BETTER MARKETS

BANKING REPORT

Strengthening the U.S. Banking System Through Higher Capital Requirements

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INTRODUCTION

The largest banks in the U.S. remain subject to woefully insufficient capital requirements that undermine the stability of the financial system and leave the possibility of future banking crises too high. Regulatory reforms put in place after the Global Financial Crisis ("2008 Crash") by the banking regulatory agencies ("Agencies") failed to eliminate the challenges that make giant Wall Street banks too-big-to-fail ("TBTF"),[1] challenges that have only increased due to Trump-era deregulation and increasing risks to the banking system. Capital standards must be strengthened to fully support the benefits to society that come from a strong and resilient banking system. One that can continue to function and make loans that support the economy during severe downturns rather than being a cause of or exacerbating downturns.

For too long a key focus of the debate around bank capital has been on the costs to the industry, the ostensible "burden" of private costs to banks and their shareholders—as if they were entitled to a certain rate of profit—and the theoretical potential costs to the economy that might result from making banks use more capital as a source of funding. Meanwhile, the incalculable benefits of protecting taxpayers and hardworking Americans from the kind of ruinous impact that resulted from the 2008 Crash—and insufficient capital generally—are too often downplayed or ignored.

Virtually every time there is a significant downturn or market disruption, the government is compelled to provide taxpayer-funded support to prevent a large bank collapse, contagion, financial meltdown, and devastating impacts on the livelihoods of millions of Americans. Much of the discussion about the challenges presented by large banks is importantly centered on the best ways to address managing crises *after severe stress has materialized*. It is past time to shift focus from after the fact crisis management and do more to prevent collapse, contagion and crises in the first place, the foundation of which is a stable banking system built on strong capital requirements.

To achieve this, regulators should require the largest banks to have as much capital as necessary to minimize the likelihood of future large bank collapses and taxpayer-funded bailouts, with consideration for the private costs this may impose on banks—to their shareholders and their executives' bonuses—being decidedly secondary concerns. Capital requirements should be set such that they further reduce the probability of large bank failure and financial turmoil without undermining the capacity of the banking system to support the U.S. economy and consumers in providing credit and services to the American people and businesses. While determining precisely where this point lies is not a simple task, and is not the focus of this report, the evidence shows that current standards remain well short of that.

The current Federal Reserve ("Fed") Vice Chair for Supervision, Michael Barr, is undertaking a wholistic review of the bank capital requirement framework to determine if capital is in fact "strong enough." This begs the question—strong enough for what and strong relative to what? Some of this was outlined in a recent speech of Vice Chair Barr, but ultimately the answer should be—strong enough to make the banks appropriately internalize the cost of minimizing the possibility that their profit maximizing activities could once again cause or contribute to financial collapses and taxpayer bailouts.

[1] It is important to remember that the TBTF problem is about much more than just a bank's asset size. TBTF is shorthand for the problem that includes larger banks also being too leveraged, too interconnected, too complex, too concentrated, with too many high-risk activities, and being too essential to the proper functioning of the financial system (e.g., critical to the payments system). TBTF includes all aspects of the problem.

Bank Capital and Regulatory Capital Requirements

What is Bank Capital?

- Similar to customer deposits and bank-issued debt (like corporate bonds), capital is a source of funding that banks use to invest in assets, such as loans and securities.
- Unlike deposits and debt, which must be repaid to depositors and creditors, capital is not required to be repaid to the shareholders, and so can absorb losses when bank assets lose value—e.g., a borrower defaults, asset prices decline, etc.
- In concept it is like a down payment on a home, i.e., it can be thought of as similar to the amount of money the owner has put into the house purchase relative to how much they borrowed. That down payment serves as a buffer to the lender if the home price declines and capital at a bank serves as a buffer if its assets lose money.
- Contrary to the way many have misdescribed it, banks do not hold capital in the sense that it is money they are unable to use. It is simply another source of funding that comes from the owners/shareholders of the bank rather than from depositors and creditors.

It is clear that capital requirements must be strengthened for our largest banks, and that this would benefit the American people. This report discusses the reasons those requirements must be increased, the baselessness of industry talking points, and two key aspects in which the capital framework must be strengthened.

Strong Levels of Bank Capital Are Critical to A Safe and Well-Functioning Financial System, But Banks Have Lobbied to Keep Them as Low as Possible

The Importance of Bank Capital

The importance of bank capital cannot be overstated. Well-capitalized banks serve their communities and fulfill their social mission in good times and bad. At its most basic this mission is to pool and transform the savings of Americans into loans that support the economy, which, ideally, enables the creation of businesses and jobs and, ultimately, wealth creation and rising living standards. At the same time, however, this transformation presents risks to those who deposited their savings as well as to the solvency of the banks themselves. Because banks use those deposited savings to make loans and invest in other assets, banks only have a fraction of those deposits readily available at any given time. As a result, depositors risk not being able to retrieve their deposited savings when they would like, especially if many of them are attempting to withdraw their funds at the same time. Additionally, the loans and investments the banks make with the deposits carry the risk of loss due to borrower default or investment failures, which can lead to losses for banks, a significant amount of which can bring a bank closer to (if not entirely to) failure.

