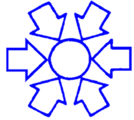

Federal Financial Analytics, Inc.

MEMORANDUM

TO: Federal Financial Analytics Clients

FROM: Karen Petrou

DATE: April 16, 2021

Earlier today, we sent you our analysis of a consequential Fed study showing how well U.S. banks weathered the pandemic and how post-2008 rules made this possible. In short, one more notch in the Fed's own belt signifying its banking-system success under not just a severely-acute stress scenario, but also the near-miss of the real thing. However, as the Fed readily acknowledges and this study convincingly demonstrates, the rules governing big banks not only made them formidably resilient, but also resolutely procyclical. As the U.S. central bank rewrites the regulatory-capital construct this year – and it will – it should abandon the failed concept of a counter-cyclical capital buffer (CCyB) in favor of what I call built-in counter-cyclical capital circuits. Here's what they are, how they would work, and why the Fed should come to count on them.

One of the many startling statistics in the Fed study is the finding that the biggest banks had almost a third more excess capital ($288 billion) in 2020's third quarter than at the end of 2019 ($211 billion). Thirty of the 34 banks studied also had still more excess capital now than they did pre-COVID excluding the big capital boost when reserves and Treasury obligations came temporarily out of the supplementary leverage ratio's (SLR) denominator. As the study concludes and the Fed thought it already knew, "the broad goal of capital buffers is not functioning as intended."

What to do? The Fed's first unfortunate instinct – add a new layer of regulation – is evident in one of the study's conclusions: that big banks didn't touch their buffers because investors wouldn't have liked it. Big banks are said to have preserved capital-distribution capacity at the cost of capital-deployment power, saving themselves instead of the financial system and macroeconomy.

The Fed study only observes this, but many in Congress will surely jump on it, arguing that -- as some in the Fed clearly favor – mandatory, sector-wide barriers to capital distribution are the most effective form of counter-cyclical capital circuit-breaker. I doubt Congress will mandate any such rule, but allegations about excess capital will figure prominently in one of the hottest political battles to come: a targeted "crisis-fee" or similar tax aimed squarely at the very largest U.S. banks now seen by Democrats as having unduly profited at the economy's expense.

What the Fed thinks of any such penalty tax remains to be seen, but I expect it to put on its "that's just fiscal policy" game face and hope the idea dies in the sharply-divided Congress. The Fed will instead turn to rewriting the SLR denominator, the advanced approach to risk-based capital, the trading-book standards, and operational risk-based capital. This not only fulfills its promises to the Basel Committee, but also and more immediately rebuilds the rules now that the Fed and other agencies were forced to carve such big holes in them in 2020.

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But, instead of slapping new rules on old ones, U.S. regulators would be far better served by going into the guts of their system to rewrite its circuits, abandoning non-functioning buffers in favor of resilient circuitry. We have shown how procyclical all of these capital rules were likely to be in a series of studies going back to 2015, but these warnings went unheeded. Just a few ways to introduce counter-cyclical circuits we identified then include new regulatory analytics that recognize the interplay between capital and liquidity rules to enhance resilience under stress, a rewrite of the advanced approach to eliminate its procyclical bias, better limits on concentrated risk positions in segments with macroeconomic or systemic clout, removing riskless assets from the SLR denominator in concert with setting it a bit higher, and providing a new approach to measuring trading-book risk independent of anachronistic value-at-risk models. Other FedFin studies have shown still other options, and the agencies should consider each of them as they move through the rulebook.