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The Answer to Recent Bank Turmoil is Not Higher Capital Requirements for All Larger Banks

Katie Collard | June 9, 2023

After recent bank failures, some prominent policymakers are calling for all banks to hold even more capital, even though the banking industry is already strongly capitalized.[1] In particular, they cite those failures as a reason to swiftly implement the updated Basel capital standards, which are widely expected to significantly increase the capital requirements of larger banks.[2]

There are clear lessons to learn from those recent bank failures (see here, here and here), including the need for adjustments to the existing regulatory and examination framework. In fact, BPI today issued a set of over 20 policy recommendations for how to improve that framework. But raising capital requirements on activities that showed no losses in March appears entirely unnecessary, and potentially harmful.

Thus, it seems that policymakers are poised to act on plans laid long ago to require banks to hold more capital and are attempting to use the recent idiosyncratic bank failures as a newfound justification. This is wholly unjustified.

Recent bank failures do not support general increases to capital requirements.

Recent banking stress has demonstrated that some banks did not properly manage their interest rate and liquidity risk and did not hold capital commensurate with the risks they had taken on. A prime example is SVB, where the bank's collapse was attributed to a poor combination of an idiosyncratic and flawed business model and deficient interest rate and liquidity risk management. Furthermore, the bank's capital levels were not commensurate with the risks it undertook. Specifically, SVB invested heavily in long-dated fixed-rate securities, which led to massive unrealized losses once interest rates began to rise. Based on publicly available data, SVB's *pro forma* CET1 capital ratio, adjusted to reflect the fair market value of securities held in its available-for-sale and held-to-maturity portfolios, stood at less than 1 percent as of Dec. 31, 2022—approximately 11 percentage points lower than its reported regulatory capital ratio and barely solvent. When SVB faced the need to sell its available-for-sale securities in order to improve its liquidity position and address the ongoing outflows of deposits, and failed to secure new equity capital, uninsured depositors swiftly withdrew their funds from the bank.

Signature Bank and First Republic similarly took on extraordinarily high levels of risk. Signature Bank accumulated high levels of uninsured deposits from a concentrated digital assets-focused depositor base and failed to

[1] For example, in recent testimony before the House Financial Services Committee, Federal Reserve Vice Chair for Supervision Michael Barr assured the public that "overall, banks have strong capital and liquidity," but nevertheless went on to argue for capital increases in response to recent bank failures, stating, "Stronger capital will guard against the risks that we may not fully appreciate today and reduce the costs of bank failures." Statement by Michael S. Barr, Vice Chair for Supervision of the Board of Governors of the Federal Reserve System before the U.S. Senate Committee on Banking, Housing and Urban Affairs (May 18, 2023), https://www.banking.senate.gov/imo/media/doc/Barr%20Testimony%205-18-23.pdf.

[2] For example, in recent testimony on the recent bank failures, Acting Comptroller Hsu stated, "The OCC remains committed to implementing the enhanced regulatory capital requirements that align with the final set of Basel III standards, and it is important that we move forward as soon as possible." Statement of Michael J. Hsu, Acting Comptroller of the Currency, before the Committee on Financial Services of the U.S. House of Representatives (May 16, 2023), https://www.occ.treas.gov/news-issuances/congressional-testimony/2023/ct-occ-2023-44-written.pdf.

appropriately manage this risk.[3] First Republic's idiosyncratic business model focused on extremely creditworthy borrowers—largely high-net-worth individuals—and extended them fixed-rate loans with long maturities that lost value and eroded the bank's tangible equity when interest rates began to climb.[4]

The failures of these banks show that they should have better managed interest rate and liquidity risk in the first instance or held more capital against these risks, and targeted supervisory and regulatory changes may be appropriate to avoid a similar situation in the future. These failures do *not* show that all larger banks need additional capital. In terms of implementation of the three components of the 2017 and 2019 changes to the Basel Accord, none of those three banks took material market risk and none experienced material operational risk losses. Yet these are the round holes that some policymakers are urging be filled with the square pegs of interest rate and liquidity risk.

Generally increasing capital requirements will unnecessarily impose meaningful costs on the broader economy.

Increasing capital requirements across the board by finalizing the 2017 and 2019 changes to the Basel Accord would fail to resolve the specific weaknesses in interest rate risk and liquidity risk management that led to recent bank failures. Such an approach would instead use a blunt club to broadly reduce the probability of bank failures. It is true that additional capital requirements may have reduced the probability of SVB's, Signature's and First Republic's failures: generally, higher capital requirements reduce the probability of any bank's failure, although those benefits are reduced dramatically as requirements rise. Importantly, when considering the appropriate level of capital, the reduced probability of bank failure is only part of the equation—there are offsetting costs of higher capital requirements that policymakers must consider, namely reduced economic growth and a potentially more fragile financial system.