Therefore, these risks must be addressed by protecting customers' savings against losses[2] and minimizing the probability a bank will fail due to losses on the loans and investments it makes. When a giant bank has sufficient capital

[2] Banks are heavily supported in securing customers' savings by the FDIC through its deposit insurance fund. The FDIC insures individual deposit accounts up to $250,000 from bank failure. The importance of the FDIC's role was highlighted in a recent speech by FDIC Chair Martin Gruenberg.

What are Regulatory Capital Requirements?

- Regulatory capital requirements, as the name suggests, are minimum amounts of capital banks must have as a funding source that are set by the banking regulatory agencies.
- They are most commonly represented by the level of capital relative to one of two metrics:
  - The values of a bank's assets that are weighted by the relative risk each asset type potentially poses to the bank, i.e., "risk-based capital requirements" ("RBC"); or
  - The total value of a bank's assets as well as risks from its "off balance sheet" activities not adjusted for risk—known as a "leverage requirement."
- Risk-based capital requirements are often seen as the "primary" requirements because they are supposed to approximate the losses that could be realized under a stressed environment tailored to the risk of the particular bank.
- Leverage requirements are often seen as a backstop to risk-based standards as they can prevent a bank from growing too large relative to its capital, without attempting to address the specific risks in a bank's portfolios, which helps protect against the very real possibility (even likelihood) that risk weightings of assets used in the RBC calculations turn out to be wrong.

to withstand large potential losses, including through periods of substantial economic and financial stress, the likelihood of the bank collapsing and causing severe damage to the economy is low. In addition, a well-capitalized bank can continue lending to support the economy and jobs during economic downturns, helping to keep a downturn from becoming deeper than it might otherwise have been or from turning into a full-blown crisis.

Having sufficient capital to withstand severe losses is especially important with respect to the largest, TBTF banks, whose financial turmoil or collapse can threaten the economy, financial system, and the livelihoods of millions of Americans. Given the scale of this threat, it is a near certainty that the government will feel compelled to provide a taxpayer-funded bailout to prevent a TBTF bank's collapse and the devastating broader effects that can result.

This is exactly what happened in the 2008 Crash when Congress stepped in with a taxpayer-funded bailout package for banks of around $700 billion, and the Fed provided trillions more to keep the financial system from collapsing.[3] The largest U.S. banks had irresponsibly and recklessly created and taken on too much risk (some of which senior management and boards of directors apparently did not even know was there) and had too little capital to absorb the massive losses that resulted.

Historically, most bank regulators have been too sympathetic to bank complaints about the cost of higher capital requirements.[4] Although the post-2008 Crash reforms substantially increased capital relative to banks' risks, regulators stopped well short of requiring as much capital as many academics, public interest

[3] There are lots of ways to measure the amount of bailouts and there are disputes about all of them, but a Better Markets' study determined that the crash caused not less than $20 trillion in lost GDP, and a study from the Levy Institute found that the maximum value of the Fed bailouts alone were $29 trillion.

[4] Indeed, prior to the crisis, the Basel Committee on Banking Supervision had spent many years working out an arrangement (known as "Basel II") that was expected to lower bank capital requirements from their already weak levels and was specifically designed to allow the banks to calculate their own capital requirements. Fortunately, in the U.S. this easily abused and manipulated system has not become the binding regulatory capital constraint.

groups, bank risk managers[5] and even some regulators have argued that the largest banks need to minimize the potential they could once again contribute to a devastating financial crisis and require massive taxpayer-funded bailouts.

As so often happens with respect to the banking industry, which wields tremendous political power in all countries, banks were successful at fighting against more substantial requirements. ***Simply put, the post-2008 Crash increase in capital standards was not big enough.*** Making the situation worse, standards have since been weakened in the U.S. under the Trump administration, including through misguided policy changes that weakened the Federal Reserve's stress testing program and effectively gutted the Fed's Comprehensive Capital Analysis and Review (CCAR), a key part of the initial post-Crash reforms put in place to strengthen large bank oversight.

There Are Strong Incentives for Banks to Use as Little Capital for Funding as Possible

Although bank management and bank boards of directors are supposed to manage risks and ensure a bank is safely run and financially sound, they have strong incentives to operate with capital as close as possible to the minimum amount that is required by regulators. They do this because the less capital they have, the higher their returns on investments will be, and return on investment is a key measure of a bank's profitability for its shareholders and thus a critical factor in determining the compensation for senior bank management and other bank executives. Higher returns on investments result from lower capital, which also results in higher pay for top executives and returns for shareholders, who are the banks' owners.

