Meeting Between Governor Kugler and Staff of the Federal Reserve Board and Representatives of Better Markets
June 3, 2024

Participants: Governor Adriana D. Kugler and Kelley O'Mara (Federal Reserve Board)

Dennis Kelleher and Shayna Olesiuk (Better Markets)

Summary: Governor Kugler and staff of the Federal Reserve Board met with representatives and members of Better Markets to discuss their concerns regarding potential broad and material changes to the agencies' Basel III endgame notice of proposed rulemaking (Basel III endgame proposal). Representatives of Better Markets indicated that—while some changes may be warranted—broad-based criticisms of the Basel III endgame proposal from industry are unsupported by data.

Attachments

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Capital Rule Critics Proved Wrong by Facts and Data

May 1, 2024

Wall Street biggest banks and their supporters have staged a widespread resistance effort in recent months to convince the American people, community organizations, and financial regulators that modestly higher capital requirements (called the "Basel Endgame") (the "Proposal") will have far-reaching dire consequences. Along with lobbying, media campaigns, television advertising, billboards, and websites, those capital critics have used seemingly limitless resources to fill the public comment file with letters opposing the Proposal. By count, the comment letters opposing the Proposal certainly outnumber those in favor of it. However, a bunch of banks and their allies saying similar things many times doesn't make them accurate and quantity isn't a substitute for merit.

This fact sheet will show that the industry's anti-capital claims lack a valid basis and provide facts and data to prove how these messages are misleading and wrong, and will actually lead to weaker economic growth, less lending, greater instability, and more volatility. Moreover, the industry's unsupported arguments and fearmongering, if successful, will shift the burden of a bank failures to taxpayers and Main Street Americans, while Wall Street's biggest banks are allowed to continue to reap higher profits without being accountable for the risk they undertake to generate those profits.

What's at Stake

Well-capitalized banks are essential for a strong banking sector, financial system, and economy where Main Street families, businesses and community banks can thrive. Well-capitalized banks are strong enough to continue providing credit to the American people through the ups and downs of the business cycle, which keeps the economy growing and creates jobs. Appropriately capitalized banks reduce the depth, length, and cost of recessions that large bank failures usually cause. The only thing standing between a failing large bank, taxpayer bailouts and an economic downturn—if not catastrophe—is the amount of capital that a large bank has to absorb its own losses. As was clearly demonstrated in the 2008 Financial Crisis ("2008 Crash") and again with the regional bank failures in 2023 ("2023 Crisis") when megabanks do not have enough capital to absorb their own losses that stem from their risky activities, the government has to step in with a bailout, that the American people ultimately pay for.

Undercapitalized banks, crashes, contagion, recessions and economic downturns—***not more capital***—are the threat and disproportionately hurt underserved communities and organizations that exist to support them:

Minorities

Evidence shows that minorities suffered large losses during and after the 2008 Crash. These losses hurt incomes, asset building, and overall economic and financial well-being for years after the downturn and continue to negatively affect generations to come. Black and Latino workers, for example, experience higher unemployment rates during recessions. Minorities were disproportionately hurt by foreclosures and declines in property values in the 2008 Crash. One study estimated that minorities shouldered about $1 trillion in losses from home foreclosures and related financial losses from the 2008 Crash. Importantly, this does not include the range of non-financial costs such as increased crime, reduced school performance, and neighborhood blight. Minorities also had larger declines in savings accounts (including retirement savings) due to pressures from the 2008 Crash, including the need to withdraw money in order to cover the rising costs.

Researchers show that the 2008 Crash will continue to negatively impact minority families for years to come. By 2031, White wealth is forecast to be 31 percent below what it would have been without the 2008 Crash, while Black wealth is estimated to be down almost 40 percent. Put differently, for a typical Black family, median wealth in 2031 will be almost $98,000 lower than it would have been without the 2008 Crash.

Small Business

Small firms and newly established businesses are vitally important to job creation and future recovery because they tend to grow faster than large businesses. During the 2008 Crash, job losses were concentrated in the smallest businesses: job losses in small businesses exceeded job gains in those same businesses by 800,000.

Community Support/Philanthropy

The 2008 Crash had a significant negative impact on community organizations whose primary mission is to support underserved communities. Between 2007 and 2008, the top 40 foundations in the U.S. together lost more than $43 billion in assets. At the same time, charitable giving by high-income individuals fell by $31 billion from 2007 to 2009.

It is imperative to consider these facts when Wall Street banks claim that the Proposal will hurt minorities, small businesses, and other vulnerable populations. The truth is that these groups have been most hurt by undercapitalized banks, financial crises, and economic downturns, so stronger capital requirements will actually help, not hurt, these communities and other Main Street Americans.

Benefit #1: Financial Stability and Resilience

Commenters assert that the Proposal will harm economic growth and banking sector resilience:

- The Business Roundtable claims that the Proposal will "reduce innovation and economic growth" and says that large U.S. banks are already resilient as demonstrated by "real life stress tests—including the COVID-19 pandemic, the Russian Invasion of Ukraine and the regional bank failures in spring 2023."

- The Bank Policy Institute and the American Bankers Association, in a joint letter, says that the Proposal "would have a profound effect on the availability and cost of credit for nearly every American business and consumer, as well as on the resiliency of U.S. capital markets. The U.S. economy would suffer a significant, permanent reduction in GDP and employment; U.S. capital markets would become less liquid, and therefore more dependent on non-bank intermediation in normal times and on governmental support when those non-banks step away from financial markets during times of stress."
- The Coalition for Derivatives End-Users worries that the Proposal will indirectly harm the economy through capital markets, "financial regulatory reform measure should promote economic stability, transparency and resiliency without imposing undue burdens on derivatives end-users and the broader U.S. economy. Imposing unnecessary regulation directly on end-users or indirectly, through their counterparties as these Proposals do, will create more economic instability, restrict job growth, decrease productive investment and hamper U.S. competitiveness in the global economy. . ."

The Proposal Promotes Financial Stability and Increases the Banking Sector's Resilience to Shocks

In the 2023 Crisis, Silicon Valley Bank, Signature Bank and First Republic Bank all failed because they did not have enough capital. This was also the case for bank failures in the 2008 Crash. In 2023, bank failures led to severe financial stress, enough to prompt a systemic risk exception, insure all bank deposits, and lead the Fed to create the Bank Term Funding Program to offer additional support to the banking system. This is exactly the type of scenario we need to avoid, and it could have been avoided if the banks that failed had enough capital to internalize and absorb the losses that their business activities created rather than falling short and shifting the burden to the government and all Americans.

In 2023, even regional bank failures were significant enough to cause significant stress throughout the financial system. This supports the Proposal's extension of more stringent capital standards to banks with $100 billion or more in total assets and disproves the notion that this change violates requirements to tailor rules by bank size. Importantly, the Proposal does not apply to banks with less than $100 billion in total assets.

