

January 16, 2024

Ms. Ann E. Misback
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue NW
Washington, DC 20551
Docket No. R-1813, RIN 7100-AG64

Mr. James P. Sheesley
Assistant Executive Secretary
Attention: Comments/Legal OES
Federal Deposit Insurance Corporation
550 17th Street NW
Washington, DC 20429
RIN 3064-AF29

Mr. Benjamin McDonough
Chief Counsel
Office of the Comptroller of the Currency
400 7th Street, NW
Suite 3E-218
Washington, DC 20219
Docket ID OCC-2023-0008

Re: Regulatory Capital Rule: Large Banking Organizations and Banking Organizations with Significant Trading Activity

Dear Ms. Misback, Mr. Sheesley, and Mr. McDonough:

I am the Elizabeth F. Putzel Professor at the Wharton School and have conducted research on international regulatory cooperation, and, in particular, the regulatory cooperation practiced at the Basel Committee for Banking Supervision, for over 25 years. I am submitting this comment because I am concerned about the effect of the proposed rule on the real international accomplishments represented by the Basel Capital Accord.

One of the virtues of the Basel Capital Accord lies in its harmonization of previously disparate domestic capital rules. Basel's capital accords have represented international governance that works, and works without the logistical, political, and practical complexity associated with the conclusion of a multilateral treaty, the establishment of a formal dispute resolution process, or any of the usual indicia of international law. I worry that the proposed American departures from the requirements of the third iteration of the Basel Capital Accord will mean that American banks, and the customers they serve, will lose some of the benefits of this high-water mark of international regulatory cooperation. The proposed rule means that banking done in the United States will be substantially different, as a capital matter, than banking done in the rest of the world. In a time of attacks against globalization, it would be regrettable if American banking regulators, once a driving force in support of harmonized capital rules, turned away from a global institution that works.

My Perspective

I have written about regulatory cooperation and Basel since 1998 and am one of the most cited and best-published scholars of international regulatory cooperation.¹ A number of articles of mine have

¹ David Zaring, International Law by Other Means: The Twilight Existence of International Financial Regulatory Organizations, 33 TEX. INT'L L.J. 281, 282 (1998).

focused on Basel’s capital accords in particular.² In 2020, I published a monograph on the phenomenon of global financial oversight – one that again focused on the Basel capital accords. That book is titled *THE GLOBALIZED GOVERNANCE OF FINANCE*, and was published by the Cambridge University Press.³

In addition, I am currently engaged, along with two other academics/consultants by the Administrative Conference of the United States to study the current state of international regulatory cooperation efforts by American agencies in the wake of a 2012 executive order encouraging regulators to make policy mindful of the opportunities posed by international coordination.⁴

I offer this comment on my own behalf and have not been compensated by any party for providing it.

The Proposed Rules Departures from Basel II

The American proposal for the adoption of Basel III Endgame differs – in some ways substantially – from the terms of the international agreement reflected by the Basel III process.⁵ Federal Reserve Chair Jerome Powell noted that the proposal “exceeds what is required by the Basel agreement, and exceeds as well what we know of plans for implementation by other large jurisdictions.”⁶ Consider some of the more prominent departures by American regulators from the Basel III requirements

- In most cases, large American banks will be unable to use internal models for credit risk; banks in other jurisdictions may still do so. Instead, all American banks with more than \$100 billion in assets would face standardized requirements (the “expanded risk-based approach”); internal models remain an alternative for comparable foreign banks.
- Under the American proposal, lending to “investment grade” corporate exposures would only receive the lightest regulatory treatment if the company or its parent must have securities outstanding on a public securities exchange, which have not been part of implementation in the European Union and United Kingdom. It is not easy to understand why lending to publicly traded firms would be so much safer than lending to privately held

² See *E.g.*, David Zaring, *Informal Procedure, Hard and Soft*, in *International Administration*, 5 CHI. J. INT’L L. 547, 596 (2005) (“Where the fact of coordination is particularly important, but the substance of the coordination is not, regulatory cooperation is a useful, low-cost choice.”); David Zaring, *Finding Legal Principle in Global Financial Regulation*, 52 VA. J. INT’L L. 685, 722–23 (2012); David Zaring, *The President and International Financial Regulation*, 45 CASE W. RES. J. INT’L L. 361, 366 (2012).