The expectation that a large, TBTF bank will be bailed out if it gets in trouble incentivizes these banks to hold as little capital as possible and to take larger risks.

Further compounding these dangerous incentives are the subsidies banks (and particularly the largest banks) receive from the taxpayer. Tax policies make debt a much-preferred method of funding for large banks rather than capital. These policies effectively mean that the more money they borrow from investors the less taxes they will have to pay. Additionally, and critically, there is the "safety net" provided by deposit insurance and Fed programs that provide liquidity and credit to banks in the face of downturns. In both the 2008 Crash and the 2020 pandemic-induced market and economic turmoil ("2020 pandemic") the Fed provided direct support to the banks as well as indirect—but no less important—support by purchasing trillions of dollars in securities, which helped keep financial markets from collapsing further.

The expectation that a large, TBTF bank will be bailed out if it gets in trouble incentivizes these banks to hold as little capital as possible and to take larger risks. This makes bailouts even more problematic beyond the massive amount of taxpayer dollars. That is, they increase the probability of future bailouts by providing an incentive for banks to take on more risk. After all, if they make more money, it all goes to them, but if they lose the taxpayer props them up.

[5] A 2019 survey of bank risk management professionals showed that nearly half of them felt that the bank leverage capital ratio requirement should be 15%, and another fifth of them felt that the requirement should be 8%.

Industry Arguments Against Higher Capital Requirements Are Wrong

The banking industry's claims of the dangers of "too-high" bank capital requirements are frequently repeated, even though they have not been supported by independent data or analyses, or borne out by real world events. On the other hand, we have seen all too clearly the devastation that can be caused by poorly run and undercapitalized TBTF banks, most dramatically and recently in the 2008 crash.

Since the higher (but still-insufficient) capital requirements for large banks were implemented in the wake of the 2008 Crash, we have not seen the negative effects that banks loudly argued would result from requiring a greater share of capital in their funding. Quite the opposite, large U.S. banks have had among the biggest increases in global capital requirements and yet have continued to make huge profits and to lend robustly into an economy that has performed well (prior to the 2020 pandemic).

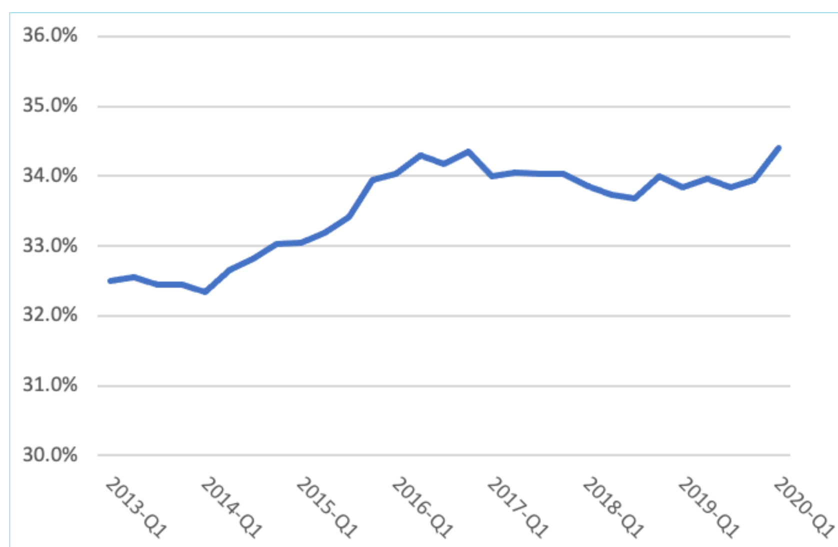
The banking industry's main public argument against higher capital requirements is the claim that this would force them to reduce lending or greatly increase the cost of credit, thus harming economic growth.

Many Bank Industry Arguments Have Been Around Since Capital Requirements Were First Implemented, And Are As Wrong Now As They Were Then

The banking industry's main public argument against higher capital requirements is the claim that this would force them to reduce lending or greatly increase the cost of credit, thus harming economic growth. This argument was repeated by the CEOs of the largest banks in the U.S. in hearings this year before Congress. Bank of America CEO Brian Moynihan made the unsupported and dubious claim that his bank would have to cut its lending by $160 billion if capital ratio requirements were increased by 100 basis points. This calculation seems to assume the bank would meet the higher requirements only by cutting lending, rather than increasing its capital funding by issuing public shares or retaining more of its earnings. Indeed, if Bank of America had to increase its capital as a result of higher requirements, it would be able to make more loans, not less. It is also worth noting that Bank of America has paid out $31.7 billion (nearly 100% of its earnings) to its shareholders over the last year through share buybacks and dividends, money that could easily have been retained as capital and used to make more loans and support the productive economy.