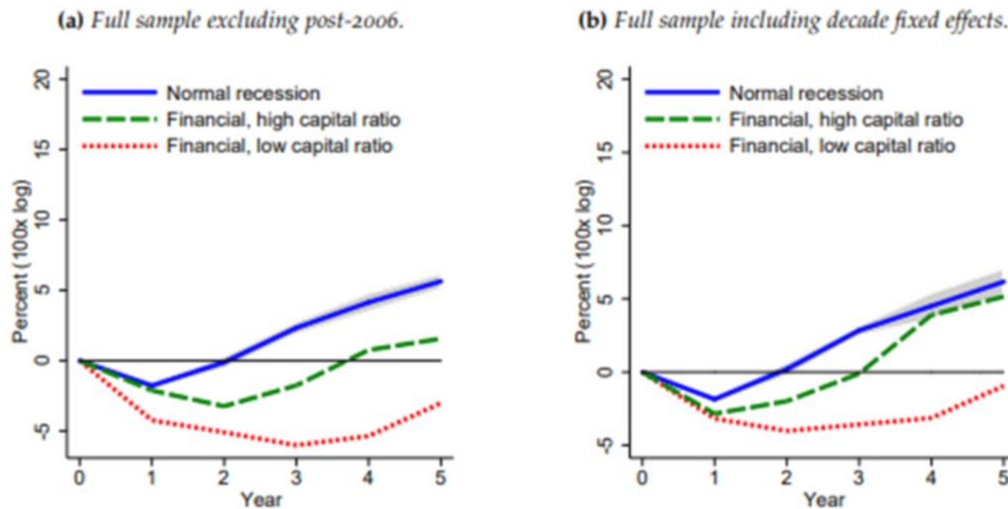
Federal Reserve Bank of Minneapolis analysis shows that capital requirements must be higher to prevent future bailouts. Bank capital levels rose during the COVID-19 shock because of Fed actions that prevented stock buybacks and restricting dividends beginning in third quarter 2023. Then, extensive government support amounting to trillions of dollars shifted risks away from banks and to the federal government, through a number of programs that were put in place to reduce the impact of the pandemic on the financial sector. Therefore, assertions that banks' performance during the pandemic illustrates their strength and resilience are incorrect. Instead, the degree of federal support that was required during the pandemic actually justifies the need for the Proposal.

Additional research from Fed economists and others shows that ***higher capital limits the economic fallout of financial crises and actually leads to stronger economic recovery and increased lending to the nonfinancial sector in the years that follow the recession***. Using data from 17

countries from the 1870–2015 period, economists compare both the degree and speed of economic recovery after financial sector recessions under both high (green, large dashed line) and low capital (red, dotted line) scenarios (See Chart 1). The results are clear. Banking systems with higher capital ratios recover faster and more significantly after financial recessions, increasing both economic growth and lending several years before financial systems with lower capitalized banks.

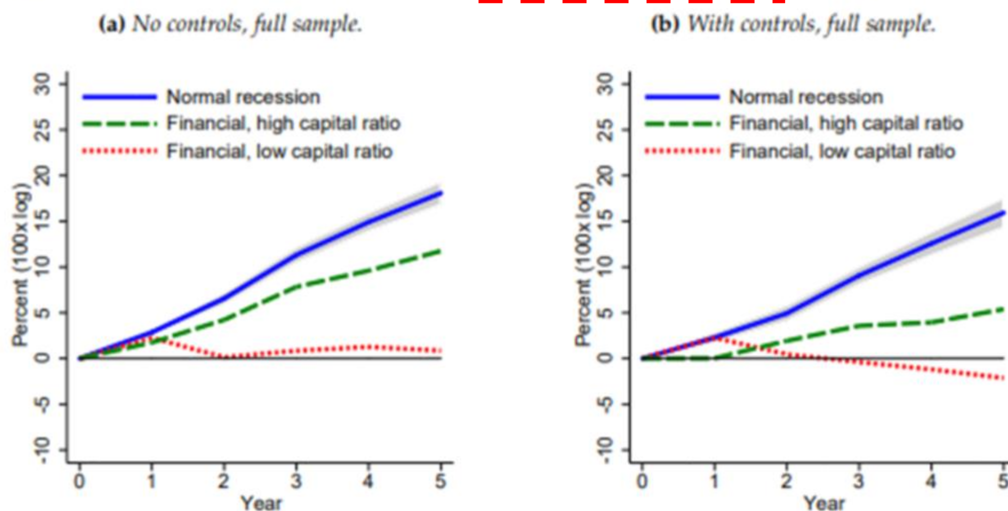
Chart 1

Figure 8: *Normal versus financial recessions, real GDP per capita binned by bank capital, controls included, alternative estimates.*



Notes: This figure displays the coefficient estimates on a sample excluding the global financial crisis, i.e., 1870–2006 (left) and on the full sample including decade fixed effects (right, Table 9). The solid blue line reports the average path after normal recessions. The grey area corresponds to the 90% confidence region around the recession path. The green dashed line corresponds to the sum of the coefficients of the average recession path and the financial recession coefficient when the pre-crisis capital ratio was high. The dotted red line corresponds to the sum of the average recession coefficient and the financial recession coefficient when the pre-crisis capital ratio was low.

Figure 9: *Normal versus financial recessions, real private credit per capita binned by bank capital.*



Notes: This figure displays the coefficients for estimating Equation 9 and Equation 6 with real private credit as the dependent variable. The solid blue line reports the average path after normal recessions. The grey area corresponds to the 90% confidence region around the recession path. The green dashed line corresponds to the sum of the coefficients of the average recession path and the financial recession coefficient when the pre-crisis capital ratio was high. The dotted red line corresponds to the sum of the average recession coefficient and the financial recession coefficient when the pre-crisis capital ratio was low.

Benefit #2: Increased Lending

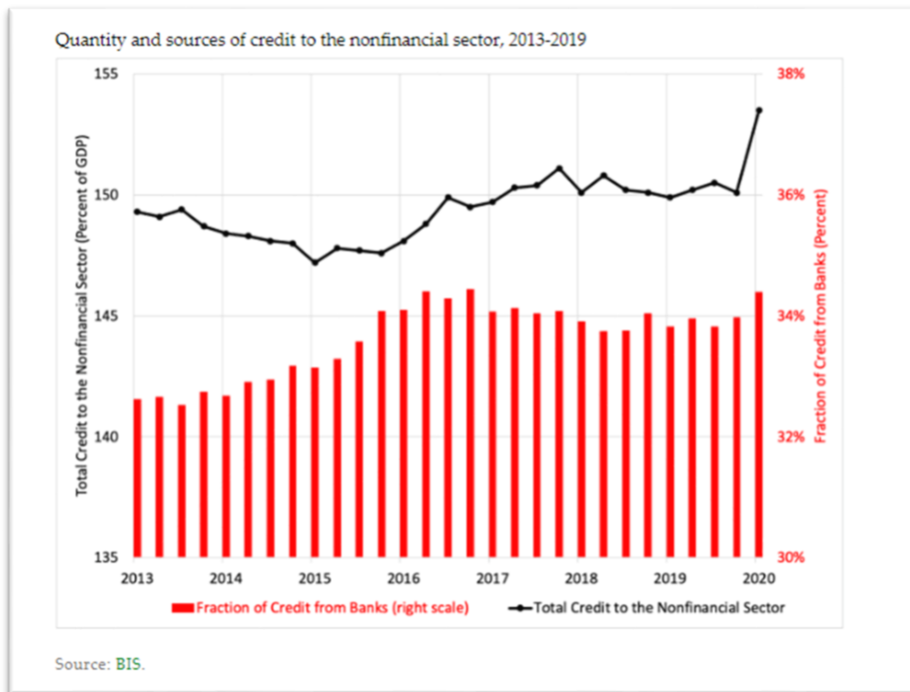
Commenters assert that the Proposal will have direct and negative consequences on borrowers, particularly in underserved communities:

- The National Community Reinvestment Coalition ("NCRC") agrees that the Proposal is necessary because "many institutions were revealed to have hidden their undercapitalization [during the 2008 financial crisis] through intentional artifice" and praises the Proposal because it will "introduce sensitivities to source of funds for repayment, create uniform and transparent guidelines for measuring capital requirements, and generally ensure banks have enough capital on hand to weather economic crises." However, NCRC is concerned that the Proposal will "undermine homeownership and certain community reinvestment activities" particularly for underserved communities.
- The Mortgage Bankers Association ("MBA") also agrees that capital requirements must ensure that there is a "cushion against losses under stressed financial conditions, thereby reducing the likelihood of bank failures and protecting the financial system." However, MBA opposes portions of the Proposal that would result in further bank withdrawal or exit from the mortgage market.
- The National Association of Realtors claims that negative impacts will transfer from the largest banks to community and local institutions. As a result, "consumers will face increased borrowing costs and a severe reduction in credit" and "will hit underserved markets and those borrowers with low and moderate incomes the hardest, those [for] whom the American Dream has already started to become nothing more than a hopeful wish."
- Goldman Sachs' 10,000 Small Business Voices worries that the Proposed "capital requirements for lending will make it more expensive for banks to loan to small businesses, and those added costs will no doubt be passed on to us. . . . [W]e are concerned that the new calculations in this proposal will make borrowing costs unaffordable and capital inaccessible."

