Federal Financial Analytics, Inc.

MEMORANDUM

TO: Federal Financial Analytics Clients

FROM: Karen Petrou

DATE: August 8, 2022

In our recent paper outlining the holistic-capital regime regulators should quickly deploy, we noted that current rules are often counter-productive to their avowed goal of bank solvency without peril to prosperity. However, one acute problem in the regulatory-capital rulebook – procyclicality – does particularly problematic damage when the economy faces acute challenges – i.e., now. None of the pending one-off capital reforms addresses procyclicality and, in fact, several might make it even worse. This memo shows how and then what should be quickly done to reinstate the counter-cyclicality all the regulators say they seek.

Last Thursday, the Fed set new, often-higher risk-based capital (RBC) ratios for the largest banks. The reason for this untimely capital hike lies in the interplay between the RBC rules and the Fed's CCAR stress test. Packaged into the stress capital buffer (SCB), these rules determine how much RBC each large bank must hold to ensure it can stay in the agencies' good graces and, to its thinking, better still distribute capital.

Put very simply, the more RBC, the less RWAS – i.e., the risk-weighted assets, against which capital rules are measured. The higher the weighting, the lower a capital-strained bank's appetite to hold it unless risk is high enough also to offset the leverage ratio's cost – at which point the bank is taking a lot of unnecessary risk to sidestep another set of unintended contradictions in the capital construct. As a Fed study concludes, all but the very strongest banks sit on their buffers, afraid that rising to the occasion of market need endangers their regulatory and investor standing.

At the time the SCB was finalized, the Fed thought that tough CCAR stress tests would rein in banks inclined to be profligate during the best of times without also thinking through what might happen if times turned tough. Ever-tighter stress tests indeed discipline banks when times are good, but counter-cyclicality is only possible if the Fed eases up its own dire predictions right about the time they might come true. This is one of the most profound and so far unrecognized contradictions in our most unholistic capital regime: reliance on stress tests focused only on bank resilience strengthens banks at grave cost to shared prosperity and, over time, financial stability.

Failing to address this, the Fed made CCAR even tougher in 2022, meaning that the SCB goes ever higher. We thus have big banks that can withstand much of what even the Federal Reserve Bank of Minneapolis threw at them, but a dearth of regulated, pro-productivity financial intermediation right when it's most needed.

One might counter that banks should abandon their own self-interest for the public good or even that, to ensure they do so, regulators should bar capital distributions. However, even if capital distributions are banned, banks will still seek to support their market capitalization because banks are private enterprises, not public utilities. We know that banks can go overboard with capital

2101 L Street, N.W. – Suite 300
Washington, DC 20037
Phone: 202.589.0880

E-mail: info@fedfin.com
Website: www.fedfin.com

distributions – see 2007 – but we also know that, if banks don't keep investors happy, then banks take risks that are ever-present in markets and still more demanding in downturns. As a study from former Treasury Secretary Lawrence Summers and others has shown, a bank's franchise value as measured by its market capitalization is a vital indicator of a bank's resilience.

In a holistic-capital regime, stress testing would be far more dynamic and buffering better designed so that, as macroeconomic or financial conditions weaken, banks are encouraged to draw on their buffers or even maintain capital ratios at adequate, but not exuberant, levels. Indeed, one of the clear lessons both the Fed and global regulators have drawn from the Covid crisis is that banks must use their buffers, not feel compelled to build them even higher under stress. Reflecting this, Treasury Under-Secretary Liang recently recommended a rewrite of the counter-cyclical capital buffer that includes far clearer triggers than the current, "we'll know it when we see it" framework. This makes a lot of sense, but only if the new, up-and-down counter-cyclical buffer is part of – yes – a holistic capital regime in which it works consistently with the RBC and leverage standards CCAR, the SCB, the GSIB surcharge, and the TLAC standards to the betterment of resilient banks in a stable, sound, equitable economy.