The reality is there is no conclusive evidence to support the argument that increased capital requirements reduce lending. In fact, according to data from the Bank for International Settlements, both the amount of lending and the share of lending coming from banks to the non-financial sector has actually increased between 2013, when higher capital requirements started taking effect, and the 2020 pandemic.

Figure 1: Share of Lending to Nonfinancial Sector by Banks



Source: Bank for International Settlements

This share of lending could have been even higher if large banks had not given so much of their earnings to shareholders. Since 2013, the four largest banks paid out $584 billion of their net income to shareholders through share buybacks and dividends, representing 80% of their net income over that period. If they had instead paid out—for example—70% of their earnings, they would have had $58 billion more in capital funding to make loans that support the economy.

Additionally, not only has there been no meaningfully negative effect on bank lending and economic support in normal, non-stress periods, it has been shown that higher capital requirements reduce the impact of economic and financial downturns. In a review of academic literature on the effects of capital requirements by the Bank for International Settlements, their own analysis of bank data going back to 1870 concludes that higher bank capital "significantly lower[s] the cost of a crisis by sustaining bank lending during the resulting recession."

Furthermore, the evidence shows that the negative financial effects for large banks of requiring them to have more capital, if any, are much less than banks try to make the public and policymakers believe. Capital funding is more expensive than some other sources of bank funding, such as deposits. However, a bank that has more capital as a share of its funding also is viewed as more creditworthy because it is less likely to fail. Therefore, investors would likely accept a lower rate of return on the capital funding they provide for a bank with higher capital funding and less risk, reducing the cost of capital funding for those banks over time. For example, a review of academic literature by the Bank for International Settlements showed that the reduction can be as much as 50% for banks that have higher capital ratios.

U.S. banks have also long argued that it is simply unfair if they face higher capital requirements than their foreign bank competitors, because it gives those foreign banks a "competitive" advantage. This has clearly proved to be wrong as stronger post-2008 Crash U.S. banks have greatly outperformed large foreign banks over the past ten years, in large part because of the greater financial strength that resulted from regulatory requirements they had fought so hard against.

A further argument claims that if bank capital requirements are too high, the activities of banks will shift to the largely unregulated "shadow banking" industry, which will make the financial system more prone to instability and crashes. To date, this has not been the case. As shown in the figure above, banks' share of credit provided to businesses has increased since 2013.

More importantly, this entire argument is conceptually and logically wrong. The answer to a poorly regulated non-bank financial sector is not to allow banks to operate with too little capital, it is to better regulate the non-bank financial sector. Indeed, in the absence of sufficient standards for shadow banking firms and activities, which is currently the case for many, banks need more capital specifically to protect themselves from the threats poorly regulated shadow banking firms can pose to them. Put differently, if interconnected shadow banks were properly regulated, including facing adequate capital requirements, then large banks may have less risky exposures to them and might need less capital to absorb potential losses than is otherwise the case.

Missing from the banking industry's arguments is an acknowledgement that the worst financial and economic downturn of the past 80 years was in large part a result of deeply undercapitalized and overly risky large banks resulting from weak regulatory capital requirements. The true costs to society were incalculable as the lives of tens of millions of Americans were hurt through the steepest economic decline since the Great Depression, causing a $20 trillion impact to the economy through the massive number of lost jobs and homes and in far too many cases the evaporation of a lifetime of personal savings.

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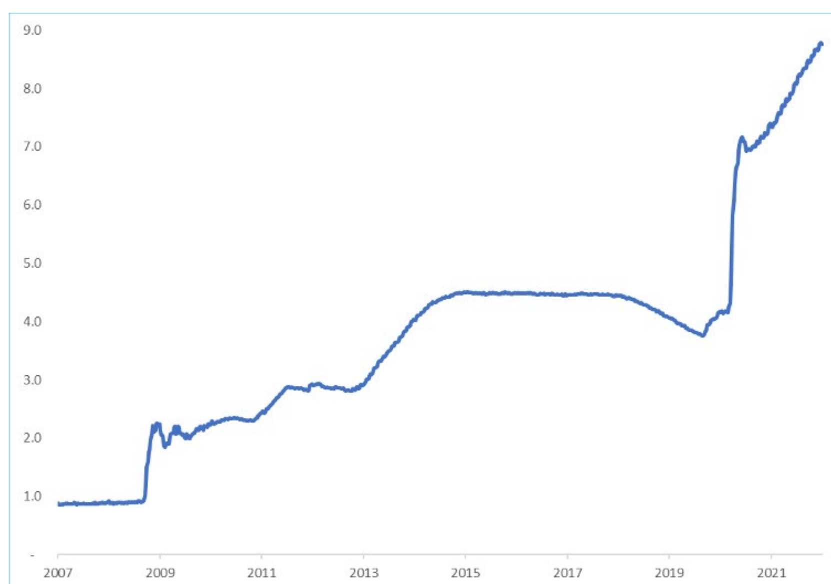
With Post-2008 Crash Requirements in Place, Banks Claim They Are Now a "Source of Strength"; Reality Says Otherwise

Claims that the 2020 pandemic somehow proved banks were sufficiently capitalized and thus a "source of strength" are wrong. While higher capital requirements for the largest banks did make them more resilient entering that crisis than they otherwise would have been, these requirements simply bought time for the Fed to roll out massive programs providing trillions of dollars of financial market support as well as regulatory relief, propping up the value of financial assets, boosting banks' trading revenues, and freeing up capital to return to shareholders. The point that the strength of banks was not truly tested in the 2020 pandemic because of the massive government support was also noted by Vice Chair Barr in his recent speech.