The Proposal Will Not Reduce Bank Lending to Households and Businesses

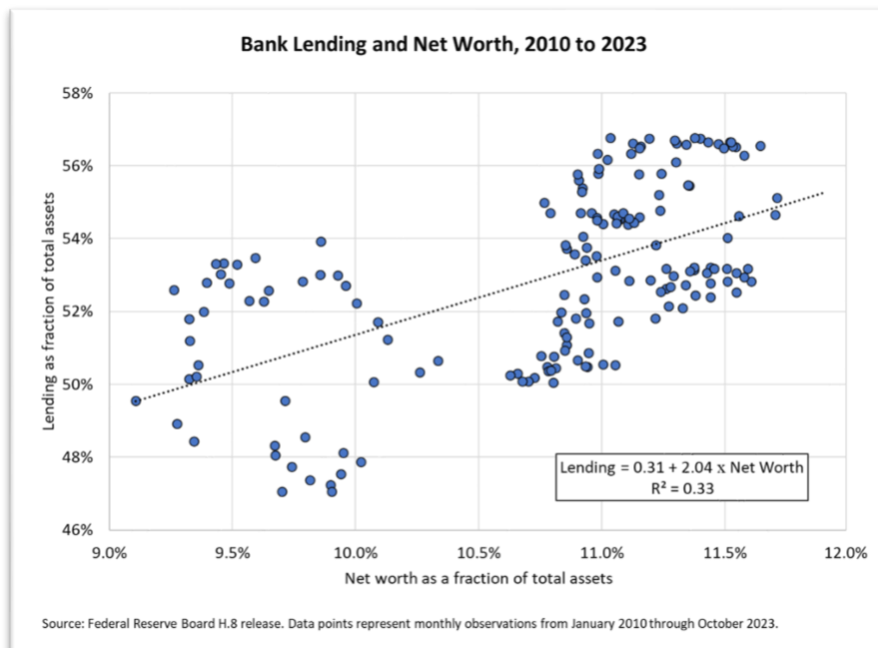
Increased capital requirements do not reduce lending; in fact as regulators required banks to increase their capital significantly after the 2008 crash, those very same banks increased their lending to the nonfinancial sector (see Chart 2).

Chart 2



Furthermore, monthly data from 2010 through 2023 show that capital levels and lending are positively correlated. As Chart 3 shows, for every 1 percentage point increase in capital, bank lending increases by 2 percentage points.

Chart 3



Mortgages and Small Business Lending

Many commenters expressed concern that certain borrowers—namely prospective homeowners and small businesses—will be hurt by the Proposal. This is not true. Higher capital will not hurt mortgage borrowers and small businesses. Quite the opposite, higher capital will protect the banking system, enabling banks to continue lending through the economic cycle, to households, small businesses, and other borrowers.

The Proposal does indeed include higher risk weights for mortgage loans with higher loan-to-value ("LTV") ratios, and this is warranted because of the higher risk inherent in these loans. Research and historical data proves that losses increase substantially for mortgage loans with higher LTV ratios. If banks are not held accountable for these higher-risk loans, policymakers are essentially requiring taxpayers to instead subsidize bank lending to higher risk borrowers and take on the added risk and cost of bank failures while the banks continue to increase their profits.

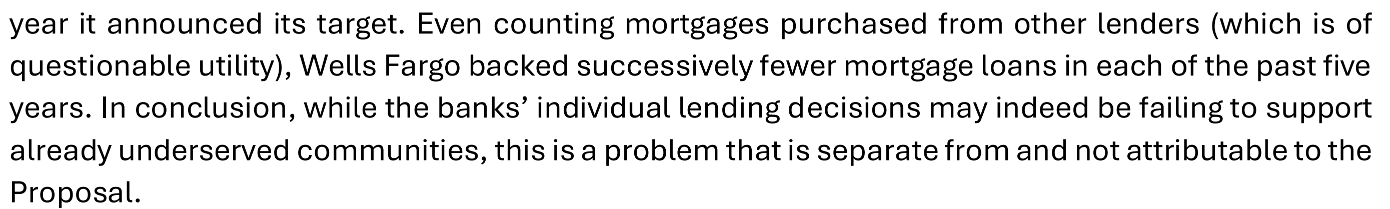
Megabanks and their advocates argue that higher capital requirements will automatically result in higher pricing for high LTV loans or a retreat by banks from lending in this market, resulting in reduced credit availability for high LTV borrowers (who are often low income or minority individuals or households). ***However, this is not true. The estimated cost resulting from changes in the Proposal that affect mortgage and small business lending is very small. Furthermore, passing along higher costs is a choice by the banks, not a requirement or an inevitable result of the rule.***

Fed Vice Chair for Supervision Michael Barr stated that the estimated increase in capital requirements for lending activity is on average only 3 basis points, or 0.03 percentage points. To put this in context, the four largest banks—JP Morgan Chase, Bank of America, Citibank, and Wells Fargo—have about $4 trillion in total loans and leases outstanding in 2023; 0.03 percent of this amount is about $1.2 billion. These same four banks paid out nearly $57 billion in dividends and stock repurchases in 2023 alone. Thus, a mere 2% reduction in dividends and repurchases would cover the entire cost of higher capital requirements for all types of lending activity and require none of the burden to be passed along to borrowers.

Moreover, the megabanks that will be subject to the Proposal have a relatively small mortgage and small businesses lending portfolio, especially compared to community banks, which further disproves claims of the Proposal's widespread negative impact on Main Street Americans. In fact, one study shows that the Proposal will only affect a fraction of all mortgage loans. It finds that **just 23 of the 62 banks that are subject to the Proposal even make mortgage loans**. Of all the mortgage loans made by these banks:

- **Only 13%** were **high-LTV and made to borrowers in LMI areas, and**
- **Only 21%** were **high-LTV and made to non-white borrowers.**

In other words, the largest banks make relatively few loans to LMI or minority borrowers. While this is certainly a concern given these banks' promises to support minorities' goals of homeownership, it proves that the widespread damage feared as a direct result of the Proposal is certainly exaggerated. For example, in 2017, Wells Fargo, the megabank that has historically focused most on mortgage lending, announced $60 billion to create 250,000 Black homeowners within the next decade. In 2021, however, Wells Fargo underwrote 42% fewer mortgages to Black buyers than in the



year it announced its target. Even counting mortgages purchased from other lenders (which is of questionable utility), Wells Fargo backed successively fewer mortgage loans in each of the past five years. In conclusion, while the banks' individual lending decisions may indeed be failing to support already underserved communities, this is a problem that is separate from and not attributable to the Proposal.

