8632b8bd57e0.pdf

[6] Jacob Pramuk, *Wells Fargo Announces $30 Billion Buyback, Shares Rise*, CNBC (July 25, 2023), https://www.cnbc.com/2023/07/25/wells-fargo-announces-30-billion-buyback-shares-rise.html.

[7] The share price of WF Holding Company at the close of the markets on August 1, 2023, is about one-third greater than its tangible book value per share of approximately $34 per share. Thus, long term shareholders of the company will only benefit from the repurchase if the true economic value of the company is greater than the repurchase price of the stock. That seems like a very speculative proposition for Wells Fargo given the unrealized losses, discussed below, which are not accounted for by the tangible book value.

[8] Wells Fargo, *Proxy Statement 2022*, WELLS FARGO (March 15, 2023), https://www08.wellsfargomedia.com/assets/pdf/about/investor-relations/annual-reports/2023-proxy-statement.pdf.

[9] Bob Henderson, *Wells Fargo Stock Rises After $30B Share Buyback Announcement*, WALL STREET JOURNAL (July 25, 2023), https://www.wsj.com/livecoverage/stock-market-today-dow-jones-07-25-2023/card/wells-fargo-stock-rises-after-30b-buyback-announcement-MdtF1asofSmA9KpLC7ib?page=1.

account scandal was similarly prompted by unwise compensation incentives at the San Francisco bank.[10]

In short, bankers wish to operate with as little capital as permitted because it drives their business model and fattens their paychecks. This simple dynamic underlies what is a most intense, sophisticated contest now playing out in Washington financial policy-making. Bankers want to continue this business model.

Conversely, the American public is better served when banks operate with greater capital, which means less risk of a bank bailout. The failure last spring of four regional banks, highlighted by Silicon Valley Bank, demonstrated that bailouts didn't end with the 2008 financial crash. Just as capital may be anathema to banks, it is the central safety mechanism for banking. Federal Reserve Vice Chair Michael Barr explained, "A safe and sound banking system is critical to a healthy economy, and capital is foundational to that safety and soundness. Capital is the cushion that allows a bank to absorb losses—no matter their source—and ensures that banks can continue to play their critical role serving households and businesses."[11]

Troublingly, some observers use metaphors that may confuse this basic arithmetic. Vice Chair Barr explains that capital is a "buffer," suggesting that it is a tangible bumper. Others describe it as a "cushion." Perhaps most misleading is the concept that banks must "hold" capital. This implies that the "capital" sits at the bank. But when a bank makes a loan, some of that may include its capital, such as retained earnings. That capital isn't "held" at the bank; it's loaned out.

Ultimately, bank capital is best understood for what it is: a concept that lives in numbers, a ratio, as noted above. Former FDIC official Hoenig has explained, "Capital is not "set aside," unavailable for lending or other activities. Rather, capital is a source of funding for a bank's activities, just like deposits or borrowings. It is funding provided by the bank's owners.[12] Public Citizen believes bank capital should be 20 percent. This means that when a bank makes a loan, it should use 20 percent of its own capital (such as retained earnings), and only 80 percent in borrowed funding, such as deposits or other debt.

Studies affirm that safer banks (those with greater capital) are better lenders. "Banks that came out of the [2008] crisis with higher capital ratios . . . were able to expand lending more," concluded one representative study.[13] We note that many financial players outside the traditional banking sector, sometimes dubbed "shadow banks," operate with double the equity capital as mega-banks.[14] [15] Researchers Steven Cecchetti and Kermit Schoenholtz analyzed data from 2013 to 2019 when regulators increased capital standards following the 2008 financial crash and

[10] Bartlett Naylor, *Inappropriate*, PUBLIC CITIZEN (September 2022), https://www.citizen.org/wp-content/uploads/Inappropriate-2.pdf.
[11] Michael Barr, *Statement*, FEDERAL RESERVE (July 27, 2023) https://www.federalreserve.gov/newsevents/pressreleases/barr-statement-20230727.htm
[12] Speech, FDIC Vice Chairman Thomas Hoenig, *The Leverage Ratio and Derivatives*: FDIC (Sept. 16, 2015), http://1.usa.gov/20dBycK.
[13] Benjamin Cohen, *How Have Banks Adjusted To Higher Capital Requirements?* BIS QUARTERLY REVIEW, (September 2013) https://www.bis.org/publ/qtrpdf/r_qt1309e.pdf
[14] Erica Jiang et all, *Banking without Deposits: Evidence from Shadow Bank Call Reports*, NORTHWESTERN UNIVERSITY (Sept. 2023) https://drive.google.com/file/d/1B3KFhyL1lEg4vJK0aFal5qoUCmcYJgfR/view?pli=1

concluded: "To be as clear as we can possibly be, higher capital requirements have not hurt banks, they have not hurt borrowers."[16]