In reality the large banks only had to be a "source of strength" for about two weeks after the onset of market stress in early March 2020. The Fed began providing unlimited support to the financial system in mid-March. Within just the first 90 days, the Fed expanded its balance sheet by $3 trillion to prop up financial markets—in which the largest banks are the dominant participants—and provided massive funding to banks and bank-owned securities dealers, including through repurchase agreements (repos).

Figure 2: Federal Reserve Total Assets



Source: Federal Reserve Release H.4.1

Additionally, Congress supported the economy through emergency fiscal measures, which also helped banks by reducing the level of potential business and consumer loan defaults. The banks and their advocates consistently fail to credit the massive taxpayer-funded support they received throughout the COVID 19 pandemic, without which many of them could well have faced huge, perhaps life threatening, losses. In fact, this support not only prevented losses, but also it led to much higher earnings—in 2021 the net income of the four largest banks was 120% of the 2019 level.

Capital Requirements Must be Stronger

The argument for higher capital requirements is simple and obvious: better capitalized banks create a stronger, more resilient, and stable financial system that is less likely to cause or exacerbate economic and financial downturns. When large banks are undercapitalized, such downturns are not only more likely, but also more likely to become severe financial and economic crises that can cause tremendous harm to Americans from coast-to-coast and lead to taxpayer-funded bailouts. There really is no counterpoint to this argument, which is why the industry falls back on unproven claims about potential harm to the economy.

Importantly, public policy choices should not be made based on considerations of what is best for banks and their shareholders, but rather they must be based on what is best for society as a whole. The regulators' job is not to ensure bank profitability. It is to promote a safe and stable banking and financial system that supports a strong economy.

Predictably, bankers and their vocal advocates almost universally claim that things that might make them less profitable or hurt bank executives' bonuses, such as higher capital requirements, are going to be bad for everyone. However, these claims come without providing evidence-based, analytical support. On the other hand, many policy makers, academic experts, and others believe strongly that

requiring banks to have more capital will be beneficial to society and base their conclusions on research and empirical evidence.

The doomsday scenarios bankers and their advocates claimed would occur given the implementation of higher capital standards have not come to pass. As discussed above, bank lending increased rather than the predicted decline, banks' share of credit provided did not fall, the costs of borrowing did not explode and undermine the economy, and most large banks were fully capable of accessing capital from private investors and of building stronger capital through their earnings. In their analysis of the empirical data from 2013 to the end of 2019, a period during which the initial stronger post-crash standards were being fully implemented, economists Steven Cecchetti and Kermit Schoenholtz noted:

> "To be as clear as we can possibly be, higher capital requirements have not hurt banks, they have not hurt borrowers…it is difficult to find any social costs associated with increasing capital requirements and improving the resilience of the financial system."

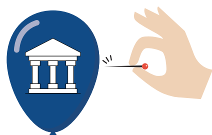
Current capital requirements for large banks do include substantial increases and vast improvements in the measurement criteria relative to the woefully inadequate standards in place prior to the 2008 Crash. Nonetheless, they fall well short of what many experts have found to be a more socially beneficial level of minimum capital the largest large banks should be required to have. Many estimates of optimal capital requirements indicate that substantially stronger capital standards are both necessary and would be beneficial:

- The Federal Reserve Bank of Minneapolis, in its "Plan to End Too Big to Fail", estimates that increasing bank capital requirements to **23.5% of risk-weighted assets and 15% of total assets** (leverage-based requirement) would substantially reduce the likelihood of future taxpayer-funded bailouts while strengthening the economy by making the banking and financial system more resilient.
- The Federal Reserve Board in one of its own proposals regarding so-called convertible long-term debt requirements discussed analysis it conducted that showed the most severe loss of a bank holding company during the 2008 Crash to be 19% of risk weighted assets. This figure likely would have been larger without all the government support that had been provided at that time.
- Economists at the International Monetary Fund have estimated the benefits of capital for large banks set at **23% of risk weighted assets** would outweigh the costs, and that if such a requirement had been in place prior to 2008, it would have substantially reduced the need for taxpayer funded bailouts to address the 2008 crash in the U.S. and Europe.
- Economists Anat Admati and Martin Hellwig, in their 2013 book *The Banker's New Clothes*, determined that capital leverage requirements of at least **20% - 30% of total assets** (leverage-based requirement) would make the banks substantially stronger without sacrificing economic growth.
- The Basel Committee on Banking Supervision (BCBS), in its 2010 paper "An Assessment of the Long-term Economic Impact of Stronger Capital and Liquidity Requirements," estimated risk-based capital requirements of 16% would be appropriate, substantially higher than the requirements the BCBS itself ultimately agreed upon for even the largest banks for post-Crash global standards.