Benefit #3: Transparency

Commenters oppose the proposed changes that would reduce the ability for large banks to use internal models:

- The Financial Services Forum states that the Proposal would increase the disparity between U.S. banks and foreign counterparts "primarily because of the elimination of the use of internal models for credit risk and the addition of operational risk into the binding capital stack."
- The Bank Policy Institute and the American Bankers Association claim that "There is no evidence that internal models for credit risk have led to a systematic understatement (or overstatement) of risk at any bank. In fact, since 2014, banks have successfully used internal models to gauge credit risk for capital purposes, subject to backtesting and model approval from an independent risk function, an independent model validation group, internal auditors and agency examiners. The virtue of internal models is that they are inherently more granular and risk-sensitive than government-imposed, one-size-fits-all standardized methodologies; they can also be adjusted over time to reflect changing behavior."

The Proposal Increases Transparency Through Standardization of Measures and Models

Research proves that there has been significant variation in results when banks use internal models that allow for choice and variation of inputs such as reference data, methodology, and definitions. Results from internal models showed that capital ratios ***varied up to 15-20% in either direction around a common benchmark for portfolios of the same risk***, because of banks' different modeling choices. This is unacceptable. The use of standardized models is also more efficient. For standard models, regulators can save time and public resources by just focusing on the results of an approved standard model, compared to bank-specific internal models that require new understanding and evaluation for each bank's models, in addition to assessment of the results.

Benefit #4: Accountability for Risky Capital Markets Activities

Commenters oppose the proposed changes that would increase capital requirements for trading and other capital markets activities:

- The Coalition for Derivatives End-Users "has serious concerns that increased transaction costs associated with prudent risk-management hedging practices by derivatives end-users will result in two materially adverse impacts: (i) even further increased costs will flow through to consumers for goods, services and everyday necessities; and (ii) reduced capacity for derivatives end-users to hedge their commercial risks because the costs to hedge those risks

could become prohibitively expensive, which would lead to greater price volatility. These results would be bad for consumers and bad for economic stability and neither result decreases risk to the broader U.S. economy."

- The Options Clearing Corporation supports the broad objectives of the Proposal to "increase the strength and resilience of the banking system" but worries new capital charges are "directly counter to the goal of promoting central clearing in financial markets that has long been supported by leading global economies, Congress, and U.S. financial regulators" and could disincentivize market activities such as clearing at banks.

The Proposal Delivers Benefits by Assessing and Pricing Risky Capital Markets Activities at Banks, Rather than Passing the Potential Cost of this Risk to Taxpayers

While some commenters worry about the Proposal harming capital markets and derivatives activity; others worry about adverse effects on businesses that rely on banks to manage financial risks and engage in capital markets transactions. The truth is that ***trading activities at banks do present risk that the banks that engage in them should be held accountable for that risk with higher capital requirements***. At the same time, careful consideration is warranted; this is long overdue, and the agencies have done that in the Proposal.

Higher capital requirements for trading activity are justified to keep the broader financial system safe. The Proposal states that new capital requirements for capital markets activities will add about 67 basis points (2/3 of a percent) to large holding companies' capital ratio. This is a relatively small and reasonable cost when considered alongside the extreme cost of the 2008 Crash: $20+ trillion in lost GDP, about 27 million Americans unemployed within a year of Lehman's collapse, 15 million foreclosure filings, $2.8 trillion in lost retirement savings, and countless other human costs (disengagement from the labor force and society because of extended unemployment, for example). Holding banks accountable for the costs and risks of their business activities (that produce their revenue, profits, and bonuses) is fair and appropriate. The moral hazard of not doing so is evident in innumerable ways leading up to the 2008 Crash. Furthermore, the cost does not HAVE to be passed on to the end user. As discussed earlier, banks could reduce their ample shareholder payouts or retain earnings by just a very small amount to meet the increased requirements. Finally, if the risk and cost is not borne by the banks, it will by default be passed along to taxpayers when banks fail and require bailouts: that enshrines privatizing gains and socializing losses.

Research from the Federal Reserve Bank of New York, which is also cited in the Proposal, examines market liquidity in the post-crisis era in light of concerns that regulatory changes could reduce dealers' ability and willingness to make markets. The researchers find that bond market liquidity remained resilient and within historical norms ***even after regulatory changes***, suggesting that it is reasonable to think that the Proposal will also have limited negative effects on capital markets. Additional research shows that average market liquidity metrics ***improved*** after the 2008 Crash and were better after more reforms were implemented, than before the 2008 Crash. The improvement from 2010-2012 to 2013-2014 occurred across both investment grade and high yield bonds, also supporting the fact that financial markets were helped, not hurt, by prior policy reform.

Benefit #5: Accountability for Operational Risk

Commenters oppose proposed changes that impose capital requirements for operational risk at banks:

- The Securities Industry and Financial Markets Association and the Futures Industry Association say that the Proposal "could have adverse effects on the U.S. capital markets by over-calibrating relatively low-risk services" and "would contravene decades of U.S. financial services policy, which has encouraged diversification in banking organizations' business models." The organizations also assert that the "Agencies have not provided sufficient rationale in support of the proposed approach or conducted an economic analysis to justify the departure from established U.S. financial services policy goals."
- The Bank Policy Institute and American Bankers Association say that the operational risk component of the Proposal is "massively overstated, and the agencies provide no basis for it in the proposal." The organizations also reject Federal Reserve research cited in the Proposal which supports the fact that that past operational loss events are an indicator of future loss events.

The Proposal Appropriately Assesses and Prices Megabanks' Operational Risk

Opponents of the Proposal criticize the new operational risk component for two main reasons:

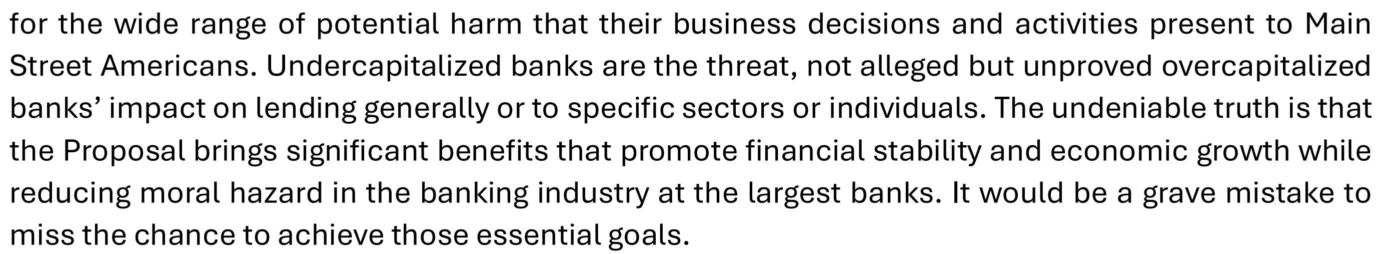
- It unfairly burdens banks with business lines that rely on fee income, and
- It would require more capital than historical loss experience.

Neither of these reasons are supported by the data or valid enough to not move ahead with the Proposal. The truth is that operational risks are evolving and increasing from historical periods. Greater instances of cyberattacks, for example, are occurring each year so comparing operational losses relative to historical benchmarks is not the correct yardstick.

