

The Minneapolis Fed v. The Facts: The Struggle Continues

BPI Staff | September 29, 2020

We missed it the first time around, but two weeks ago, the President of the Federal Reserve Bank of Minneapolis, gave a speech “Capital Markets and Banking Regulation.” Among other things, he advocated a massive increase in bank capital requirements, at a time when current events have demonstrated to most observers that banks are amply capitalized. Not surprisingly, then, the speech included many misleading statements, but there are only so many hours in a day, so we decided to discuss only the top four.

4. **“Our analysis, and that of many other independent researchers and academics since, confirms that... [large banks’] capital levels are not high enough to balance the benefits society gains from their scale with the risks they pose to the economy. This analysis shows clearly that large banks should fund themselves with equity of at least 24 percent of risk-weighted assets—up from around 13 percent today.”**

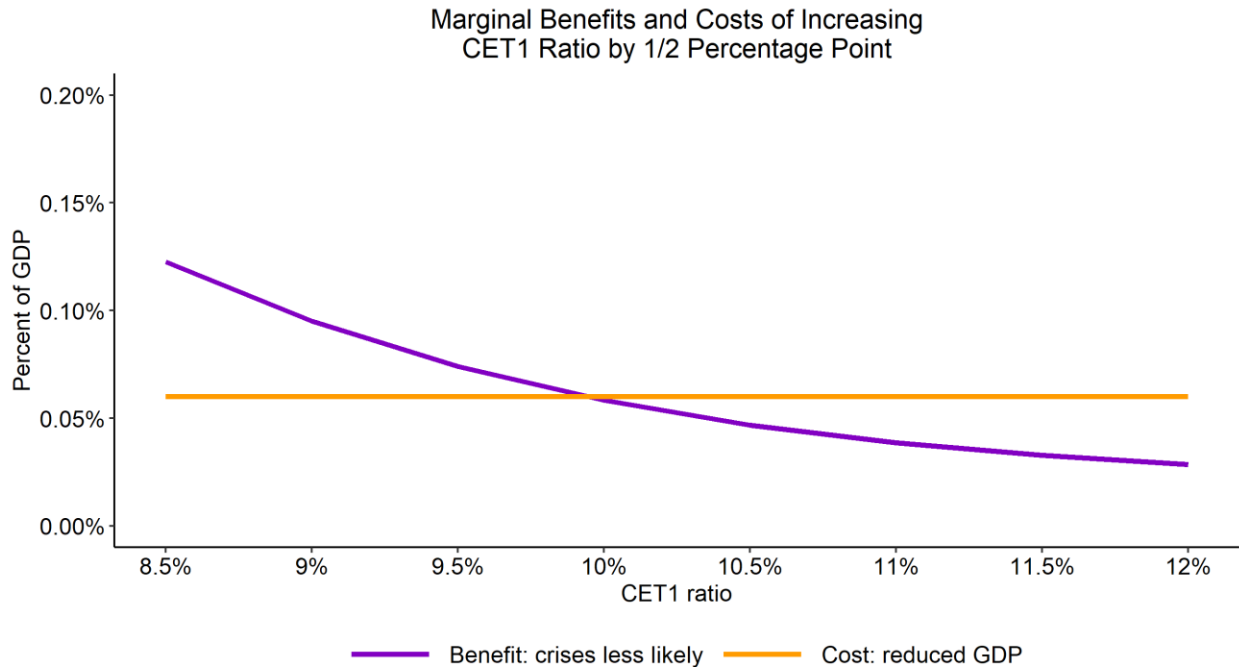
As then-governor Jay Powell [wrote to Congress](#) on June 22, 2017:

There is a growing body of research regarding the costs and benefits of bank capital that addresses the impact of capital standards on economic growth...While the optimal level of capital varies between studies, the basic framework is the same.

Powell is referring to the framework used in the seminal 2010 study by the Basel Committee on Banking Supervision (BCBS) on the costs and benefits of the Basel III regulatory reforms, available [here](#). That basic framework has since been used, each time with a different set of assumptions and modest variations, by economists at the Bank of England (2015), the IMF (2016), the Federal Reserve Board (2017), and the Minneapolis Fed (2018) (the analysis President Kashkari is referring to).

Just three months ago, a working group of the Financial Stability Board published analysis using the same framework (available [here](#)) adjusted to reflect the changes Basel III made to asset risk-weights and the definition of capital (adjustments not done in the Minneapolis Fed analysis). As shown in figure 1, using exactly the method of the FSB working group, social welfare is maximized (benefits equal costs) when banks’ CET1 ratios equal 10 percent. The average CET1 ratio of U.S. bank holding companies at the end of the first quarter was 12 percent (see the New York Fed’s quarterly report on the banking industry available [here](#)).

Figure 1



Actually, 10 percent is probably a touch too low. As we discuss in a recent note (available [here](#)), while we are not fans of the framework, taking it on its own terms, it makes two fundamental mistakes: It does not include the private benefits of bank capital (private benefits are part of social benefits), and it does not take into account the benefits of deposits. Adjusting for these two omissions, the optimal level is a bit higher – 10.5 percent, but still lower than U.S. banks’ current level.