Strengthening Capital Requirements in Key Areas of the Current Framework

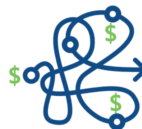
The strengthening of capital regulations and of bank supervision for the largest banks was foundational to post-2008 Crash reforms. Most important was the Federal Reserve's implementation of an annual stress test, and the requirement that large banks remain adequately capitalized even after potential stress losses.

Fed Vice Chair for Banking Supervision Michael Barr announced the Fed is undertaking a wholistic review of the capital framework, and in doing so is asking the critical question is capital "strong enough." For the largest banks it is not. Large bank capital requirements must be increased to strengthen our banking system and ensure our economy will be well-supported in both good times and bad. As Better Markets has noted before, there are multiple factors (including some both un- or under-addressed in the current capital framework) that necessitate higher requirements:



1. Too-big-to-fail is alive, well and getting worse;

2. Capital requirements were unnecessarily reduced during the Trump administration;



3. The banking system has become even more concentrated, interconnected, and complex;

4. The 2020 pandemic revealed significant ongoing weaknesses and fragility; and,

5. The nonbank financial sector, which comprises a large and increasing danger to the banking system, has grown in size, significance, complexity, and interconnectedness with the banking sector, as also evidenced by the Fed's response to the 2020 pandemic.

While a holistic review of capital standards that addresses all parts of the framework is welcomed, there are two parts of the framework whose strength must be a priority: (1) the Fed supervisory stress test, which is the basis for the most important and binding U.S. large bank capital requirements, and (2) any potential Basel Endgame modifications, which must not be driven by a goal (that has been misguidedly promoted by many) to maintain capital requirements at approximately the same level as those currently in place.

The Stress Test and Capital Planning Frameworks Must Be Strengthened

Capital requirements determined through the supervisory stress test and implemented through the so-called stress capital buffer (SCB) must be strengthened and made more dynamic. Three key elements that had made the initial version of the stress test (i.e., prior to changes made under the Trump administration) more rigorous, effective, and meaningful must be reinstated:

1. The assumption that banks will make all planned capital distributions—through dividends and stock buybacks—over the full nine-quarter stress test timeframe, rather than the current assumption they will only payout four quarters of dividends and will suspend all stock buybacks;

2. The assumption that banks' balance sheets can grow under stress; and
3. The requirement to meet a minimum leverage ratio after accounting for stress losses.

These changes would help increase the likelihood that banks will build up sufficient capital in normal times to be able to withstand severe unexpected stress that could come at any time. It would align with the observed reality that balance sheets can grow tremendously in a crisis, and that banks often continue to distribute capital to shareholders (and thus deplete capital) during periods of stress. In fact, the balance sheets of the six largest banks grew by an aggregate 23% between the end of 2019 and the first quarter of 2021. Additionally, although large banks voluntarily suspended stock buybacks at the onset of the 2020 pandemic (purportedly in response to the expectation that regulators would require this if not instituted voluntarily), they continued dividend distributions and almost certainly would have reinstated stock buybacks sooner if not prevented from doing so by the Fed. The assumptions noted above should be reinstated in time for the 2023 stress test.

If those assumptions had been in place for the last three years of stress tests, we estimate that the SCB requirements for the so-called U.S. Global Systemically Important Banks ("GSIBs") would have been higher by an average of 1.3 percentage points, or roughly $90 billion more of aggregate common equity capital across the U.S. GSIBs.

2020-2022 Average Actual and
Estimated Capital Requirements (Based on Pre-Trump Stress Test Assumptions)

BANK HOLDING COMPANY	ACTUAL	ESTIMATED
Bank of America	9.8%	11.4%
Bank of New York Mellon	8.5%	10.7%
Citigroup	10.7%	11.3%
Goldman Sachs	13.4%	14.2%
JPMorgan Chase	11.5%	12.6%
Morgan Stanley	13.2%	15.9%
State Street	8.0%	8.3%
Wells Fargo	9.3%	10.7%
AGGREGATE	**10.7%**	**12.0%**

In addition, the scenarios used in the Fed stress test must be more dynamic to capture varying salient and emerging risks. Based on recent results, the stress test and associated capital requirements have become too predictable for banks and not stressful enough. For example, nearly two-thirds of the country's largest banks had stress-based capital requirements this year that either decreased or remained the same as last year, including most of the largest, most complex, systemically important too-big-to-fail banks. Additionally, one-third of the banks had stress-based requirements that were set equal to the unstressed "floor" point-in-time requirement, because the estimated losses from the "severely adverse" scenario used in the Fed's stress test were so small they did not cause banks to fall below this real-time threshold.

