Issue Brief

Capital versus Credit:
2017's Critical Reform Questions

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During the week of February 13, FRB Chair Yellen emphatically asserted that the new capital rules have had no adverse impact on U.S. credit availability. Republicans assailed her even as Democrats strongly defended not only the point, but also the data she presented to support it. Here, Federal Financial Analytics (FedFin) assesses not only these data, but also the broader capital-versus-credit question. We conclude that capital rules do not quash credit availability under ordinary circumstances, but 2017's circumstances are anything but ordinary. All the other rules applicable to large U.S. banks, continuing dependence on these banks for most household and small-business credit, sluggish growth, and under-employment combine to make stiff capital regulation another hurdle holding back sustainable credit and thus the robust U.S. recovery needed to provide opportunity across the full spectrum of American regions and incomes.

This issue brief is premised on two hypotheses:

- The U.S. financial crisis led to a "balance-sheet" recession in which traditional neoclassical economic assumptions do not apply well, if at all. This is because both growth-generating capital in a balance-sheet recession[1] is marooned from financial intermediation through banks because savers do not spend and banks do not or cannot lend. Each instead preserves capital to recover from crisis-driven losses and, for banks, also from the impact of rules.
- Because the dynamic of the great financial crisis differs from those the FRB believes it understands, the data on which it relies do not capture well the current condition of U.S. employment and growth. "Facts" premised on "full" employment except for the odd "marginal" group are belied by profound popular discontent with economic realities. Not all of these are the fault of monetary and regulatory policy, but enough of them are that monetary and regulatory policy requires rapid remedy to offset its impact not only on U.S. income and wealth inequality, but also on populist discontent and growing demands for economic nationalism.

This FedFin issue brief also builds on prior Federal Financial Analytics (FedFin) work on challenges to transmission of U.S. monetary policy[2] and income inequality[3] to present new data addressing the critical question of the extent to which the post-crisis framework of U.S. capital regulation for large U.S. banks has stifled the longer-term, lower-interest loans to households and small business essential to prosperity and social welfare. This brief is not intended as an in-depth analysis; rather, we highlight the major issues of most importance to policy-makers considering the extent to which they should preserve the capital regime implemented since 2008 by the Federal Reserve and other U.S. regulators.

Is There a Credit-Availability Challenge?

This is of course the threshold question – if there is no U.S. credit-availability problem, then further evaluation of the capital rules in this regard is irrelevant. As with any complex question, answers depend first upon how one frames the inquiry. Here, we posit the following:

- Gross, undifferentiated assessments of total increases in U.S. lending do not clarify the link between capital, credit, and recovery because not all credit supports growth. For example, new credit does not support growth if it is provided to large corporations that then only refinance older, costlier credit and then lead to more corporate dividends or share repurchases, not new investment in plants, equipment, or other growth engines. Between the third quarters of 2012 and 2015, nonfinancial companies added $1.4 trillion in debt yet spent $1.3 trillion repurchasing stock.[4] The reasons for this are complex, but one reason large corporations do not, as the FRB intends, use ultra-low rates to grow but rather to restructure is the need in a balance-sheet recession for these companies to rebuild their market capitalization. These strategies do not support the long-term organic growth that truly enhances franchise value, but they are rational and often unavoidable strategies during periods of weak growth and economic or geopolitical uncertainty.

- Gross credit numbers also do not necessarily reflect the real relationship of credit to growth unless credit availability matches or exceeds gross domestic product (GDP). Bank for International Settlements (BIS) data indicate that the U.S. credit-to-GDP gap as of the second quarter of 2016 stood at 8.8 percent below its long-term trend.[5]
- Sectoral factors also affect credit availability and growth. Because the U.S. has a mortgage-finance system largely dependent on fixed-rate mortgages, new mortgages with reduced interest rates do not automatically translate into lower mortgage payments unless a borrower is able to refinance into a lower-interest loan. Changes in mortgage-underwriting and securitization practices[6] have altered the U.S. refinancing market so that creditworthy borrowers use housing value to reduce payments on a newly-lower balance – essentially using the new loan as a savings vehicle. A focus on gross lending also does not account for significant shifts in mortgage credit availability, which has become far more difficult for first-time and lower-income borrowers.[7]
- The relationship between credit data and demand is uncertain given the slow pace of U.S. economic growth and the impact of a balance-sheet recession. Data sources such as the FRB's "beige book" present an uncertain picture of supply and demand, but anecdotal evidence shows numerous examples of efforts by banks, including large ones, to support critical credit areas such as mid-market lending.[8]
- Even if refined credit data show substantial growth in the types of credit critical to sustainable recovery (which does not appear to be the case), not all credit comes from banks and thus the impact of the capital rules cannot be clearly seen in gross credit data. The most recent report from Treasury's Office of Financial Research found that non-banks now supply more U.S. credit than insured depositories, concluding that this is in part the result of higher, more costly capital requirements.[9] This transformation of credit into a non-bank business might satisfy credit-availability needs (although this does not now appear to be the case), but it would do so at significant risk to the financial-stability objectives on which the bank regulatory-capital framework is premised.