The agencies' proposal steps in the right direction, with capital increased by about 16 percent. This is not a capital ratio of 16 percent, but rather an increase from the current ratio. This new level is easily met. Some banks already conform to the proposed standard. Those that do not could easily meet it by retaining earnings for a few quarters, suspending dividends.[17]

Capital and Risk Weighting

Capital requirements are not new in the United States, but they have varied significantly over nearly three centuries. The earliest banks formed in the days of Alexander Hamilton literally held capital in the form of gold. After many decades, geography, not size, determined the amount of capital. For example, the National Banking Act of 1864 detailed that a bank operating in an area with less than 6,000 people must demonstrate $50,000 worth of capital. The National Bank Act of 1863 described capital invested by shareholders. A shareholder, or "subscriber" might put up the cash for half of his investment but could be liable for the other half if the bank began to suffer losses. By 1939, the newly formed Federal Deposit Insurance Corporation described adequate capital as one-tenth. That is, for every $1000 in loans, there must be $100 in capital.[18]

A series of banking problems in Europe during the 1970s led to the establishment of the Basel Committee on Banking Supervision. Housed in the Bank for International Settlements in Basel, Switzerland, central bankers from the largest 10 economies formed the Basel Committee. [19] After years of study with considerable bank lobbying, they prescribed a new way to look at capital, namely, through risk weighting of assets. They called for a minimum capital of 8 percent. But they also introduced a relatively new concept. The assets would be "risk weighted."[20] Assets are a bank's loans such as its business loans to large and small enterprises; its investments in sovereign securities such as U.S. Treasuries and other items of value that it discloses on its balance sheet. On the surface, not all assets are equally risky. A loan to a small business might possibly go bad; an investment in a US Treasury has never failed. A loan to a small business

[15] Using the more generous risk-weighted measure of capital, economists at the conservative Mercatus Center argue that the optimal capital ratio is 25 percent. A study by the Minneapolis Federal Reserve Bank found that a 23.5 percent ratio would help end the problem of mega-bank bailouts.—Renita Marcellin, Testimony, House Financial Services Committee, (Nov. 7, 2023) https://docs.house.gov/meetings/BA/BA20/20231107/116543/HHRG-118-BA20-Wstate-MarcellinR-20231107.pdf

[16] Steven Cecchetti and Kermit Schoenholtz, *Setting Bank Capital Requirements*, MONEY AND BANKING, (Oct. 12, 2020) https://www.moneyandbanking.com/commentary/2020/10/11/setting-bank-capital-requirements

[17] Jeremy Kress, *Jeremy Kress on the Newly Proposed Banking Regulations*
BITE-SIZED BUSINESS LAW (2013) https://podcasts.apple.com/us/podcast/jeremy-kress-on-the-newly-proposed-banking-regulations/id1671246836?i=1000632409678

[18] Joseph Haubrich, *A Brief History of Bank Capital Requirements in the United States*, FEDERAL RESERVE BANK OF CLEVELAND (Feb. 28, 29020) https://www.clevelandfed.org/publications/economic-commentary/2020/ec-202005-evolution-bank-capital-requirements

[19] *History of the Basel Committee*, BANK OF INTERNATIONAL SETTLEMENTS (website visited September 23, 2023) https://www.bis.org/bcbs/history.htm

[20] *History of the Basel Committee*, BANK OF INTERNATIONAL SETTLEMENTS (website visited September 23, 2023) https://www.bis.org/bcbs/history.htm

with a thin track record might be riskier than a loan to a large, profitable business that even floats high grade bonds. If all risk weights are the same, proponents of risk weighting contended, banks would concentrate on those that are the most risky, with the greatest potential for reward. But the concept of risk weighting resulted from considerable lobbying by the banking industry. Risk weighting became a clever way of reducing the amount of assets in the denominator.[21] If assets can be reduced through lower risk weights, capital can be reduced.