The result of insufficiently rigorous and increasingly less dynamic stress tests is to give the public a false sense of security that the largest banks are strong enough to withstand extreme stress when actually they are not. Compounding that, it also creates an unacceptably higher likelihood that large banks will fail under real stressed conditions and have to get bailed out by taxpayers yet again. The scenarios must be more stressful, more dynamic, and more inclusive of a variety of financial and economic complexities, incorporating risks and second-order effects that are missed by the current design, as also suggested by former Governor Daniel Tarullo in a speech at this year's annual Federal Reserve stress testing research conference.

Additionally, including a stress-based leverage requirement would strengthen the capital standards significantly and make the stress test more valuable. While so-called risk-sensitive capital requirements are meant to serve as the primary binding constraint for banks, rather than leverage ratios, minimum leverage requirements based on the losses of the stress test also have the benefit of dynamic risk sensitivity on a bank-by-bank basis. Additionally, they provide a clear view of capital relative to assets after stress, without the uncertainty created by complexities inherent in opaque (and often inaccurate) asset risk weighting. Moreover, if a leverage-based requirement is meant to serve as a backstop to protect against the inherent danger of incorrectly estimating risk weights used in a risk-based capital ("RBC") framework, then a post-stress RBC requirement should logically be backstopped by a post-stress leverage one.

Restoring a post-stress leverage requirement could be done relatively easily this year by re-proposing and finalizing the previously proposed—but never finalized or implemented—stress leverage buffer. Our estimates show that if such a buffer had been in place the last three years, it would have resulted in an average of nearly $150 billion in additional aggregate required capital each year across all eight U.S. GSIBs relative to current leverage requirements. This shows an additional increase of $60 billion of capital on top of the $90 billion increase of common equity that would come from returning to the stronger assumptions discussed above.

2020-2022 Average Actual and
Estimated Capital Requirements (Based on Pre-Trump Stress Test Assumptions)

BANK HOLDING COMPANY	DIFFERENCE IN REQUIRED CAPITAL ($B)
Bank of America	$ 29.9
Bank of New York Mellon	$ 8.3
Citigroup	$ 7.8
Goldman Sachs	$ 23.1
JPMorgan Chase	$ 31.5
Morgan Stanley	$21.5
State Street	$ 2.9
Wells Fargo	$ 23.0
TOTAL	**$ 147.9**

Basel Endgame Must Be Implemented with A Focus on Addressing Risks Rather Than the Effect on the Overall Level of Required Capital

In 2017 the BCBS put forth the Basel Endgame modifications to the capital framework that are intended to address gaps in the currently implemented framework, especially with respect to risks of large banks' trading and counterparty activities. Some of these reforms are part of the unfinished business of the post-2008 Crash reforms and improve the capital framework meaningfully.

However, in designing the reforms, the BCBS stated that they "focused on not significantly increasing overall capital requirements." As a result, while some requirements appropriately have been increased in-line with the level of the risks they are addressing, others were reduced in line with achieving the goal of not significantly increasing minimum requirements.

At a high level, the Basel Endgame modifications—if implemented as proposed by the BCBS—would increase capital requirements for trading-related risks and, as an offset, generally reduce capital requirements for more "traditional" credit activities, primarily loans to consumers and businesses.[6] In the U.S. implementation of the Basel Endgame, the Agencies should maintain or strengthen places in which the current U.S. standards are more conservative than the Basel Endgame reforms—at least for the largest institutions—unless there is compelling, well-documented, data-driven support and analysis for doing otherwise. Without such support, it opens the question of whether the process is arbitrary and driven by the proper goals of a capital regime (and, by extension, whether risks are being better addressed by the changes).

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For example, a residential mortgage with a loan-to-value ratio of 80% would be given a reduced risk weight of 40% under the Basel Endgame standards as opposed to 50% under the current framework, resulting in a lower capital requirement. Additionally, the lowest risk weight for residential mortgages under the Basel Endgame is 20%, much lower than the current framework's 35% minimum. Yet no justification was provided in the BCBS documentation proposing these modifications other than the general goal of "enhancing risk sensitivity," which in this case seems to be a euphemism for the misguided goal of not significantly increasing overall requirements from current levels.

