



MEMORANDUM

TO: Federal Financial Analytics Clients
FROM: Karen Petrou
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Late last week, we released a new [issue brief](#) laying out how to quickly take Michael Barr's suggestion of a holistic regulatory-capital regime from rhetoric to reality. The [American Banker](#) did a fine job summarizing the paper and putting it into the policy context, generating a lot of questions to which I'll turn in this memo. By far the most common assertion is that this paper is a stealth big-bank campaign to cut regulatory capital. If it is, that's news to all of them, as they saw the paper about the same time the *Banker* article appeared. More to the point and as I'll discuss below, a holistic-capital regime wouldn't come cheap, it would just be better honed and more effective.

The paper was sparked by what might have been an offhand comment from Mr. Barr at his Senate confirmation hearing for the Fed's supervision vice chair. He was asked his views on the "Basel IV" package of regulatory-capital rewrites and said that he favored thinking about capital as a whole rather than finalizing individual standards in the absence of a broader vision. Or that's what he seemed to mean because, sensible man that he is, the less said at a confirmation hearing, the better, and talk quickly turned to other matters. Assuming he meant what we thought he said, FedFin did our best to give it legs.

We did so in part by providing a short taxonomy of key capital requirements showing how they relate to other capital requirements and the broader nexus of safety-and-soundness standards. When one does so, it quickly becomes clear that capital is all too often a default backstop for risks best suited to supervisory standards made credible by enforcement that CEOs and boards of directors take very, very seriously. Think of capital as a belt to hold up a pair of pants that would fit far better if they were taken in at the waist and sides. The belt works in one sense – the pants don't fall down -- but the fit is awkward and your shirt keeps coming out.

The holistic-capital framework thus tailors capital to purpose, not just crudely to size as is now the case. It thus should be measured not by how many capital rules it has and the big number to which they add up, but rather by demonstrable resilience under even acute stress across the spectrum of ills that all too often befall big banks.

Critics of our approach seem to believe that altering one part of the current regime guts it all. Some have thus targeted my doubts about the stress capital buffer (SCB), suggesting I want it relaxed or even eliminated. What I in fact want is for regulators to look at the pile-up of add-on capital charges to see whether their sum total makes banks resilient to stresses likely to lead to their downfall. The SCB may well need to get tougher and more dynamic, but it still omits key stress if not also refined to capture liquidity, operational, and other hazards.

Indeed, perhaps what a bank may need isn't more equity, but more cash or additional systems redundancy. We have what should be strict resolution-planning requirements to ensure even the biggest banks can be readily resolved without systemic risk, but then we add to this a GSIB surcharge and another charge for "total" loss absorbency. If we now don't trust the resolution plans, why not make them credible under penalty of significant structural change as mandated in the [Dodd-Frank Act](#) and pick the capital charge that best supports ready recovery or manageable resolution?

Ever since it was clear in 2008 that banks didn't have enough capital, there seems to be no amount of regulatory capital that's too much capital for each and every risk covered by capital calculations even as new risks arise outside the reach of log-bound capital standards. It was effective supervision reinforced by well-managed risk tolerances that kept banks out of harm's way in the crypto collapse, not capital rules only now maybe taking [some form](#) of shape to deal with the evolution of digital finance. This is clear evidence that capital isn't a cure-all if supervision suffices and risks are manageable without added resources. This time it did; next time, who knows in the absence of a coherent construct that puts capital into the context of public policy's over-arching goal: sound banks that support economic growth and smooth market functioning and, should they falter, fail only at cost to themselves.