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An Errata Sheet on Vice Chair Barr's Holistic Review

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On Monday, Federal Reserve Board Vice Chair Barr gave a speech that described the results of his "holistic review" of capital standards. We highlight and analyze in this blog post nine key parts of that speech that strongly suggest that this "holistic review" failed to consider an important range of issues and reached policy conclusions that are unsupported – and in some cases contradicted – by the facts.

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1. Vice Chair Barr on his "holistic review" of capital standards*:*

> "I initiated a review of capital standards as one of my first actions as Vice Chair for Supervision. This review was focused on capital requirements for large banks with more than $100 billion in total assets. Capital requirements are multi-layered with different components. A holistic approach is important because the requirements function as a system—each component treats risks and associated capital needs differently, but all components together result in a certain amount of capital required. …."

***BPI analysis*:**

The "holistic review of capital standards" that Vice Chair Barr announced this week differs significantly from the review he committed to undertake in 2022. At that point, the review was to be conducted by the Federal Reserve Board,[1] but this week's remarks make clear that the review was conducted only by Vice Chair Barr in his personal capacity. Earlier remarks also suggested an academic approach, but the resulting speech is supported by no research or cost-benefit analysis developed by Federal Reserve Board staff, and the only supporting citations provided are references to the Vice Chair's own prior speeches. Furthermore, Vice Chair Barr had earlier noted that the Federal Reserve Board would "not [be] looking only at each of the individual parts of capital standards, but also at how those parts may interact with each other—as well as other regulatory requirements—and what their cumulative effect is on safety and soundness and risks to the financial system."[2] Yet this week's speech includes no consideration of the interaction of capital standards with other related rules, including liquidity regulation, total loss absorbency requirements, resolution/recovery planning rules and margin requirements and other derivative rules.

2. Vice Chair Barr on the impact of increasing capital requirements:

> "One can think of the proposal's more accurate risk measures as equivalent to requiring the largest banks hold an additional 2 percentage points of capital, or an additional $2 of capital for every $100 of risk-weighted assets. While this increase in requirements could lead to some changes in bank activities, the

[1] *See* Michael S. Barr, *Making the Financial System Safer and Fairer*, (Sep. 7, 2022); Michael S. Barr, *Why Bank Capital Matters* (Dec. 1, 2022) (noting that "[i]n my first speech as Vice Chair for Supervision in September, I said that the Federal Reserve Board would soon engage in a holistic review of capital standards").

[2] *Id.*

benefits of making the financial system more resilient to stresses that could otherwise impair growth are greater.

That is not to ignore concerns that changes in capital requirements may cause firms to change their behavior and the way that financial services are provided to our economy. We intend to consider comments carefully and any changes would be implemented with an appropriate phase-in."

BPI analysis:

The Vice Chair's brief and indirect acknowledgment of the cost of higher capital requirements wholly ignores abundant literature on that subject. It is now well understood that increases in capital requirements beyond a certain point 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). Capital adequacy to ensure stability is essential, but incremental capital beyond that point has diminishing value for safety and soundness yet comes at significant extra cost. For example, 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 or about $42 billion of output lost per year.[3] Therefore, by this measure, the Vice Chair's intended proposal would reduce annual U.S. GDP by more than $80 billion each year. His "holistic review" ignores this point entirely.

Moreover, he asserts that extending the phase-in period for increases in capital requirements would lessen their impact. First, a delay does nothing to reduce the eventual, permanent effect of increased capital requirements on GDP levels. Second, as anyone who has worked in the private sector knows, banks and other companies make business plans based on the future regulatory environment; thus, even with a delayed effective date, banks will immediately begin divesting from businesses that will eventually become unprofitable given new, uneconomic capital charges. This was acknowledged by Chair Powell during his recent testimony, and bank investors and analysts will expect banks to do so.

If a holistic review of capital were to have one purpose, one would have thought it would be to identify and weigh these costs against potential benefits.

3. Vice Chair Barr on the ease of banks' compliance with new capital standards:

"This phase-in will allow ample time for banks to adjust their balance sheets and activities, and to build capital over time. In fact, most banks already have enough capital today to meet the new requirements. For the banks that would need to build capital to meet the requirements, assuming that they continue to earn money at the same rate as in recent years, we estimate that banks would be able to build the requisite capital through retained earnings in less than 2 years, even while maintaining their dividends."

BPI analysis:

Like many past discussions of capital increases by Federal Reserve policymakers, this analysis fundamentally confuses the relevant policy question, which is not whether banks can bear the costs of higher capital requirements, but rather whether those costs are warranted relative to the demonstrable benefits of such higher requirements. By analogy, in setting fines for traffic offenses, the government does not impose the largest fine that would not push the driver into bankruptcy, but rather one set at a level sufficient to encourage compliance.

[3] *See* Basel Committee on Banking Supervision, *The costs and benefits of bank capital – a review of the literature* (Jun. 2019), *available at* https://www.bis.org/bcbs/publ/wp37.pdf.

Thus, it appears that his holistic review of capital was focused less on how much capital is warranted for a given risk and more on how much capital banks can afford to raise.

