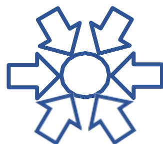

Federal Financial Analytics, Inc.

MEMORANDUM

TO: Federal Financial Analytics Clients

FROM: Karen Petrou

DATE: July 17, 2023

Banks and Republicans are beating up on Michael Barr for much in his new capital construct. The furor focuses on the high cost of the new capital rules, cost glossed over in Mr. Barr's talk via an over-arching assumption that banks can readily do without two years of post-dividend retained earnings. Maybe they can; investors not so much. This is a big problem, but a little-noticed one also warrants more scrutiny: the decision to leave untouched and apparently not even considered the U.S. version of the counter-cyclical capital buffer (CCyB). This makes the new framework still more procyclical and even less holistic. CCyBs have worked well around the world and a well-designed one in the U.S. would obviate the need for some – not all, but some – of Mr. Barr's most counter-productive ideas even as it makes banks more resilient, the financial system safer, and the economy less volatile.

What are CCyBs? The basic idea is that these are capital charges triggered in good times that are released under stress, making banks and the economies they serve better able to ride out macroeconomic boom-bust cycles. The final U.S. version of the global CCyB framework acknowledges this global standard, but it goes on to say only that the Federal Reserve will know a boom or bust when it sees it and will do something about it via some sort of CCyB should it feel inclined to do so possibly after a rulemaking process on the up- and down-sides that might make the whole thing moot.

This is thus a thoroughly meaningless standard that ignores important lessons of recent history and, indeed, the Fed's own behavior in its course. When Basel in 2022 looked at CCyBs across the globe, it found that buffers regulators clearly released rather than those they just hoped banks might breach preserved continuing capital adequacy under even acute stress. Not all of these helpful buffers were counter-cyclical because, as in the U.S., not all nations have instituted them. However, based on this as well as numerous academic papers, Basel concludes that CCyBs or other express buffers banks know they can breach did and/or would have helped a lot in the Covid crisis by allowing banks to absorb macroeconomic and financial-market stress without the fear of under-capitalization that kept U.S. banks on the sidelines.

Or, at least they would have been on the sidelines but for a stealth CCyB maneuver. In one sense, the U.S. did adopt the equivalent of a CCyB at the time not via a clear and certain CCyB, but by moving fast to waive the supplementary leverage ratio. This gave the largest U.S. banks an express cushion to absorb shock, a cushion removed in a counter-cyclical fashion when the banking agencies in early 2021 reinstated the extra leverage requirement. This in fact worked so well that Treasury Under-Secretary Liang proposed a U.S. CCyB focused on the leverage ratio that could ensure bank portfolio capacity in the event of Treasury-market or other acute stress scenarios. Mr. Barr doesn't mention this idea when he espouses the enhanced supplementary leverage ratio as is, yet another indication of the piecemeal nature of this "holistic" proposal.

U.S. banks have long opposed the CCyB on grounds – more than reasonable – that they are already under the world's highest capital standards including what's intended as a stringent counter-cyclical charge by way of the stress capital buffer (SCB). This indeed adds extra capital to ensure resilience, but it's in no way a counter-cyclical charge because – as the Fed's standards stipulate – the stress buffer is an immutable charge that may not be waived by regulators or reduced by banks. Under the SCB, banks must hold so much good-time capital that they are able to keep lending under stress without ever falling below maximum capital requirements. Whether banks actually would make loans is very much to be doubted given the cost of new loan loss reserves as well as the added caution demanded both by prudence and a raft of other Rules. Capital flexibility is key to new lending and Basel's report thus concludes that buffers that cannot be breached are buffers in name only, contributing to banks that run for cover under stress and thus accelerate financial instability or macroeconomic woes. In essence, the SCB forces a fortress balance sheet in which banks must always keep the drawbridge up and the moat full of crocodiles – when the peasantry needs help,

the bank is impregnable beneath its turrets but it's also useless to all who need it.

Better-designed, targeted, and transient capital standards would make banks both more resilient and better intermediaries along with making the financial system safer, growth more equal, and the economy stronger. A more orderly and truly holistic capital framework would judge capital requirements against baseline or even mildly-adverse scenarios and ensure that the capital rules fit snugly into the broader construct of liquidity, resolvability, and single-counterparty exposure standards – issues also unfortunately omitted in Mr. Barr's holistic hegemony.

Mr. Barr also said he didn't much care that capital rules change bank behavior, but he should care – a lot. Under this plan, the largest banks will become more akin to distributional conduits for nonbanks outside the regulatory perimeter than the resilient, regulated financial intermediaries Mr. Barr and all his colleagues prefer.

Indeed, that's the plan. Late last week, the CEO of a bank well able to absorb still more capital, Jamie Dimon said that his bank could easily transition from corporate lending to supporting nonbank corporate lenders if private-credit grows apace empowered by regulatory arbitrage. JPMorgan won't be the bank Mr. Dimon or Vice Chair Barr wants, but it will be a successful institution its investors enjoy even as the financial system slips ever farther beyond the Fed's reach. And what of midsized regionals unable to switch from being banks to being capital-market enablers? Holistically speaking, they have a problem.