The first Basel Accord (Basel I) was adopted in 1988 by the G-10 with the stated goal of harmonizing capital regulation across countries and strengthening the stability of the international banking system. The Basel committee explained that this framework would encourage banks to increase their capital positions and to make regulatory capital more sensitive to banks' perceived credit risks. Accordingly, assets and off-balance sheet activities were assigned risk weights between 0 and 100 percent according to their perceived risks, and banks were obliged to hold a minimal amount of capital relative to total risk-weighted assets and off-balance sheet activities.[22] The most risky assets were weighted at 100 percent. But other assets are weighted at less than 100 percent. Sovereigns, which are bonds issued by governments, are weighted at zero percent. Hypothetically, if a bank invested only in US Treasuries, it would need no capital.

Risk weighting, though, suffers obvious flaws. For example, not all sovereigns are equal. While the United States has not defaulted on its obligations, Greece has. Risk weighting has not always served well to prepare banks for troubles. Leading to the 2008 crash, mortgages were risk weighted at less than 100 percent. Those arguing for this lower weight contended that housing prices rarely fell, and mortgage defaults were rare. In fact, that lower risk weight proved fatal, as Wall Street fraudulently wrote mortgages beyond what the market demanded to serve a securitization frenzy.[23] The regional banking failure of Silicon Valley Bank on March 10, 2023, followed the fatal error to purchase long term Treasuries. As the Federal Reserve raised interest rates, the value of those bonds declined, revealing a marked-to-market loss beyond the bank's capital. Large, uninsured and arguably more sophisticated depositors could see this accounting insolvency and withdrew their funds in magnitude—a run. Many banks also held these arguably safe Treasuries, threatening runs at other banks, forcing the FDIC to effectively declare all deposits covered by federal insurance at banks that size and above. In other words, risk weighting helped cause, not prevent, the two most recent bank calamities.

Observed Kevin Dowd from the conservative Cato Institute, the explanation for the banking industry's affinity for risk-weighting "is simple: the regulatory system was being gamed by banks engaged in risk-weight 'optimization'—exploiting the loopholes and inconsistencies in the system via regulatory arbitrage, in effect gaming both the denominator and the numerator in the risk-weighted capital ratio. In so doing, they hijacked the system into a race to the bottom.[24]

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[21] Adam Chalmers, *Characteristics and Banking Regulations on International Bank Lobbying* Business and Politics, (Feb. 1, 2017) https://www.cambridge.org/core/journals/business-and-politics/article/when-banks-lobby-the-effects-of-organizational-characteristics-and-banking-regulations-on-international-bank-lobbying/2F1C268EF453991B7DF6B5EC486004BF

[22] Leonardo Gambacorta, *Leverage and Risk Weighted Capital Requirements*, Bank for International Settlements, (Sept. 2016) https://www.bis.org/publ/work586.pdf

[23] Bartlett Naylor, *TOO Big*, Public Citizen (2016) https://www.citizen.org/wp-content/uploads/toobig.pdf

Thomas Hoenig, a professor at the conservative Mercatus Center, has served on the front lines of the capital debate for decades. From 1991 to 2012, he led the Federal Reserve Bank in Kansas City, and then joined the board of the FDIC. From this vantage, he watched the financial sector promote risk weighting. He observed,

> The risk-based system is still pitched as a cure for slow economic growth. The Clearing House Association, a trade group for large banks, [claims] that a risk-weighting system is the only reliable way to judge bank capital. . . . Let's look further at the financial and regulatory record. The preponderance of independent research, including by the International Monetary Fund and Bank for International Settlements, demonstrates many of the weaknesses of the risk-based capital measures that contributed to industry problems. Risk-based capital schemes encouraged banks to use their financial engineering tools to increase leverage and reported returns associated with artificially low risk-weighted asset classes. Low weights were assigned to subprime mortgages, foreign sovereign debt, collateralized debt obligations and derivatives like credit default swaps. These asset classes ended up dominating the banks' balance sheet, leading to massive losses. Unfortunately, and surprisingly, these risk weights have changed little since the [2008] crisis.[25]

Risk weighting also leads regulators (and bank lobbyists) to pick winners and losers. In the current proposal, mortgages with large downpayments receive a lower risk weight than those with low downpayments. This discriminates against low- and moderate-income home buyers. A loan to a small business is risk weighted higher than a loan to a large firm that has issued AAA-rated bonds. This discriminates against small business. We believe this discrimination is unwarranted even when considering risk alone. Banks will charge those mortgage borrowers with low downpayments or small business with less operational history than large corporations that issue bonds at higher rates.

