Counterproductive Countercyclical Capital Buffer

Bill Nelson | June 2, 2021

On May 6, 2021, Governor Lael Brainard stated in her introduction to the Fed's latest Financial Stability Report:

> "With valuations and risk appetite at elevated levels, strong microprudential safeguards and macroprudential tools such as the Countercyclical Capital Buffer will be important to address risks to financial stability and enable monetary policy to focus on its maximum employment and average inflation goals."

The countercyclical capital buffer (CCyB) is an adjustable capital requirement imposed on large banks over and above existing capital requirements. The buffer is designed to be increased when risks of bank losses rise as a result of building financial imbalances and reduced when those imbalances abate.

For those who read the report, it may seem odd to conclude from it that the problem facing the U.S. financial system right now is that bank capital requirements aren't high enough. The report states that U.S. banks are highly capitalized, liquid and healthy. After having been briefed on the material in the report, in the press conference following the April FOMC meeting Chair Powell stated "…capital is in a good place as far as I'm concerned in the banking system." The report highlights the risks associated with equities and junk bonds, two asset classes that banks are not allowed to hold, and with elevated hedge fund leverage.

The explanation for the CCyB callout may lie at the end of the quote. Raising the CCyB would "…enable monetary policy to focus on its maximum employment and average inflation goals." The FOMC is currently providing an extraordinarily high degree of monetary policy stimulus by purchasing $120 billion in Treasury securities and Agency MBS each month, keeping its target for the federal funds rate pinned to zero and promising to do more of the same until the economy improves further. At the same time, the economy is growing strongly, and inflation is picking up. No doubt FOMC participants are actively debating whether monetary stimulus should be reduced, and it is likely that some of those calling for tighter policy are stating that low interest rates are contributing to asset price bubbles that raise financial stability risks. Those who want to keep the policy stance unchanged would be likely to point to the CCyB as a way to address those concerns rather than raising interest rates.

Envisioning such a scenario does not strain our powers of imagination because it is similar to what happened as the Fed approached the end of its last easing cycle. As we wrote about a few years ago, as QE3 dragged on, several FOMC participants argued that the asset purchases were contributing to financial instability including frothy conditions in the leveraged loan market. The Fed issued guidance and then especially strident FAQs to stop banks from originating leveraged loans for sale to investors that the originating banks would not themselves be able to keep on their books – that is, loans that were special mention or classified as substandard or doubtful upon origination. Chair Yellen pointed to the guidance in FOMC meetings as a reason why QE 3 asset purchases should be allowed to continue. All this even though most leveraged loans were not being held by banks or any other leveraged institution and so were neither a risk to bank safety and soundness nor a risk to financial stability.

The outcome of that episode should be cautionary for those arguing now that the CCyB should be raised for monetary policy reasons. As we discussed in a blog in February, the GAO recently issued a report stating that based on analyses by government agencies, leveraged loans do not threaten financial stability. Moreover, transcripts of the 2015 FOMC meetings reveal that internally both Governor Tarullo and Nellie Liang, the head of the Board's Financial Stability Division, were arguing that leveraged lending did not increase financial stability risks. Consequently, not only with hindsight (given the contemporary observations of Tarullo and Liang), all that was accomplished by curtailing bank lending was preventing businesses from getting credit and slowing economic growth.

Returning to the current episode, once again, those responsible for assessing financial stability at the Fed appear to question the whole premise of those seeking to raise bank capital so that monetary policy can remain highly stimulative. The Financial Stability Report includes an entire special section questioning the idea that low interest rates lead to excessively elevated asset values. Financial asset prices equal the present discounted value of future cash flows, so low interest rates of course lead to higher asset prices. The issue is whether low interest rates reduce risk premiums. The section in the Report lists reasons why low interest rates might narrow risk premiums and reasons why they might *reduce* financial system vulnerabilities and states that "[t]he connections between persistently low interest rates and risk premiums are not well understood."

If low interest rates are not contributing to financial risks, then requiring already well-capitalized banks to hold more capital would simply hold back economic growth without a net benefit. And if risks are building outside the banking system, and banks are both well-protected against and largely unexposed to those risks, again raising bank capital requirements would just shift lending activity to a vulnerable shadow bank sector and slow economic growth without a net benefit. Ironically, if the Fed raises the CCyB to keep monetary policy easy, the action would undercut the economic growth the easy monetary policy is intended to support.