Research from the Federal Reserve Board and the Federal Reserve Bank of Richmond offers additional perspective that supports the Proposal. The results of this research shows that past operational losses lead to future losses, even after controlling for a wide range of factors. So, basing capital charges on banks with concentrations in business activities that are vulnerable to operational losses is appropriate, not an unfair burden. Furthermore, research from the Federal Reserve Bank of Dallas, grounded in about 400,000 individual loss events from 2001 through 2018, shows that there is high variability in losses from operational risk, also known as fat tails. Therefore, calibrating capital requirements by average losses is not enough to account for potential future loss events.

Conclusion

An assessment of criticism of the Proposal with independent facts and data demonstrate that the criticism is without basis. In fact, those facts and data show that the Proposal is well grounded, fully supported, and would be highly beneficial to the American people. It would unwise and wrong to allow the megabanks to continue to underprice risk and not be required to take actions to account



for the wide range of potential harm that their business decisions and activities present to Main Street Americans. Undercapitalized banks are the threat, not alleged but unproved overcapitalized banks' impact on lending generally or to specific sectors or individuals. The undeniable truth is that the Proposal brings significant benefits that promote financial stability and economic growth while reducing moral hazard in the banking industry at the largest banks. It would be a grave mistake to miss the chance to achieve those essential goals.

Better Banks | Better Businesses

Better Jobs | Better Economic Growth

Better Lives | Better Communities

Better Markets is a public interest 501(c)(3) non-profit based in Washington, DC that advocates for greater transparency, accountability, and oversight in the domestic and global capital and commodity markets, to protect the American Dream of homes, jobs, savings, education, a secure retirement, and a rising standard of living.

Better Markets fights for the economic security, opportunity, and prosperity of the American people by working to enact financial reform, to prevent another financial crash and the diversion of trillions of taxpayer dollars to bailing out the financial system.

By being a counterweight to Wall Street's biggest financial firms through the policymaking and rulemaking process, Better Markets is supporting pragmatic rules and a strong banking and financial system that enables stability, growth, and broad-based prosperity. Better Markets also fights to refocus finance on the real economy, empower the buyside and protect investors and consumers.

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CAPITAL

FACT SHEET

The Truth About Wall Street's Massive Misleading Lobbying Campaign Against Necessary Capital

January 17, 2024

Banking regulators have proposed new, long overdue, capital requirements which will only be applicable to less than 40 of the largest bank holding companies in the country and none of the more than 4,000 community banks. The new rules will be focused on megabanks' dangerous, higher risk trading and investment activities. Bank capital is critical to protect Main Street families, jobs, small businesses, community banks, the financial system, and the economy.

But Wall Street and its supporters are making more and more false, baseless, and dangerous arguments about capital to protect their bottom line. Reported bank lobbying had already increased 20% and now Wall Street is doubling down on influence tactics that they do not have to report, which include a television ad campaign (with placements on television's top-rated program- Sunday Night Football), expensive Beltway media sponsorships, social media advertising, and a bank lobbyist website filled with false claims about capital and its importance to our economy.

Below are factual responses to some of the most frequent false claims made by the banking industry and its allies.[1]

False Claim: Higher capital will harm the economy and the American people.

TRUTH: Higher capital requirements actually result in higher lending to the real economy and more credit to the American people, and promote economic growth, and financial system stability, thereby also protecting Main Street from bank failures, crashes, and bailouts.

- The biggest threat to Main Street families comes from banks that do not have enough capital like Silicon Valley Bank, Signature Bank and First Republic Bank, which all failed in early 2023 because they didn't have enough capital. The problem is that ***under***capitalized banks are incentivized to engage in high-risk and dangerous activities that increase the likelihood and severity of bank failures, devastating crashes, and taxpayer bailouts. Wall Street's misinformation campaign is based on the false claim that adequate capital would result in ***over***capitalized banks which they claim would harm the economy.
- The evidence definitely proves that the banks' claims to be false and that increased

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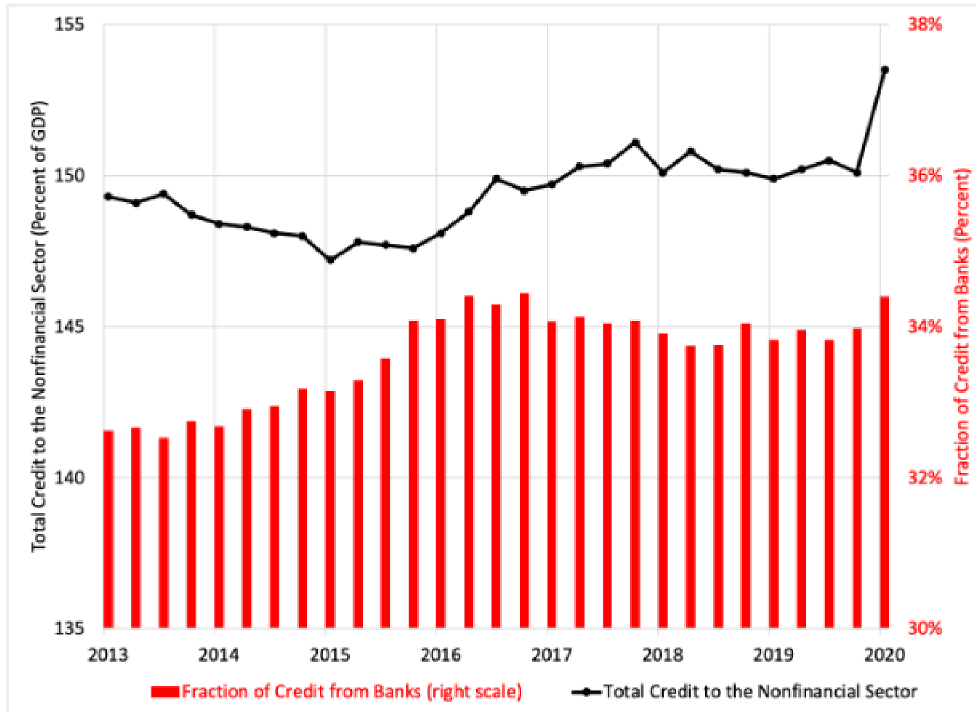
[1] For those who want a more comprehensive list of the megabanks false claims about capital with detailed rebuttals, Stanford Professor Anat Admati has complied, posted, and updates such a document here, which currently addresses 44 such claims!

capital requirements do not reduce lending. In fact, as regulators required banks to increase their capital after the 2008 crash, those very same banks increased their lending to the nonfinancial sector, as clearly shown here[2]:

Quantity and sources of credit to the nonfinancial sector, 2013-2019



Source: BIS.

- That is exactly the same time when significantly higher capital requirements were imposed on megabanks because they were so undercapitalized leading up to and causing the devastating 2008 global financial crash.
- Moreover, in addition to there having been no meaningfully negative effect on bank lending or economic support in normal, non-stress periods, it has been shown that higher capital requirements reduce the impact of economic and financial downturns. For example, a review of academic literature on the effects of capital requirements by the Bank for International Settlements, containing 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***."

False Claim: Banks survived the pandemic, so they don't need more capital.

TRUTH: The COVID-19 pandemic did not prove that banks were a source of strength. Instead, the scope and scale of U.S. government's fiscal policy and unprecedented Fed actions to support financial markets served as a back-door bailout of the banking system during the

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

pandemic. Without those trillions of dollars to support the financial system and economy, numerous banks would undoubtedly have failed almost certainly causing a financial crash.