Summarized Stanford Professor Anat Admati

> Risk weights introduce distortions in multiple ways. (i) They allow the use of internal models that often ignore tail risk, thus encourage concentrated tail risks and increase systemic risk; (ii)The use of banks' internal models allows manipulation of the requirements in order to increase leverage and risk. (iii) Risk weights distort bank lending, often away from business lending and towards government lending and other investments. A recent example is the excessive lending of private banks in Europe to the Greek government in 2001–10. Such lending received zero risk weight and thus the risk was ignored.[26]

We welcome the agencies' reform of risk weighing models by terminating the ability of banks to use their own internally generated models. Instead, the agencies propose a uniform risk weight

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[24] Kevin Dowd, *Math Gone Mad*, CATO INSTITUTE (Sept. 3, 2014) https://www.cato.org/sites/cato.org/files/pubs/pdf/pa754_1.pdf

[25] Thomas Hoenig, *Why Risk-Based Capital is Too Risky*, FEDERAL DEPOSIT INSURANCE CORP (Aug. 11, 2016) https://www.fdic.gov/about/learn/board/hoenig/op-ed-081216.html

[26] Anat Admati, The Missed Opportunity and Challenge of Capital Regulation, National Institute Economic Review (February 2016https://www.fsb.org/wp-content/uploads/Anat-Admati-Stanford-GSB.pdf

model. Internal models failed to appreciate the growing risk that led to the 2008 crash. An analysis from 2013 by the Basel Committee found that internal models at banks with similar risk profiles generated different risk weights for their own credit and market risks of their assets, including loans and securities.[27] Ideally, the agencies would abandon risk weighting and adopt a simple ratio, commonly known as the leverage ratio, as the sole measure for capital.

Artificial Intelligence

As stressed above, stronger capital requirements constitute the front line of bank safety. We believe stronger capital requirements are especially important with the emergence of artificial intelligence (AI), which poses enormous new risk to the financial system. The ingredients are many. AI that uses neural networks suffers from opacity, a "black box" problem where human overseers cannot readily understand the connection between inputs and outputs. Where firms use models, there may be overreliance on a given model, which, in turn, could be subject to a cyberattack.[28] The Equifax data breach, allegedly perpetrated by the Chinese army, exposed thousands of customer records.[29]

Writes American University Prof. Hilary Allen, "A panicked fire sale is just one example of "herding," a well-documented phenomenon that is inimical to financial stability. When market participants behave in a correlated manner, such participation will often lead to suboptimal outcomes for the financial system as a whole." This herding can inflate asset bubbles, as happened in the run-up to the 2008 financial crash, where banks collectively underwrote mortgages beyond market sense, leading to inflated housing prices and an inevitable deflation.[30] Other researchers worry that robo-investing could inflate stock market prices. Firms generally categorize their investment clients into between five and eight profiles. Then AI constructs an investment portfolio for each. Economies of scale make this cheaper for investors, but also influence the choices of larger groups. Deflation following the market surge caused by such herding could lead to a loss of clients. For a mega-bank reliant on a sizeable investment bank affiliate, a rapid loss of clients could impair its earnings, and therein, its capital.[31]

Climate Change

Public Citizen also believes that climate change poses significant and growing risks to banks and to the financial system. Climate-related transition risks to large banks are growing, for example,

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[27] Basel Committee on Banking Supervision, *Regulatory Consistency Assessment Programme Analysis Of Risk-Weighted Assets For Credit Risk In The Banking Book*, BANKING FOR INTERNATIONAL SETTLEMENTS, (July 2013) https://www.bis.org/bcbs/publ/d424.htm.