- **Economic Growth.** Increases in capital requirements reduce economic growth by making it more costly for banks both to lend and to support certain capital markets activities (e.g., holding inventories of securities for market making purposes). A recent review of the academic literature by the Basel Committee on Banking Supervision found that a 1-percentage-point increase in capital requirements reduces annual GDP by up to 16 basis points.[5] There is a constant tension between economic growth and capital requirements, and the calibration of each piece of the capital regulations must evaluate this tradeoff by conducting a robust cost-benefit analysis.
- **Financial Stability.** The reason why it is nevertheless socially valuable to have capital requirements is that they reduce the likelihood of financial crises, and financial crises are incredibly costly in terms of GDP. But there is also a financial stability tradeoff. Excessively high capital requirements push financial intermediation into the nonbank sector,[6] which is significantly less regulated than the banking system and therefore riskier to the system overall. So the notion that higher capital requirements unambiguously guarantee a safer financial system is not true. We detailed this dynamic in a previous post.

To be sure, recent bank failures have raised important questions with respect to certain elements of the overall bank regulatory framework that merit a thorough and careful review, among others the supervisory and examination structure for banks as well as some specific regulations addressing interest rate and liquidity risk

[3] United States Government Accountability Office, Bank Regulation: Preliminary Review of Agency Actions Related to March 2023 Bank Failures (Apr. 2023) at 16-17, https://www.gao.gov/assets/gao-23-106736.pdf.
[4] Rachel Louise Ensign, Eliot Brown, AnnaMaria Andriotis, and Gina Heeb, Wall Street Journal, Why First Republic Bank Collapsed (May 1, 2023), https://www.wsj.com/articles/first-republic-bank-collapse-why-banking-crisis-61660d96.
[5] Basel Committee on Banking Supervision, Working Paper 37: The costs and benefits of bank capital – a review of the literature (Jun. 2019), https://www.bis.org/bcbs/publ/wp37.pdf.
[6] Juliane Begenau and Tim Landvoigt, Financial Regulation in a Quantitative model of the Modern Banking System, 89 Rev. of Econ. Studies 1748 (Jul. 2022), https://www.nber.org/system/files/working_papers/w28501/w28501.pdf.

management. It may also be appropriate to adjust capital requirements to better reflect unrealized losses. The policy recommendations BPI released today touch on all of these issues.

That said, the vast majority of larger banks did not accumulate the extreme interest rate and liquidity risks that the failed banks did, and, in discussing the recent bank turmoil, the Federal Reserve's most recent Financial Stability Report noted, "For the banking system as a whole, aggregate bank capital levels were ample."[7] Therefore, increases to overall capital requirements, rather than targeted supervisory and regulatory improvements to improve interest rate and liquidity risk management, would unnecessarily reduce economic growth and could also reduce financial stability.

Implementing the international Basel capital standard in the United States will not address the interest rate and liquidity risks that underlay recent bank failures.

As noted above, agency leaders have linked recent bank failures with a renewed urgency to implement the most recent changes to the international Basel capital standards in the United States. But there is no connection between the risks that led to the recent bank failures and the Basel package. As discussed above, those failures stemmed from traditional interest rate and liquidity risks, whereas the Basel updates pertain to refinements in the measurement of credit, operational and market risk.[8] Those are not the same types of risk. Recent bank failures do not validate the merits of those changes or justify their application to a broader set of firms. And to the extent those changes result in broadly applicable increases to banks' capital requirements, those increases would be counter to the public interest for the reasons discussed above.

Furthermore, the forthcoming changes will likely disproportionately increase capital requirements for lending at a time when credit is already being crunched; and for market making at a time where illiquidity in capital markets could be the next source of financial instability. Using the recent stress of a completely different category of firms with entirely different risk profiles to increase capital requirements on all larger banks is a *non sequitur* and risks distracting policymakers and stakeholders from devoting appropriate attention to changes that would in fact address the risks that were the undoing of the failed banks.

Conclusion

After any bank failure or significant stress, it is worthwhile to take stock and honestly assess what went wrong and consider policy changes designed to avoid similar risks in the future. Information gathering and analysis of recent bank failures is ongoing and should continue to inform any policy response, and BPI has released an initial set of recommendations. What is already clear, however, is that recent bank failures do not justify increased capital for all larger banks and all types of risk, nor do they demonstrate the merits of forthcoming changes to capital requirements based on Basel standards.[9]

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[7] Board of Governors of the Federal Reserve System, Financial Stability Report (May 2023), at 31 https://www.federalreserve.gov/publications/files/financial-stability-report-20230508.pdf.

[8] For additional detail regarding the changes included in the Basel Finalization package, *see* BPI, Basel Finalization: The History and Implications for Capital Regulation (Part I, II and III) (Feb. 2023), https://bpi.com/wp-content/uploads/2023/02/Basel-Finalization-Final.pdf.

[9] In fact, the last three-and-a-half years have put the banking industry through a real-world stress test that would have been hard to imagine five years ago. The fact that it remains as strong as it does today is an incredible success of the present regulatory regime.