³ DAVID ZARING, *THE GLOBALIZED GOVERNANCE OF FINANCE* (2020).

⁴ EO 13609 (May 1, 2012).

⁵ Reports on the differences between the proposed American rule and the approaches in other jurisdictions may be found at Jason J. Cabral, et. al., *Federal Banking Agencies Issue Basel III Endgame Package of Reforms*, GIBSON DUNN (Aug. 23, 2023), <https://www.gibsondunn.com/federal-banking-agencies-issue-basel-iii-endgame-package-of-reforms/>; Alejandro Johnston, et. al., *Basel III Endgame: Complete Regulatory Capital Overhaul*, PWC (Aug. 2023), <https://www.pwc.com/us/en/industries/financial-services/library/our-take/basel-iii-endgame.html>; *Basel III ‘Endgame’: Regulators Propose Significant Revisions to Capital Rules Applicable to Large Banks*, SULLIVAN & CROMWELL (Aug. 1, 2023), https://www.sullcrom.com/SullivanCromwell/_Assets/PDFs/Memos/sc-publication-basel-iii-endgame.pdf; Travis Hill, Statement by Travis Hill, Vice Chairman, FDIC, on the Proposal to Revise the Regulatory Capital Requirements for Large Banks (July 27, 2023), available at <https://www.fdic.gov/news/speeches/2023/spjul2723b.html>.

⁶ Jerome Powell, Statement by Chair Jerome H. Powell (July 27, 2023), available at <https://www.federalreserve.gov/newsevents/pressreleases/powell-statement-20230727.htm>.

ones. In the United States, after all, half of the capital raised in the United States is raised in private, rather than in public markets.

- The American proposal would increase the risk weights for residential real estate exposure more than would the European or British approach. Moreover, the proposal comes at a time when American banks are increasingly leaving mortgage origination to nonbanks, meaning that financing mortgages would, if the proposed rule is adopted, be done by different players under different regulatory regimes, depending on where the prospective homeowner lives. In particular, the American departure on residential mortgages could make mortgages more expensive for Americans and further disincentivize American banks from originating mortgages in the United States.
- Basel III reduced the risk weighting for lending to corporate small and medium enterprises, securities firms, some nonbanks, and well-capitalized banking firms. The American proposal does not adopt these reduced risk weightings. It also maintained a higher-than-Basel approach to short-term lending to banks.
- The American proposal does not adopt the Basel approach for so-called simple, transparent, and comparable (“STC”) securitizations.

The cumulative effect of these differences could be a cumulative capital increase of 16% for American banks, while British banks face a 3% increase in capital increases, and European banks 10%.⁷ As one observer put it, “European regulators estimate that the region’s banks would only need an extra €600 million of capital, versus more than \$170 billion that the Fed figures U.S. lenders will need to add.”⁸

What May Be Lost

One problem posed by these American departures is that, whatever the merits of the increased capital requirements, one of the achievements of the Basel Committee has been to level the global playing field for banks seeking to do business outside of their own borders. If the Basel III Endgame represents a sharp upward departure from the requirements of the international accord, the value of that level playing field will be lost.

The Basel Capital Accords are a remarkable achievement in the history of international regulatory cooperation. They work through a soft law mechanism that sets bank capital requirements at the international level and then implements those requirements when the regulators return to their domestic jurisdictions. The consequence has been an effective form of international governance — and many more formal international legal systems enjoy far less compliance than Basel does. An American departure from Basel could undermine both international and industry support for the Basel process, which has served, until now, as a sustainable, long-lasting, and impactful case study for the merits of international cooperation.