3. **“Banks make all sorts of arguments against higher capital requirements that are easily refuted. First, they say they will be at a competitive disadvantage if other countries don’t follow suit. But that has already proven to be false because U.S. banks are outcompeting European banks that have even more lax regulations.”**

We agree with you that the issue is not about competitiveness, and that is why we have never made that claim in our analysis. We’ve looked back over several years of our research on capital requirements –everything from stress testing to operational risk capital to the global market shock. We can’t find anything in there about competitive advantage. It’s all about how the requirements appear to overstate risk and fail to consider their own costs.

Also, just for the heck of it, do note that a primary purpose of the BCBS is to create international

standards for bank regulations, beginning with the 1988 Basel Capital Accord. According to the [official history of the BCBS](#), the BCBS's stated objectives in establishing the Accord were "to strengthen the stability of the international banking system *and to remove a source of competitive inequality arising from differences in national capital requirements.*" [emphasis added] We're sure that the BCBS would be surprised to learn that a fundamental reason for its existence is "easily refuted."

2. **"Finally, their favorite line is that lending will be curtailed if they have to fund themselves with more equity. But up until COVID-19 hit, they were buying back billions of dollars of their stock each year...if capital was constraining lending, why were they buying back their stock? It is nonsense."**

The conclusion that requiring banks to hold more capital reduces bank lending is not nonsense; it is, in fact, a fundamental premise of the BCBS framework for estimating the optimal level of capital requirements -- the framework used by, as noted, the Fed, BoE, IMF, [and the Minneapolis Fed](#). For example, the FSB working group cited above concluded that each one percentage point increase in the ratio of common equity to risk-weighted assets reduces GDP each year, every year, by 0.12 percent. Capital is more expensive than debt or deposits as a way to fund loans, so higher capital requirements make lending more expensive, reduces the supply of credit, and reduces GDP. There are, of course, also social benefits to bank capital. The BCBS framework weighs those costs and benefits. If there were no costs associated with higher capital requirements, then the optimal level for capital requirements would be 100 percent.

Of course, this statement elides the fact that even as banks have repurchased their shares, their capital levels and regulatory ratios have continued to increase. With M&A opportunities suppressed and bank cost of capital high (even at the current levels the Minneapolis Fed decries), bank shareholders should expect capital distributions, so that they can invest in companies not subject to similar restrictions.

There is no meaningful economic difference between a stock buyback and a stock dividend; in finance theory, they are equivalent. Both are just ways for a corporation to distribute profits to its owners. In reality, each type of distribution has advantages and disadvantages; banks, like other corporations, tend to both pay dividends and buyback stock as a way to compensate investors. (Through the CCAR and SCB process, the Federal Reserve Board has required banks to pre-fund dividends but not repurchases, thereby giving banks a significant incentive to emphasize repurchases.)

When a bank has to fund itself with more capital, it will also have to increase the total amount of its distributions to shareholders, both dividends and buybacks. In a real sense, saying "how can higher capital requirements be constraining lending if banks are buying back their stock?" is like saying "how can higher iron prices curtail steel production; look at all the money steel manufactures are paying to iron distributors?"

In another sense, a stock buyback can be thought of as an investment decision. A corporation compares the net return it will earn buying its own stock with, say, investing in a new manufacturing plant.¹ If the

¹ Indeed, there is evidence that stock buybacks are a good indication that a stock is undervalued (see [Nelson \[1999\]](#)).

net return to a corporation's internal investment options are low, it will be more inclined to invest in its own shares. For that reason, if the net return to making a loan is reduced by raising capital requirements, banks will be more, not less, likely to buy back stock.

- 1. “How have the tens of millions of Americans who lost their jobs because of COVID-19 been able to make their credit card payments, car payments, and rent and mortgage payments? Most have been able to make these payments because Congress acted so quickly and aggressively to send money to people, including the \$1,200 one-time checks many Americans received and the extra \$600 a week in unemployment benefits. Bank losses would have been much, much larger if the American people didn't have [sic] this extra money to make payments on their loans. ... [W]e need to be clear that families weren't the only beneficiaries. This was also a banking bailout.”**

While banks are definitely better off because households received support from the government, so is virtually every other U.S. business. Was this also a grocery store bailout? A dry cleaner bailout? We know of no evidence that Congress provided income support to U.S. households in order to help banks specifically. If President Kashari is saying that everyone got a bailout, including banks, we guess that's sort of true, but it is not clear what it proves. Banks benefit from the interstate highway system too, but it would be weird to say that President Eisenhower did a bank bailout.

In fact, banks in the current pandemic were the best capitalized and most liquid institutions in the country. Cash-strapped companies of all types turned to banks for loans or to draw on lines of credit, and banks supported them. This was no accident. Banks entered the COVID crisis with twice the capital and four times the liquidity as they did the 2007-09 crisis, and they have been a source of strength for the economy. Indeed, between February 12, 2020 and April 1, bank loans increased a bit over \$700 billion, in large part because banks were funding draws on lines of credit as large and small businesses sought to stockpile cash. By contrast, Fed lending peaked at about \$130 billion at the beginning of April. Of course, if their capital requirements were increased massively as the Minneapolis Fed advocates, they would have provided a lot less of that credit.

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