Proposal: 1814(AG65) Regulatory Capital Rule: Risk-Based Capital Surcharges GSIB BHCs; Systemic Risk (FR Y-15)

Description:

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From: University of Chicago, Karl Muth

Proposal: 1814(AG65) Regulatory Capital Rule: Risk-Based Capital Surcharges GSIB BHCs; Systemic Risk (FR Y-15)

Subject: Risk-Based Capital Surcharges for Global Systemically Important BHCs; Systemic Risk Report (FR Y-15)

Comments:

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Proposal: Regulatory Capital Rule: Risk-Based Capital Surcharges for Global Systemically Important Bank Holding Companies; Systemic Risk Report (FR Y-15) [R-1814]
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First name: Karl
Middle initial:
Last name: Muth
Affiliation (if any): University of Chicago
Affiliation Type: ()
Address line 1:
Address line 2:
City:
State:
Zip:
Country: UNITED STATES
Postal (if outside the U.S.):
Your comment: Dear FDIC, the Federal Reserve, and Certain Other Bank Regulatory Agencies or Regulators,
This is a timely filed reply to an inter-agency request for comment (SEC File PR-55-2023, Regulatory Capital Rule: Risk-Based Capital Surcharges for Global Systemically Important Bank Holding Companies; Systemic Risk Report (FR Y-15) [R-1814]).

I worked as the primary buy-side negotiator representing a party interested in buying the $1.82B of distressed assets in controversy in the wind-down of Corus Bank in Chicago following its financial crisis NASDAQ delisting and failure, among the largest bank wind-downs in Illinois in the post-Continental era. I have worked on a wide variety of complex transactions, including restructuring transactions, in the banking and insurance industries. I have seen up-close what a bank failure looks like.

I studied law at the undergraduate level in the Netherlands before earning a law degree and a master's degree with a concentration in economics, the latter from the University of Chicago. Following my masters degree, I earned MPhil and PhD degrees from the London School of Economics, after which I was part of the Emerging Leaders program at Harvard's Kennedy School. I have taught law, economics, public policy (including policy economics), and other topics for nearly fifteen years at top universities.

I have been involved in the making and interpreting of rules, including being cited by the SEC in both Proposed Rules and Final Rules and being cited by the Secretary of the SEC, a Commissioner of the SEC, and in various law journals and in the mainstream press on topics like 10b5-1 trading plans, the interpretation and consequences of Dodd-Frank 953(b), the optimal structure for certain kinds of riskoriginating firms, and the consequences of decoupling contractual obligations from LIBOR.

I write in favor of the proposed framework, particularly its general-reconciliation-of-capital frameworks, making it easier for auditors and risk control personnel, officers and operators, and attorneys whether in-house or outside counsel, to understand the magnitude of the four basic species of risk in play (credit, market, operational, and instrument/derivative) and to make the classification of, and accounting for, these areas of risk more standardized across the marketplace and more comparable between firms.

In my experience, firms, but particularly firms holding exotic investment instruments or unusual reinsurance obligations, tend to create special tranches or cumbersome taxonomies to classify and reclassify obligations in ways that add audit opacity, accounting complexity, and legal questions. While it is understandably tempting to put a strange investment into its own bucket, pretty soon the buckets tend to multiply and the exception swallows the rule. We see this in options, crypto, and other areas.

While it is impossible, and perhaps not even desirable, to manage toward a 100% survival rate for banks in the United States, predictable and orderly failures are more attractive than sudden and interlocutory-action and generally-litigation-plagued proceedings. Importantly, the Basel III endgame does not require a zero mortality rate for banks and bank-like (whether deposit-taking or not in the FDIC sense) institutions. Rather, guardrails, however implemented, will produce some number of orderly failures.

At the time I became involved in the Corus matter (in charter and regulatory documents: Corus Bankshares, Inc.), Corus had a Texas ratio of 70%, was clearly in failure, and all T1 capital of the bank had been cannibalized (T1 capital was preliminarily at ($151M), a negative figure, later described as $157M or more in settlement documents). The FDIC and other regulators did not close Corus, even though it has been the custom (but not obligation) of regulators to close banks with negative T1 figures.

In the Corus scenario, we were fortunate some of the remaining salvage assets had generally-recognized positive values, even if those values were encumbered. This cannot be assumed and will not always be the case. Often, troubled banks will hold assets that are deeply distressed due to macroenvironmental conditions or assets that have no recently-realized auction value. In other scenarios, banks will hold assets that can be liquidated but on timelines too long for the first wave of creditor satisfaction events.

As you know, most banks affected by the Basel III endgame rules already have sufficient T1 capital to meet the new requirements. Some banks that are not sufficiently capitalized may be able to reallocate or reclassify existing capital, or change obligations, to meet the new obligations without taking in substantial amounts of fresh capital. Other banks have unusual or exotic investments that they may be able to unwind, resell, or restructure prior to the July 2028 proposed deadline, a generous window.

The area where I would encourage attention and higher-resolution regulatory scrutiny is the topic of bank consolidations, where the banks involved are often of different size and on substantially different financial footing. There is a scenario one can easily envision where banks near (but not necessarily below) the compliance envelope may feel pressure to get acquired by a larger bank in mid-2025 (the transition date) in preparation for the start of the combined entity's compliance burden in mid-2028.

Mergers and acquisitions negotiations are inevitably delicate and often characterized by thoughtful, if glacial, diligence. I fear, however, a compliance burden on the horizon will in some cases accelerate, and even potentially encourage, suboptimal courtships.

I published research in The Journal of Private Equity in 2010 on the topic of M&A negotiation in a regulated industry; research in both finance and negotiation suggests the smaller bank (the potential acquiree) in this scenario will perceive any arbitrary timeline (including looming regulation) as a deadline for a deal and will even bid against itself if needed to get acquired at any price to avoid a non-compliant, orphan small bank result. This issue should be considered in FDIC plenary conversations.

There is no optimal number of banks for the United States and no optimal number of bank failures in any given epoch. Efforts to standardize accounting, operations, and reporting are welcome and, even if not imminently needed, a near future in which this standardization is needed is not only imaginable but likely. The Basel III endgame allows, and even invites, localization in rulemaking and the Fed and FDIC should take historical knowledge and empirical research on rule-making and apply them here.

As always, should any regulatory agency within the ambit of this project require help in any aspect or stage of this effort, I am happy to discuss any of these policymaking opportunities further.

Respectfully submitted,
Karl T. Muth, JD, MBA, MPhil, PhD