- Large banks only had to be a "source of strength" for about two weeks after the onset of pandemic-caused market stress in early March 2020. That's because the Fed began providing enormous support to the financial system in mid-March via direct capital injections, monetary policy (zero interest rates and quantitative easing), and innumerable rescue programs aimed at almost every financial market. For example, within just the first 90 days of the pandemic, the Fed injected $3 trillion into the markets to prop up the financial system -- in which the largest banks are the dominant participants – and provided massive funding to banks and bank-owned securities dealers. On top of that, the government provided the economy with more than $5 trillion of fiscal support, which also dramatically helped banks by reducing the level of business and consumer loan defaults.
- The banks and their advocates consistently fail to mention the immense Fed and taxpayer-funded support they received throughout the COVID 19 pandemic, without which many of them would have faced catastrophic losses and certain failure. In fact, this support was so massive that it not only prevented losses, but it also led to increased bank earnings. For example, net income at the four largest banks in in 2021—the middle of the pandemic—was 120% higher than their net income in 2019.
- The Federal Reserve's own analysis says that claims the 2020 pandemic somehow proved banks were sufficiently capitalized and thus a "source of strength" are wrong. While the capital requirements for the largest banks did make them more resilient entering the crisis than they otherwise would have been, those requirements simply bought the Fed a little time to roll out programs that prevented the banks from running out of capital and failing. Thus, the banks' capital levels were not adequate to prevent their collapse; that was due to the trillions of dollars of fiscal and Fed financial market support as well as regulatory relief and related actions.

False Claim: Higher capital requirements will make borrowing more expensive for all Americans.

Truth: The proposed increase in capital requirements related to lending activities is small and if banks choose to pass the cost to borrowers, it is because they are also choosing to prioritize maximizing executive bonuses and shareholder payouts.

- As Fed Vice Chair Michael Barr detailed, the estimated increase in capital required for lending activities on average—inclusive of both credit risk and operational risk requirements—is very limited. Barr stated that the rise is expected to increase the cost to banks for funding the average lending portfolio by at most 3 basis points out of 100, which is just 0.03 percentage points.
- If the banks choose to pass that very minimal cost of slightly higher capital to their customers, that is a choice that they make – it is not the result of the rule. Additionally,

even if some banks choose to increase rates on borrowers, that doesn't necessarily mean that borrowers will have to pay more. Borrowers could—and should—shop around to other banks—such as community banks—to find the best rate. Of course, banks could also just decide not to pass along these costs to consumers and instead remain competitive within the lending marketplace by building capital in other ways, such as reducing dividends, bonuses, and stock buybacks.

- For example, the four largest banks - JP Morgan Chase, Bank of America, Citibank, and Wells Fargo - have about $4 trillion in loans and leases currently outstanding. 0.03 percentage points, or 3 basis points, of this total is about $1.2 billion – an amount that could certainly be covered by other sources of funds at these banks, with no cost increase for borrowers.
- Remember, since 2013, those four megabanks paid out $584 billion in dividends and buybacks to shareholders. That was 80% of their entire net income. They didn't have to pay out that much income to shareholders and themselves (given CEOs and executives have large shareholdings). Instead, for example, they could have paid out only 70% of their earnings. That would have freed up $58 billion in more capital funding. Going forward, the megabanks could pay out a minuscule amount less which would easily cover the potential maximum costs, even adjusting for additional loan growth. Thus, there is no need for even the possible minimal increase in costs being passed along to borrowers – unless the megabanks choose to do so.

False Claim: Higher capital will hurt Main Street small businesses.

Truth: Higher capital on Wall Street's megabanks will not hurt small businesses, but will protects the banking system and enables banks to continue lending, through ups and downs in the economic cycle, to small businesses and all borrowers.

- It's important to note that these claims are mostly being made by a tiny number of small businesses that are funded by Goldman Sachs which has organizing its borrowers into a lobbying and PR group. The claims are, however, a smokescreen that distracts from the facts.
    - First, Goldman's survey is biased and grossly unrepresentative. It is based entirely on its own "10,000 Small Business Voices" program, but there are 33,185,550 small businesses in the U.S. Thus, Goldman's survey of its 10,000 borrowers about a third of 1 percent of all small businesses.
    - Second, the capital rules are focused on megabanks high risk and dangerous trading and investments, not small business activities.
    - Third, Wall Street megabanks only provide a very small percentage of small business loans. In fact, Goldman's small business lending is less than 2 percent of its total loan portfolio and only half a percent of its total assets.
    - Fourth, the capital rules will actually help ***all borrowers***, including small businesses because well-capitalized banks that are able to lend no matter the economic environment.
- Maybe most importantly, community banks are, in fact, far more dedicated supporters of and lenders to small businesses than Wall Street megabanks. An FDIC study shows

that community account for 36 percent of all small business loans. That is more than double their 15 percent share of the banking industry's total loans. Put differently, community banks provide only 15 percent of all banking industry loans but provide 36 percent of small business loans. Wall Street megabanks simply don't focus on small business lending and no amount of lobbying by an unrepresentative sample of the very small number of small businesses that borrow from Goldman can change those facts.

False Claim: Higher capital requirements will force banks to limit mortgage lending, especially to minority borrowers.

Truth: Banks do very little mortgage lending, have been reducing it dramatically for decades, especially to minorities, and that reduction has not been related to capital requirements. Most mortgage lending is done by nonbanks and none of the capital rules do apply them.

- The proposed capital rules should actually help ***all borrowers***, including low and moderate and minority borrowers. Stronger banks that should have a lower cost of capital, won't fail, cause an economic crisis, and throw people out of the jobs and homes, and will be able to lend throughout the ups and downs of the economic cycle.
- However, in addition to the ***ability to lend***, banks must have ***the willingness to lend*** and that is where they have fallen short. Banks have been reducing their mortgage lending for decades as developments in primary and secondary mortgage markets, securitization, and technological innovation have evolved. Mortgages have become relatively easy to provide and have low margins; consequently, nonbanks have increased mortgage lending dramatically and banks have reduced their participation in the market. To illustrate, in the third quarter of 2023, the six largest megabanks held just 7 percent of all outstanding mortgages, well below their 35 percent share of total loans and more than 43 percent share of total assets in the banking industry. This reduction in mortgage lending isn't new, isn't being caused by higher capital requirements, and isn't focused on any one minority group.
- Moreover, despite making pledges and setting ambitious goals for increased mortgage lending in minority communities, the megabanks have fallen short and broken promises to support minorities' goals of homeownership. For example, in 2017, Wells Fargo, the megabank that has historically focused most on mortgage lending, announced $60 billion to create 250,000 Black homeowners within the next decade. But, in 2021, Wells underwrote ***42% fewer*** mortgages to Black buyers than in the year it announced its target. Even counting mortgages purchased from other lenders (which is of questionable utility), Wells Fargo backed successively fewer mortgage loans in each of the past five years, hitting a 15-year low in 2021. And that is the record of the "best" mortgage lending megabank. Of course, none of this even addresses the all too frequent charges of redlining and discrimination against the megabanks, who are now conveniently professing concerns about dubious implications from capital requirements.
- Even more disturbing are the inflammatory and misleading "studies" and claims from organizations that appear to be independent of the banks but which receive massive donations from megabanks. For example, one study about the potential impact of the new capital requirements on mortgage lending at first glance suggests that new rules

will have a large and negative impact on lending. However, the study fails to focus on the fact that the proposed rules will only affect a small fraction of all mortgage loans−only those made by the largest banks that would be risky enough to be subject to the new rules.

- Finally, the regulators have made it clear that the focus of the rules are on the megabanks high risk trading and investments, not legitimate lending to Main Street Americans, the real economy, or communities of color. To the extent there is an unintended adverse consequence or disproportionate impact, the regulators have made it clear that they will address that in the final rule. After all, that's what the comment process is for and we are highly confident that the regulators will ensure that there will be little if any impact on lending, including in particular mortgage lending to minority borrowers.