[28] Gary Gensler, Lily Bailey, *Deep Learning and Financial Stability* MIT, SSRN (Nov. 2020) https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3723132

[29] Federal Bureau of Investigations, *Chinese Military Hackers Charged in Equifax Breach*, FBI.GOV (Feb. 10, 2020) https://www.fbi.gov/news/stories/chinese-hackers-charged-in-equifax-breach-021020

[30] Hilary Allen, *Driverless Finance*, HARVARD BUSINESS LAW REVIEW (April 16, 2019) https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3366016

[31] Hilary Allen, *Driverless Finance*, HARVARD BUSINESS LAW REVIEW (April 16, 2019) https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3366016

as the US and other countries move away from fossil assets, and as renewable energy becomes more accessible and achieves greater demand. Fossil assets are increasingly likely to become stranded assets as countries commit to phasing out fossil fuels, renewable energy technologies advance and become more affordable, policies increase attention to climate risks, and public demand for addressing climate change grows. Research indicates that half of the world's fossil fuel assets—$11 trillion to $14 trillion worth—could become worthless by 2036 under a net-zero transition.[32] A Federal Reserve Bank of New York study looking at fossil fuel transition risk determined "the effect of climate stress could potentially be substantial in the future if banks are not sufficiently capitalized."[33] Physical risks are also growing for banks of all sizes, through risks to their borrowers, collateral, and investments, exacerbated by the growing insurance protection gap for residential and commercial real estate.

Large US banks are significantly contributing to these risks, but not significantly bearing responsibility for them or related costs. Five of the top twelve global financiers of fossil assets are the US Global Systemically Important Banks (GSIBs) JPMorgan Chase & Co., Citigroup Inc., Wells Fargo & Company, Bank of America Corporation, and Morgan Stanley. Since the Paris Agreement, these entities have provided more than US$1,516.8 trillion in financing for fossil fuels. Through their financing of fossil assets, these banks are, essentially, originating and distributing risks to the financial system in a manner not dissimilar to the origination and distribution of risks by lenders and securitizers of mortgage-backed securities during the 2008 financial crisis. They are originating loans to the fossil fuel industry, and risks associated with these loans—including physical risks associated with fossil fuel-related emissions, as well as transition risks associated with the distributed loans—are being broadly disseminated to consumers and to other entities. A disproportionate percentage of these consumers are individuals who are more vulnerable to climate impacts as a result of discriminatory practices. And many impacted consumers and entities, including community banks and credit unions that disproportionately serve low- and moderate-income communities, lack the capacity to avoid and address these risks.

The agencies have confirmed, in their "Principles for Climate-Related Financial Risk Management (hereafter, the climate principles),[34] that climate change is a threat to the safety and soundness of banks and the stability of the financial system. This perspective is shared by the Financial Stability Oversight Council, which recently recognized climate-related financial risk as a "development [affecting] the resiliency of the financial system" and a potential risk to financial

[32] Jonathan Watts, et al., "Half world's fossil fuel assets could become worthless by 2036 in net zero transition," *The Guardian* (Nov. 4, 2021), https://www.theguardian.com/environment/ng-interactive/2021/nov/04/fossil-fuel-assets-worthless-2036-net-zero-transition.

[33] Hyeyoon Jung, Robert Engle, and Richard Berner, "CRISK: Measuring the Climate Risk Exposure of the Financial System," *Federal Reserve Bank of New York Staff Reports*, no. 977, at 4 (Revised Mar. 2023), https://www.newyorkfed.org/medialibrary/media/research/staff_reports/sr977.pdf?sc_lang=en.

[34] Federal Agencies *Principles for Climate-Related Financial Risk Management*, 88 Fed. Reg. 74,183 (Oct. 30, 2023). https://www.govinfo.gov/content/pkg/FR-2023-10-30/pdf/2023-23844.pdf

stability.[35] Treasury Secretary Yellen has described climate change, as "an existential threat" that "poses "tremendous risks to our country's financial stability."[36]

Capital requirements should play an important role in mitigating these risks. As one expert has noted: "One of the most powerful tools in financial regulators' arsenal is the bank capital framework, and it should be at the heart of efforts to improve the resilience of the financial system to climate-related risks."[37]

While the Basel Endgame proposal appropriately strengthens requirements for credit, operational, and market risks, it is confusingly silent on the ways that climate-related financial risks should be incorporated into capital requirements and capital adequacy assessments. Regulators must attend to transition and physical risks posed to large banks, while also ensuring that banks don't unfairly and unjustly limit lending to low- and moderate-income (LMI) and other underserved communities in climate vulnerable areas.