⁷ Kyle Campbell, *Basel III Endgame: 5 Things to Watch in 2024*, AMERICAN BANKER (Dec. 25, 2023), <https://www.americanbanker.com/list/basel-iii-endgame-5-things-to-watch-in-2024#:~:text=With%20a%20proposed%20cumulative%20capital,%25%20and%2010%25%2C%20respectively.>

⁸ Liz Hoffman, *Big Banks Mull The Unthinkable: Suing the Fed*, SEMAPHOR, Jan. 11, 2024, <https://www.semafor.com/article/01/11/2024/big-banks-mull-the-unthinkable-suing-the-fed.>

To be sure, as FDIC Director Jonathan McKernan has observed, “departures from these international standards can be appropriate to serve American interests,”⁹ but it is not clear that American interests do benefit from such upward departures on capital requirements. More capital makes banks safer – no question. But it is certainly possible that the capital rules will make American banks less competitive than their foreign counterparts, and, more generally, will make it harder for banks to serve clients across borders, given that they will have to navigate capital rules with different requirements depending on the various jurisdictions in which they do business. This in turn could reduce competition between banks from different jurisdictions – and when robust competition is on offer, bank clients benefit. Moreover, as Board Governor Philip Jefferson has noted, there are benefits to “increasing standardization” and “reducing unwanted variability in capital requirements.”¹⁰ As finance has globalized, financial regulators have used cooperation, quite successfully, to address the risk of externalities and spillovers. Moreover, effective and consistent cooperation across borders has its own value, especially in a time where global tensions have risen. American regulators really drove that cooperation in the past; it would be costly to turn away from it.

As I observed in 2015, the Basel Capital Accord

has, in large part, been an effective regulatory enterprise, one that addressed a problem posed by a productive but risky industry that had started to spread both its production, and its risk, across borders. In 1974, scores of financial intermediaries operated all over the world. They encountered bespoke, idiosyncratic, and inconsistent oversight, even on such fundamental questions as to how they should prepare for crises. American banks, for example, held six percent of their capital in reserve to deal with emergencies, while others, such as Japanese banks, did not have to hold any.

Today, almost every bank of any size across the world is required to hold much more capital in reserve -- roughly 8-10 percent. Banks are restricted from engaging in certain transactions the world over, and face oversight that, regardless of the jurisdiction, has been committed to approach the job of supervising financial institutions in roughly similar ways, with roughly similar tools.¹¹

We all benefit from increasing standardization of international financial regulation. The Basel process has created a more organized international system of bank oversight, and it makes little sense to supervise a global financial system through purely national means. Moreover, as finance has globalized, and as the largest American banks do more and more work abroad, the Basel process has

⁹ Jonathan McKernan, Statement by Jonathan McKernan, Member, FDIC Board of Directors, on the Proposed Amendments to the Capital Framework (July 27, 2023), available at <https://www.fdic.gov/news/speeches/2023/spjul2723c.html>.

¹⁰ Phillip N. Jefferson, *Financial Stability and the U.S. Economy* at the 22nd Annual International Conference on Policy Challenges for the Financial Sector, Washington, D.C. (May 31, 2023) available at <https://www.federalreserve.gov/newsevents/speech/jefferson20230531a.htm>.

¹¹ David Zaring, *Legal Obligation in International Law and International Finance*, 48 CORNELL INT’L L.J. 175, 178–79 (2015) (footnotes omitted).

become more procedurally fair. As the initially cobbled together, secretive, and minimalist system of financial regulation has been replaced with a routinized one, with notice and comment, ideals of publicity, and principles of national treatment, most favored nation treatment, subsidiarity, peer review, action through rulemaking, and a network form, it is possible to ascertain goals and processes of this system. The result is coherent on metrics that do not necessarily favor one state or another. The turn to harmonized regulatory standards in what is clearly a soft law enterprise is a fascinating indicator of that enterprise's appeal and winning qualities.

I recommend adjusting the proposed rule to hew more closely to the agreement reached on Basel III.

Sincerely,

A handwritten signature in black ink, appearing to read 'D. Zaring', with a horizontal line underneath.

David Zaring

Elizabeth F. Putzel Professor

Professor of Legal Studies & Business Ethics