False Claim: "Large banks have more capital now than in 2008, so therefore they don't need any more."

TRUTH: Banks were extremely undercapitalized in 2008. This undercapitalization was a primary cause of the devastating 2008 crash, which required trillions of dollars in bailouts, and resulted in the Great Recession that put tens of millions of Americans out of work and crippled the U.S. economy for years. Of course, capital requirements were increased after that, but the starting point for determining adequate capital levels now cannot be when they were historically and catastrophically low in 2008. The key issue is not how much higher capital levels are now compared to 2008; it's how high capital levels should be to protect the American people. Furthermore, key changes were made during the Trump Administration that significantly weakened the post-2008 crash improvements, making the need for enhanced capital even more imperative.

- Between 2001 and 2006, risk-based capital ratios for the largest banks in the country (GSIBs) were around 7 percent and fell below 5 percent in the fourth quarter of 2008. Tier 1 leverage ratios for the GSIBs between 2001 and 2006 were even lower, between 5 and 6 percent. Risk-based capital levels are now around 12 percent, but that was still not high enough to prevent the failure of three large banks in the spring of 2023, causing contagion, a credit contraction, and massive deposit flight.
- Although the post-2008 crash reforms increased capital relative to banks' risks, regulators stopped well short of requiring as much capital as many academics, public interest groups, regulators, and even banks' own risk managers have argued is needed.
    - The largest banks' capital must minimize the potential that they could once again cause or contribute to a devastating financial crisis and require massive taxpayer-funded bailouts, as well as economic misery for tens of millions of American families.
- Many independent parties have determined 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—far higher than current or proposed capital requirements. This figure would have been even 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 US and Europe.
- Economists Anat Admati and Martin Hellwig, in their 2013 book (with a new, updated version being released on March 23, 2024) *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.
- A 2019 survey of bank risk management professionals showed that nearly half of respondents felt that the bank leverage capital ratio requirement should be 15%. In other words, professionals that manage bank risk for a living believe that current capital minimums are insufficient and should be significantly increased.
- Unsurprisingly, none of the industry's "studies" and "analysis" are independent or credible. Those are little more than purchased propaganda (with the conflicts of interest often undisclosed or actively concealed) that have not been peer-reviewed or subjected to independent analysis and confirmation. Indeed, most of those materials do not disclose the data underlying their baseless claims which prevents third parties from subjecting those claims to independent analysis.

False Claim: If bank capital requirements are increased, financial activity will shift from banks to the dangerously unregulated "shadow banks."

TRUTH: Systemically significant large banks, which are deeply interconnected with the shadow banking system, need to have enough capital to protect the financial system, the economy, and

Main Street families from devastating economic crashes. If activities migrate from those banks to systemically significant shadow banks, then the solution is not to underregulate and undercapitalize banks; it's to properly regulate those shadow banks. This false claim is really based on an argument that both systemically significant large banks and shadow banks should be undercapitalized, but that would be the worst of all worlds. Properly regulating systemically significant financial firms of all types is the right solution.

- There is no question that the systemically significant nonbanks are un- and under-regulated. But the response 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 nonbank sector.
- In the absence of sufficient standards for shadow banking firms and activities, banks actually need more capital to protect themselves from the threats posed by poorly regulated shadow banking firms. That's because, as was evidenced in the crashes of 2008 and 2023, banks are deeply interconnected with nonbanks and, when nonbanks get into trouble, they can and do endanger banks.
    - 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 relatively less capital to absorb potential losses than would otherwise be the case.
- With its recently adopted analytic framework and process for regulating systemically important nonbanks, the Financial Stability Oversight Council ("FSOC") must be held accountable for recognizing systemic risks in the nonbank sector and mitigating them. The FSOC must use its power to identify, assess, and address the full range of financial risks that can threaten the country by systemically significant nonbanks. FSOC must designate and properly regulate systemically significant nonbanks. It is unacceptable that there is not one financial firm designated as a systemically significant nonbank in the United States today, especially in light of the many significantly significant nonbanks that received extraordinary support from the Fed in 2008 and again in during the 2023 pandemic-caused crash.

False Claim: Higher capital requirements put U.S. banks at a global disadvantage.

TRUTH: Higher capital standards for U.S. banks have not resulted in a competitive disadvantage relative to foreign banks. In fact, U.S. banks dominate the world's banking system where there is little if any genuine competition. Moreover, even if there was some competitive disadvantage, that would not justify threatening the U.S. financial system and economy with undercapitalized banks.

- U.S. banks have consistently outperformed their foreign counterparts since U.S. capital standards were strengthened following the 2008 crash, due at least in part to the greater financial strength that resulted from regulatory requirements they had fought so hard against.

- As a result, the six largest megabanks had [profits of $1 trillion] in just the last ten years and the four biggest U.S. lenders alone [made 45 percent of total banking industry profits] in the third quarter of 2023 (and a 10 year average of 39 percent).
  - And that is all AFTER the capital increases following the enactment of the Dodd Frank Act, which the banks fought using the very same arguments they are using now.
    - And which were proven baseless and false then as much as they are now.

- U.S. banks have far outperformed their global counterparts for years. One striking study compares two equal investments of $100 in a US bank index fund and €100 in a European banking index fund, beginning in January 2008. By January 2019, the US banking index investment would have been worth approximately $170 (a return of 70 percent) while the European fund investment was only worth €40 (a return of negative 60 percent). The study breaks down performance in three periods.
  - 2008- 2010: Both the US and European banking sectors struggled during this period, recovering from the 2008 crisis, with comparable losses in index value.
  - 2011 – 2015: US banks began to outperform their European counterparts in 2011. Europe was weighed down by a variety of factors including the euro crisis, doubts about the viability of a single currency, and concerns about specific countries such as Greece while US banks enjoyed a period of recovery and growth.
  - 2016 – 2018: Growth continued for US banks while European banks continued to suffer because of political risk, largely driven by Brexit and the Italian elections, and negative interest rates that resulted from European Central Bank monetary policy.
- London has lost ground in its ranking as the world's top financial centre, according to the latest (2023) study by the City of London Corporation comparing London to other global cities across a range of competitiveness factors. On the overall scale, London lost ground and tied New York, but New York far outperformed on the "Reach of Financial Activity" measure.
  - The US increased its share of worldwide lending and with 18 percent of the global total overtook the UK, which has 16 percent of lending, in the global financial ecosystem.

The US also far exceeds all global asset manager competitors with the most assets under management (£37 trillion), more than three times the UK with (£11.6 trillion).

False Claim: We need more time to understand the effects of higher capital.

TRUTH: The financial industry uses and abuses the rulemaking process to protect its profits instead of protecting the American people by needlessly delaying and then weakening or killing essential rules. The banking agencies must not allow that to continue and must act as decisively to prevent the next banking crisis as it does when reacting to a crisis.