Chair Yellen has rightly focused on small-business lending as a critical growth engine. Here too, though, care with data is necessary to ensure meaningful facts are mobilized to answer the capital-versus-credit question. Perhaps recognizing that the smallest companies are the most important U.S. growth engine,[10] Ms. Yellen brought before Congress survey data from the National Federation of Independent Business[11] focusing on credit-availability views by relatively small-business owners. Based on the NFIB's most recent data, Ms. Yellen told Congress that only four percent of surveyed owners said credit is now hard to find. In an exchange with Members of Congress, Ms. Yellen also agreed that these data can be read as finding that 96 percent of small-business owners receive the credit they need.[12]

In fact, this NFIB study and those that precede it in this regular survey are at best equivocal. The one cited by Ms. Yellen finds expressly that 31 percent of surveyed owners say that their credit needs are satisfied, 52 percent did not want a loan, and thirteen percent did not answer the question. Federal Reserve data indicate that the smallest businesses – again those most critical to growth – often do not seek credit if they think they cannot get it.[13] Many small-businesses also use non-traditional credit – for example, one estimates finds that a quarter of small business owners use home equity to fund their businesses.[14] Owners who told NFIB that they are not seeking credit may well be doing so not because they do not need sustainable financing, but rather because after the crisis showed how dangerous it is to tap home equity, they fear using the only credit resource they think available to them.[15]

Perhaps more useful as a data point about credit satisfaction is the NFIB question about whether owners find that credit is now harder or easier to get compared to three months ago. The survey cited by Chair Yellen finds that the difference between those who describe obtaining credit as harder and those who describe it as easier has not significantly changed since the depth of the crisis – the average for 2012 (before the Basel III rules were implemented) was 7.9 percent, with this difference now equal to five percent in January of 2017. This number is less than it was in prior years as the Basel III capital rules began to come into effect, but it is surprising to see it go up despite economic growth. FDIC data also show a sharp drop in loans of less than $1 million from banks since 2010.[16]

How Do Capital Rules Intersect with Credit Availability?

As is clear from the short discussion above, determining if there is enough credit is not a simple assessment. Similarly, determining the extent to which the capital rules applicable to banks play a role in any credit shortfalls and then the degree to which these shortfalls may play a role in slow growth, income inequality, and/or financial instability is challenging. To make any such judgments, one needs to know:

- Capital Framework: How each type of capital requirement affects specific loan segments and how the cost of capital runs into market pricing and related profit considerations are essential analytical considerations. One recent paper has estimated that U.S. banks are under as many as 28 different regulatory-capital requirements.[17] The interplay among risk-based, leverage, and stress-test standards is particularly critical – an asset such as Treasury bills with a zero risk weighting can become prohibitively expensive after taking the leverage rules and/or stress-test scenarios for market or interest-rate risk into account. In sharp contrast to the way other nations implement their capital rules, the U.S. requires large banks to meet the highest of any applicable capital requirement. Banks thus must arbitrage the rules with market reality to optimize portfolio compositions. Gross credit data are likely to obscure significant shifts in credit allocation by banks due to each relevant capital requirement for individual types of loans and the role they play in each bank's market and strategy. Recent FedFin research assesses this question in more detail.[18]
- Investor Demand: Banks are shareholder-owned companies and shareholders demand return on investment before parting with the funds needed to capitalize a bank. Some have recently suggested[19,20] that banks should simply retain earnings and thus build capital at no cost to credit. The sharp drop in market capitalization in concert with new capital rules[21] shows clearly that this cannot be done without cost to investors – cost banks cannot long impose and still hope to remain viable enterprises. Arguably, the safer the bank, the lower the cost of capital,

permitting investors to get their return, banks to get their capital, and borrowers to get their loans without constraint. However, numerous studies[22] show that the cost of bank capital has not declined since the crisis due to factors such as the adverse impact of new rules on bank profitability and resulting financial-stability risk. It is thus likely that higher capital requirements lead to reduced credit at least in certain asset classes as banks seek to rebuild profitability and satisfy their investors.