Similarly, the GSIB surcharge proposal recognizes large bank contributions to systemic risk, but regulators should acknowledge and address bank financing of fossil assets as a contributor to this risk.[38] As explained by one expert, "Regulators have a responsibility to mitigate financial risks created by financial institutions, not only the risks to which financial institutions themselves are exposed. Accordingly, regulators should implement a macroprudential climate risk contribution capital surcharge to bolster big banks' resilience to the systemic risks they are creating and to require them to bear the future costs their carbon financing activities are placing on the financial system as a whole. The capital surcharge should be calibrated based on the total GHG emissions financed by the institution."[39]

Reform Banker Pay

As noted, expanding banker bonuses drives banker opposition to safer capital rules. We ask the regulators to complete rulemaking for Section 956 of the Dodd-Frank Wall Street Reform and Consumer Protection Act. This rule bars compensation structures that may lead to "inappropriate" risk taking. Public Citizen reports and testimony demonstrate the connection between inappropriate pay structures and misconduct, which include the reckless decisions behind the regional bank failures of last spring.[40] To reform this dynamic, we propose that a significant portion of incentive compensation for senior bankers be deferred in a collective fund. If the bank fails, or must pay a fine for misconduct, this collective fund is mandated to be used.

[35] "Analytic Framework for Financial Stability Risk Identification, Assessment, and Response," 88 Fed. Reg. 78,026, 78,033 (Nov. 14, 2023).

[36] Janet Yellen, *Remarks by Secretary Janet L. Yellen at the Open Session.* FINANCIAL STABILITY OVERSIGHT COUNCIL (March. 31, 2021), https://home.treasury.gov/news/press-releases/jy0092.

[37] Gregg Gelzinis, Center for American Progress, *Addressing Climate-Related Financial Risk Through Bank Capital Requirements,*" CENTER FOR AMERICAN PROGRESS (May 2021), https://www.americanprogress.org/wp-content/uploads/sites/2/2021/05/Addressing-Climate-Financial-Risk.pdf.

[38] Id.

[39] Id.

[40] Bartlett Naylor, *Testimony,* SENATE BANKING COMMITTEE (March 27, 2023) https://www.citizen.org/article/submission-to-banking-housing-and-urban-affairs-committee-re-silicon-valley-bank-compensation/

This deputizes every banker to police one another; their own pay is on the line. The regulators' 2016 proposal comes close to this mechanism.[41]

Conclusion

In conclusion, Public Citizen welcomes efforts to improve stability of the largest financial sector actors. Improving bank capital will be an important element in reforms necessary to achieve a world where the nation is no long held hostage to mega-banks that are too big to fail. Other reforms are necessary, such as breaking up the mega-banks (which includes disallowing commercial banks joining with investment banks) and a stricter ban on banks operating in normal commercial markets (such as energy exploration and sales). [42]

We understand the agencies face stiff opposition from Wall Street. They've marshalled their formidable army of lobbyists to Capitol Hill, where an obliging House Financial Services Committee has already held several hearings designed to undermine the capital rule.[43] At a hearing at the Senate Banking Committee the CEOs of America's mega-banks declared grave harms would come to the American economy with the new rule, even while acknowledging that previous increases in capital only made them stronger and didn't deter robust banking.[44]
We urge the agencies to ignore their misleading arguments and remain focused on establishing a safer financial sector that serves average Americans.

For questions, please contact Bartlett Naylor at bnaylor@citizen.org, and/or Anne Perrault aperrault@citizen.org.

Sincerely,

Public Citizen

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[41] The collective fund under the 2016 proposal is not automatically forfeited to pay a misconduct fine or to pay creditors after a bank failure but left to the discretion of the board. Public Citizen opposes board discretion for many reasons, including the fact that board failures abet misconduct and failure. Indeed, the SVB board paid bonuses to SVB executives hours before failure.

[42] Bartlett Naylor, *TOO Big*, PUBLIC CITIZEN (2016) https://www.citizen.org/wp-content/uploads/toobig.pdf

[43] *Hearings, House Financial Services Committee, 118th Congress*, HOUSE FINANCIAL SERVICES COMMITTTEE (website visited Dec. 10, 2023) https://financialservices.house.gov/calendar/?EventTypeID=309&Congress=118

[44] *Annual Oversight of Wall Street Firms*, SENATE BANKING COMMITTEE, (Dec. 6, 2023) https://www.banking.senate.gov/hearings/11/29/2023/annual-oversight-of-wall-street-firms