The current set of risk weights were determined with the support of underlying data analysis and informed by the idea that there should be some level of backstop conservatism to account for unforeseen risks that cannot be measured using historical data. Considering there has not been another significant, extended financial crisis and deep recession since the experience in 2008-2010, it is difficult to imagine what updated analysis could have been performed that would have led to these lower risk weights for residential mortgages and other credit-based assets. Without appropriate justification, including publicly

[6] That being said, banks that engage primarily in trading and counterparty activities—e.g., Goldman Sachs and Morgan Stanley—would not have as much traditional credit activities as an "offset" and could have capital requirements that increase more.

disclosed robust analysis and data, reductions in current requirements cannot be defended and must not be implemented.

In other parts of the Basel Endgame, the standards have appropriately been strengthened and made more risk sensitive in a sensible and meaningful way. This was largely done for banks' trading-related risks. For example, there are more clear rules about what must be included as a part of the so-called "trading book" for purposes of capital requirements.

This change would reduce the amount of "gaming" banks have done in the past by reclassifying assets held in their trading books to be accounted for as more "traditional" banking activities like loans, which allows them to achieve lower capital requirements without reducing their risks. Also, the Basel Endgame proposes to change the measurement of the risk of severe declines in the values of trading positions to more fully account for "tail risks", the types of risks that can cause—and have caused—immense losses in banks' trading portfolios. While this goal is welcomed, the Fed must not use it as a rationale for weakening treatment of trading-related risks in its annual supervisory stress test.

The Agencies have the discretion of which banks to apply these modifications to and how to incorporate these modifications into other parts of the capital framework. In a recent statement from the Agencies, they affirmed that "community banking organizations...would not be impacted." However, they only stated that the reforms would apply to "large banking organizations" without specifying which large banking organizations. Indeed, the updated standards, as recommended in this report, should apply to all banks above $250 billion.

Importantly, since the Basel Endgame standards will be applicable for larger banks, they must also be incorporated into the stress testing framework to ensure they are reflected in stress-related capital requirements. That is, it is possible that the current standards could continue to be used for determining stress-related capital requirements instead of the potentially stronger standards of the Basel Endgame. If the purpose of the stress test is to ensure that large banks have enough capital to withstand a stress scenario, then the stress test assessment and stress-related capital requirements must be based on the applicable standards even if that leads to higher stress-related capital requirements.

The Agencies discretion in implementing the Basel Endgame must not be used in the way former Fed Vice Chair for Supervision Randal Quarles advised using it—to implement it in a way that does not "unduly increase the level of required capital in the system." The Agencies must focus on appropriately accounting for all risks facing the banks and doing so in the most effective way for large TBTF banks regardless of the potential for this to lead to an increase in current capital requirements. Indeed, such an outcome is clearly warranted—capital requirements remain too low and have left the financial system and the American public too vulnerable to the threats these giant banks represent.

Conclusion

Since the implementation of the post-2008 Crash reforms that strengthened capital standards and upgraded the regulatory capital measurement framework, complacency around (and attacks by the banking industry on) capital requirements for the nation's largest banks has been growing. Indeed, if anything, recent momentum has been on the side of those calling for those standards to be weakened. That those standards stemmed from globally negotiated agreements that fell short of higher requirements that many view as more appropriate does not get as much attention as it should.

The banking industry—whose motivation, as a private industry, is to maximize bank profits—often dominates public and private debates with the claim, unsupported by any compelling evidence, that current capital requirements are already too high and hurt the economy. At the same time, many others, who focus on trying to make the U.S. economy and financial system safer and fairer, and on protecting U.S. taxpayers from both the devastation a financial crisis causes and from having to bail out large dangerously run banks again, have argued persuasively that capital standards for large banks are too low, and should be strengthened substantially.

> *Large banks must be financially strong enough to withstand severe stress from these activities and be able to continue to play their role, without having to rely on taxpayer-funded support or bailouts when times get tough.*

Large banks remain key participants in all aspects of the economy and financial markets, serving as the intermediaries between funders and borrowers, and as critically important buyers and sellers in financial markets. They must be financially strong enough to withstand severe stress from these activities and be able to continue to play their role, without having to rely on taxpayer-funded support or bailouts when times get tough.

The Agencies must not accept the industry's decades-long, disproven claims about being required to "hold" so much capital that it harms the economy, when the opposite is demonstrably true. Using more capital as a source of funding makes banks stronger and both supports and protects the economy, the financial system, and the wellbeing of Americans. Unless the industry can provide compelling, robust data and analyses to prove their claims in a way that can be validated by independent experts, arguments against requiring them to be financially stronger should be dismissed, and capital requirements should be strengthened further.

As the Fed in conjunction with the other regulatory agencies review and consider modifications to the current capital framework, it must keep in mind that the ultimate goal for large banks is to promote economic strength while at the same time protecting the system from the dangers giant banks can pose. Stronger capital requirements would do both. This is the best way to promote a resilient and robust U.S. banking system that will continue to be a leader and serve the American economy and the American people in the future.

Better Banks | Better Businesses
Better Jobs | Better Economic Growth
Better Lives | Better Communities

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