- Low Interest Rates: As discussed above, any analysis of credit and capital must be careful to take into account an array of "moving pieces" in this critical puzzle. One such piece is the simultaneous application of new credit rules in concert with the decision by the Federal Reserve to drop interest rates to close to zero in nominal terms and below zero when inflation is taken into account. Even though rates have now risen somewhat, they are still ultra-low by historical standards. New BIS research[23] finds that low interest rates are the principal cause for the sharp drop in lending by 108 large, international banks. Capital is part of the reason for this because low rates reduce loan profitability (clear from FDIC data on U.S. return on assets[24]). To be sure, this study shows that well-capitalized banks lend more than weaker ones, but the impact of interest rates applies across the sector suggesting that the cost of capital combines with the reduced return on it from low-yielding loans to discourage credit availability.

- Balance-Sheet Constraints: When banks cannot raise more capital at manageable cost in response to rules demanding they do so, they must optimize their capital allocations – i.e., use what they've got as well as they can – to preserve at least some of the profitability critical to market stability, long-term franchise value, and as the study above suggests also to their ability to lend. Optimizing balance-sheet capacity requires banks first to determine the most profitable assets based on which capital rule is each asset's binding constraint. This can distort credit allocation, diverting lending from the lower-profit, longer-term loans essential to economic recovery (e.g., mortgages for first-time buyers, small-business lending, trade finance, sustainable manufacturing finance) to the high-yield, short-term paper (e.g., commercial real estate lending) fueling the asset bubbles of such concern to the FRB and other global agencies.[25]

- Sector Impact: As noted above, gross data obscure the potential impact of capital rules on sectors such as residential mortgages for moderate-income households. A recent study from the Federal Reserve examining the link between higher capital requirements and unemployment[26] finds that higher capital requirements have historically had at least a temporary impact on unemployment, especially for smaller businesses where ready substitutes for bank loans (e.g., access to the capital market through bond issuance) are not feasible.

- Cumulative Impact of Other Rules: Incentives for what is generally called yield-chasing are exacerbated by the interplay between the U.S. capital and liquidity rules. The latter require larger U.S. banks to hold significant balances in "high-quality liquid assets" (HQLAs) such as Treasury bonds. Due to the leverage and stress-test requirements cited above, HQLAs are costly in terms of balance-sheet capacity even though they are very low risk holdings. In short, banks cannot meet all rules all at the same time – especially in slow-growth economies where ultra-low interest rates further crimp profitability – and they thus make hard choices that generally optimize profit and compliance above public service in areas such as lower-return lending. New rules mandating the issuance of long-term debt to meet total loss absorbing capacity (TLAC) rules for the very largest U.S. banks also swallow balance-sheet capacity, with the sum total of these and other requirements altering and likely reducing U.S. bank credit capacity, especially for the types of credit most important to income and wealth equality.

- Timing: When capital rules are imposed also appears to have significant impact on how they affect credit availability. A new study from the Bank of England[27] has found that higher capital may well lead to more loans, but only during periods in which the economy is growing. When it is not, higher capital is used for balance-sheet repair, not employment-generating and income-distribution benefit. A recent study by The Clearing House[28] also demonstrates that the beneficial credit-availability impact some studies expect from higher capital are generally obtained when a bank elects to hold this higher capital, not when it is required to do so regardless of underlying risk and thus at cost to its risk-adjusted rate of return.

What Then Do We Know About the Impact of Capital Rules on Credit Availability?

The discussion above is a brief synopsis of an array of data and observations about the challenges confronting anyone seeking to make a definitive statement now about the impact of the post-crisis regulatory capital rules. There are data on all sides of the question – those Chair Yellen brought before Congress, those we present here, and much elsewhere. All of these data are irrelevant if stringent U.S. capital rules are warranted despite any and all of their credit impact because the U.S. financial system would be in danger of imminent instability or even crisis without them. The Federal Reserve has taken this view in various rulemakings, doing so for example with regard to a new capital surcharge for the largest U.S. banks and the TLAC rules described above.

However, review of governmental and academic surveys of the impact of post-crisis regulations leads one to a far more equivocal conclusion. For example, a 2015 study found that, "In conclusion, both theoretical and empirical studies are not conclusive as to whether more (stringent) capital (requirements) reduces banks' risk-taking and makes lending safer."[29]

Even though the prudential benefit of higher capital is uncertain, it does appear clear that the capital rules have had a significant impact on U.S. banks, at the very least sharply reducing franchise value prior to the recent equity-market surge which may or may not prove a lasting recovery and may or may not have any relationship to the sustained ability of banks to make more loans. One new study[30] suggests that bank capital regulation will remain regressive even if expectations are realized for the stronger growth and higher interest rates on which investors appear to be betting since the November U.S. election. This study concludes that credit growth will be robust in these conditions only if non-banks take an ever larger role – a role which of course would lead one to conclude that new capital rules have done little to make the financial system any safer given that these non-banks will gain this new credit hegemony only because they are exempt from regulatory-capital regulation.

Notes:

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