Insight

Federal Reserve Previews Upcoming Bank Capital Crackdown

THOMAS KINGSLEY | JULY 10, 2023

Executive Summary

- The Federal Reserve's (Fed) Vice Chairman for Supervision, Michael Barr, has in prepared remarks previewed the likely contents of a sweeping bank capital restructure expected later this year.
- Barr recommends that bank capital requirements should be more onerous, apply to more banks, and rely less on a bank's own estimation of risk, but declines to tailor parts of the framework that are decades out of date.
- What the Fed has failed to demonstrate is that the banking system is undercapitalized or in need of what could be the most sweeping increase in capital requirements since Dodd-Frank.

Context

The replacement in July 2022 of Randal Quarles by Michael Barr as the Federal Reserve's (the Fed's) Vice Chairman for Supervision, the third highest officer of the Federal Reserve, brought with it a sea change in how the Fed planned to approach banking supervision. During Quarles' tenure he sought to simplify the banking regulatory framework and in particular the excesses of Dodd-Frank. On succeeding Quarles, Barr has by comparison (and a comparison drawn by Barr himself) made clear his intent to challenge what he views as the previously "permissive" nature of Fed supervision and to strengthen bank capital requirements.

While the banking industry has been awaiting the results of Barr's "holistic capital review" since at least December, the debate as to the necessity of new or stricter bank capital requirements was re-invigorated in March by the collapse of Silicon Valley Bank (SVB), despite the fact that no capital requirement framework could possibly prevent the failure of a bank that saw depositors attempt to withdraw nearly a quarter of its assets under management in a single day.

While the Fed's holistic review of capital is still ongoing and not expected until later this year, the banking industry got a significant insight into the direction of Barr's thinking in the form of a series of recommendations he made in a July 10 speech at the Bipartisan Policy Center. In what may be the most significant bank capital regulatory expansion since Dodd-Frank, Barr envisages a more onerous capital adequacy framework that covers more banks. While any changes to capital requirements would likely be phased in over years, it is unfortunate that the Fed has chosen this time to propose the increase of the regulatory and compliance burden on the banking industry and decrease the ability of banks to lend in light of a systemic threat (or even existing capital insufficiency) that the Fed has failed to articulate.

Barr's Recommendations

Barr recommends that existing risk-based capital requirement standards be updated to better reflect credit, trading, and operating risks, and that these updates be entirely consistent with international standards, namely Basel III. Perhaps the most significant of these requirements is ending a system of reliance on a bank's own individual estimates of risk via internal risk models. Rather than assume that the bank itself is best placed to judge the risks it and its unique portfolio faces, the Fed may propose a one-size-fits-all internal model that will significantly reduce the sensitivity of these models – and presumably lead to a significant expansion of the Fed's supervisory role.

Barr also recommends that the new capital framework should apply to all banks and bank holding companies with more than $100 billion in assets, summarily stripping away the bank tailoring efforts of his predecessor. In particular, these banks would become subject to long-term debt requirements. In his rationale Barr points to the failure of SVB, a better example of a supervisory failure than a capital one. SVB made a series of strategic, investment, and reporting errors that are unrepresentative of America's mid-size banks – and it is disappointing that the Fed would paint them all with the same brush. Barr estimates that under the new framework, banks will have to hold an additional 2 percentage points in capital, an astonishing increase where many banks hover between 8 and 14 percentage points.

Barr also recommends that stress testing – while "sound" – should evolve to better capture risk and referenced global market shock and in particular operational risk as a focus for review. Barr declined to provide further detail in his speech but did note that the Fed "could use a range of exploratory scenarios to assess banks' resilience to an evolving set of risks and use the results to inform supervision" which, if not describing the stress testing regime itself, can only represent a possible expansion in stress testing.

Finally, Barr recommends that other capital buffers (including the global systemically important bank (G-SIB) surcharge, the countercyclical capital buffer (CCyB) and the enhanced supplementary leverage ratio (eSLR)) not be changed at any fundamental level. While at first this might seem like a win for the banking industry, banks have chafed under several of these requirements and called for an update. Barr noted that even if a "fundamental" change to the panoply of requirements may not be in the cards, he would recommend "a series of adjustments of a more technical nature." It is unclear, but unlikely, that the Fed will propose better tailoring capital buffers to banks' risk profiles or whether it will even update a G-SIB surcharge that is decades out of date.

Conclusions

While Barr's remarks were framed simply as policy recommendations made in an informal setting, the banking industry should view this as what it is: A soft launch preview of the new capital framework to expect later this year that will feature an expansion in both the capital requirement framework and the number of banks it will cover. What makes the Fed's approach particularly difficult to understand, however, is the lack of evidence that there exists a problem that needs to be solved. All 23 banks tested in the Fed's severe recession stress test scenario passed with flying colors. If those banks don't present a risk, what is the new framework designed to address? By increasing the regulatory and compliance burden of small and mid-size banks, already low profit margins will shrink further, only incentivizing the risky business strategies that led to SVB's collapse. Bad businesses fail and this should also apply to banks. A reflexive approach to bank capital requirements that increasingly renders the basic business of banking uneconomic and in which regulatory requirements stifle new banking entrants is not the answer.