- The traditional rulemaking process was intended to enable and ensure that agencies received ample public comment to ensure that the best rules were adopted. However, the financial industry repeatedly abuses the rulemaking process to delay, weaken, or kill as many rules as possible to protect their profits regardless of how necessary those rules are to protect the public. In effect, the "public comment" process has been largely hijacked by the industry and transformed into an "industry comment" process where the pubic and the public interest gets drowned out. The evidence for this is overwhelming and already present here regarding the capital rules:
  - Wall Street's CEOs were opposing the capital rules sight unseen. As CNN reported on July 19, 2023, "Bank CEOs are already complaining about new regulations they haven't even seen yet." That's because the CEOs don't have to see the proposed capital rules; they are already against the rules no matter the merits or how necessary they may be.
  - The five most powerful financial industry trade groups representing the country's largest banks sent a letter to Chairman Powell on July 12, 2023, asking for a comment period of 120 days, rather than the typical 60- or 90-day comment period, to respond to the proposed changes to bank capital requirements. These trade groups, with vast if not unlimited resources, influence, and access, including hundreds of lawyers, lobbyists, and staff, are fully capable of responding within any time period to any proposed rules.
  - Even though the 120-day comment period was granted, the same five trade groups submitted another letter on October 6, 2023 asking for even more additional time. These pleas are just the latest example of an attempt to abuse and delay the rulemaking process, which endangers the financial system and increases the risks to the American people.
  - These actions followed the financial industry's failed attempt through their political allies to prevent the capital rule from even being proposed. For example, ten Republican members of the Senate Banking Committee, clearly on behalf of Wall Street's biggest banks, wrote to Fed Chair Powell on March 3, 2023, in a preemptive strike on Vice Chair for Supervision ("VCS") Barr's then-ongoing holistic capital review. Better Markets sent a letter to Chair Powell rebutting the Senators' premature, unwarranted, unnecessary, unfair, and baseless claims and suggestions against VCS Barr and potential capital increases.
    - Proving how wrong those Senators were, their March 3, 2023, letter was literally just days before Silicon Valley Bank collapsed on March 10, 2023, due to a lack of capital which required an FDIC bailout of $16.1 billion, i.e., the FDIC injected $16.1 billion of capital to cover the lack of capital the bank should have had to prevent its collapse in the first place.
- Banking regulators acting decisively and with urgency could avoid the next bank failure, expensive clean up, extraordinary actions, and taxpayer bailouts. There is no justification for delay or an even longer rulemaking process to address long overdue, well known, and abundantly demonstrated weaknesses, including insufficient capital at the megabanks.

Better Banks | Better Businesses

Better Jobs | Better Economic Growth

Better Lives | Better Communities

Better Markets is a public interest 501(c)(3) non-profit based in Washington, D.C. that advocates for greater transparency, accountability, and oversight in the domestic and global capital and commodity markets, to protect the American Dream of homes, jobs, savings, education, a secure retirement, and a rising standard of living.

Better Markets fights for the economic security, opportunity, and prosperity of the American people by working to enact financial reform to prevent another financial crash and the diversion of trillions of taxpayer dollars to bailing out the financial system.

By being a counterweight to Wall Street's biggest financial firms through the policymaking and rulemaking process, Better Markets is supporting pragmatic rules and a strong banking and financial system that enables stability, growth, and broad-based prosperity. Better Markets also fights to refocus finance on the real economy, empower the buyside, and protect investors and consumers.

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BETTER MARKETS

BANKING REPORT

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

By DENNIS KELLEHER, TIM P. CLARK, AND PHILLIP BASIL

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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).

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.

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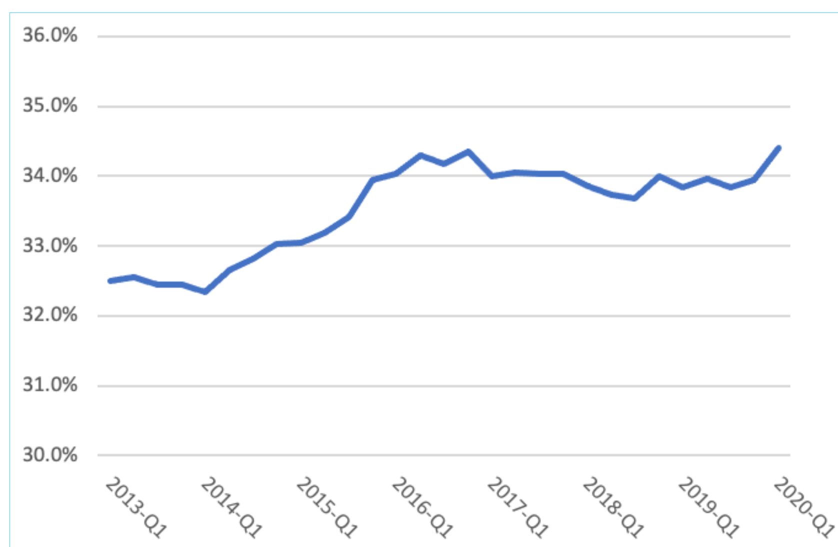
The reality is there is no conclusive evidence to support the argument that increased capital requirements reduce lending. In fact, according to data from the Bank for International Settlements, both the amount of lending and the share of lending coming from banks to the non-financial sector has actually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

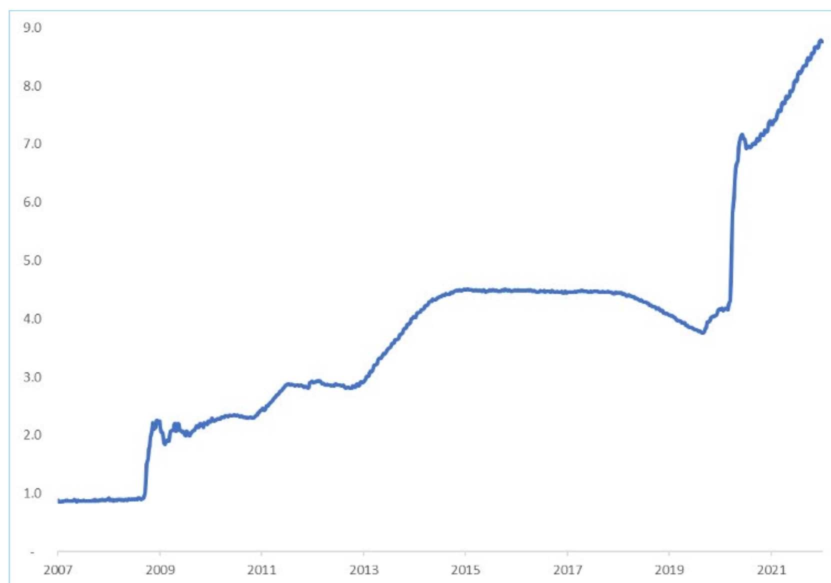
> *Missing from the banking industry's arguments is an acknowledgement that the worst financial and economic downturn of the past 80 years was in large part a result of deeply undercapitalized and overly risky large banks resulting from weak regulatory capital requirements.*

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."

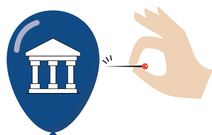
Current capital requirements for large banks do include substantial increases and vast improvements in the measurement criteria relative to the woefully inadequate standards in place prior to the 2008 Crash. Nonetheless, they fall well short of what many experts have found to be a more socially beneficial 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

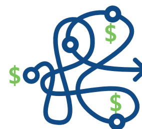
The strengthening of capital regulations and of bank supervision for the largest banks was foundational to post-2008 Crash reforms. Most important was the Federal Reserve's implementation of an annual stress test, and the requirement that large banks remain adequately capitalized even after potential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

The Basel Endgame modifications—if implemented as proposed by the BIS—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

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 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.

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.

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

Better Markets is a public interest 501(c)(3) non-profit based in Washington, D.C. that advocates for greater transparency, accountability, and oversight in the domestic and global capital and commodity markets, to protect the American Dream of homes, jobs, savings, education, a secure retirement, and a rising standard of living.

Better Markets fights for the economic security, opportunity, and prosperity of the American people by working to enact financial reform to prevent another financial crash and the diversion of trillions of taxpayer dollars to bailing out the financial system.

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