Countercyclical Capital Buffer Issue Summary

The countercyclical capital buffer (CCyB) is a "macroprudential" tool that allows the Federal Reserve to raise capital requirements on only the largest banking organizations when it identifies heightened risks of a financial crisis. The Federal Reserve has argued that the CCyB could increase the resilience of large banks and may moderate the impact on lending in a crisis.

BPI's Position

The CCyB is unnecessary, would shift risk to the unregulated sector and would reduce lending to consumers and businesses.

- Large banks are already holding three sizeable capital buffers - capital conservation buffer, the stress tests capital requirements, and the GSIB capital buffer - above their minimum requirements. Further, the Fed's stress tests, which simulate how banks would fare during a severe economic downturn, ensure that the largest banks have sufficient capital to deal with financial imbalances during a crisis. The most recent stress test scenario includes declines in equity, house, and commercial real estate prices as well as a worsening bond market that are materially more sudden and severe than the recent financial crisis. This is significant because some argue the CCyB as requiring large banks to build up capital in good times to be ready for bad times. But stress testing requires banks to be capitalized for unprecedentedly bad times, all the time.

- Raising the buffer would very likely mask systemic risk by shifting some activity from the small number of banks to which it applies to non-banks.

- Further, and significantly, one leading study found that a 1 percentage point increase in capital requirements results in a 1.2 to 4.5 percent decline in lending to businesses and households, with a concomitant, permanent decrease in economic activity. This decrease would have a disproportionate impact on bank-dependent borrowers such as households and small businesses.

- Moreover, the CCyB is an extremely blunt tool for macroprudential purposes, as it imposes the same capital charge on all assets. Thus, if the CCyB were imposed because of a perceived bubble in leveraged lending, it would not just apply to leveraged loans; it would apply to mortgages, credit card loans, small business loans, and unleveraged loans.

Recommendation: Increasing capital requirements by tens of billions of dollars on a limited number of banks above what is required under CCAR would impose significant economic costs on borrowers that would greatly exceed any potential benefits. As a result, CCyB should not be imposed.

The Time to Raise CCyB is Not Now

The Federal Reserve Board's regulation implementing the CCyB states that it would only raise the CCyB when financial system vulnerabilities are "meaningfully above normal." In his remarks about the Fed's first Financial Stability Report, released at the end of November, Federal Reserve Chairman Jerome Powell stated: "My own assessment is that, while risks are above normal in some areas and below normal in others, overall financial stability vulnerabilities are at a moderate level." Furthermore, following the April 30-May 1 FOMC meeting, Powell noted "financial stability vulnerabilities as moderate." Thus, judging by the Fed's assessment, the current risk of a financial crisis is normal, not elevated, so the economic conditions continue to call for a CCyB of zero.