4. Vice Chair Barr on tailoring (or not) of enhanced capital standards:

> "One important question involves the size of institutions that the new risk-based capital rules should apply to, and I will recommend that the enhanced capital rules apply to banks and bank holding companies with $100 billion or more in assets. A threshold of $100 billion would subject more banks to our most risk-sensitive capital rules compared to the current framework, which applies to firms that are internationally active or have $700 billion or more in assets."

BPI analysis:

Vice Chair Barr's remarks take no account of various factors required under Section 165 of the Dodd-Frank Act. As amended in 2017, that law directs the Federal Reserve to give proper consideration to a range of factors when deciding whether and how to apply enhanced prudential standards to banks, including their capital structure, risk, complexity, financial activities (including the financial activities of their subsidiaries) and size.[4] It further states that the Federal Reserve "shall … differentiate among companies on an individual basis or by category," meaning that not all the same standards should apply to all firms. Vice Chair Barr's holistic review thus appears to have been premised on repeal of this statute.

5. Vice Chair Barr on the lessons of SVB's failure:

> "Some industry representatives have claimed that SVB's problems were really related to poor management and shortcomings in the Federal Reserve's supervision…. It is not a choice between supervision and capital regulation—capital is and has always been the foundation of a bank's safety and soundness. …."

BPI analysis:

Vice Chair Barr's remarks attempt to avoid the core issue raised by any suggestion that higher capital via implementation of the 2017 and 2019 Basel agreements would address the problems that led to Silicon Valley Bank's failure. The 2017 and 2019 Basel agreements revise the capital rules for (1) credit risk, (2) operational risk and (3) market risk; yet SVB failed not because of these, but because of (4) interest rate risk and (5) liquidity risk. Silicon Valley Bank's customers repaid their loans; Silicon Valley Bank did not have a cyber event; Silicon Valley Bank did not experience major trading losses. Yet Vice Chair Barr appears to recommend that, as an answer to SVB's asset/liability mismatch and depositor concentration risk, many banks should hold vastly more capital for cyber and other operational risks and hold vastly more capital against the risk of trading losses. If that occurs, it would be the greatest *non sequitur* in regulatory history.

6. Vice Chair Barr on the enhanced supplementary leverage ratio:

> "With respect to the enhanced supplementary leverage ratio (eSLR), I am not recommending changes to the calibration at this time…. Some have argued that when banks are close to the eSLR as a binding constraint that it has reduced Treasury market intermediation. The evidence on that is inconclusive. To the extent it matters, the revisions in risk-based capital requirements I discussed today would mean that the eSLR generally would not act as the binding constraint at the holding company level, where Treasury

[4] *See* 12 U.S.C. § 5365.

> intermediation occurs. To the extent that there are problems with Treasury market intermediation in the future for which the eSLR might matter, the Board could consider an adjustment."

BPI analysis:

This discussion of the eSLR is odd for two reasons. First, it makes no mention of the fact that the 2017 Basel agreement that he otherwise pledges to implement faithfully actually included changes to the calibration of the eSLR; indeed, the Federal Reserve and the OCC already proposed to implement those changes in a 2018 notice of proposed rulemaking.

Second, it is impossible to understand how Vice Chair Barr has concluded that the evidence that the current calibration of the eSLR poses no risk to the orderly function of Treasury markets "is inconclusive." No evidence is cited for this conclusion, which appears to ignore the fact that, just three years ago, the Federal Reserve acted on an emergency basis to temporarily exclude cash and Treasuries from the eSLR's calculation because the eSLR's current calibration would otherwise "adversely affect [banks'] ability to intermediate financial markets and hamper their ability to provide lines of credit to households and businesses."[5] It's not clear why this recent, real-world experience with the eSLR's adverse consequences was disregarded, but it certainly would have been a good topic for any holistic review of capital standards.

7. Vice Chair Barr on the importance of international consistency in capital standards:

> "With respect to risk-based requirements, the standards should be updated to better reflect credit, trading, and operational risk. To help promote international comparability, the updates to the standards should be consistent with international standards adopted by the Basel Committee. The international standards were developed through a rigorous, lengthy process, have been under discussion for nearly a decade and will improve on the extent to which capital requirements fully reflect the risks posed by different banks engaged in a variety of activities."

BPI analysis:

It is difficult to reconcile Vice Chair Barr's commitment to "promot[ing] international comparability" and "consistency" in capital standards with the remainder of his remarks, and in particular his later statements that any use of internal models for credit risk should be eliminated from the U.S. framework. Such a change would in fact constitute an enormous divergence in international capital regulation – while nearly all foreign banks would continue to use internal models to measure credit risk for purposes of capital (and receive lower risk weights from doing so, given that standardized measures tend to be set at a "highest common denominator" level), all U.S. banks would instead use blunter and less risk-sensitive standardized measures.

Similarly, it is difficult to reconcile these comments with the fact that current U.S. capital rules already vary significantly from international standards adopted by the Basel Committee. For example, U.S. banks are subject to a GSIB surcharge that is roughly double the international standard and calculated pursuant to an alternative methodology, as well as a binding stress test-generated buffer that in many cases exceeds the standard 2.5% capital conservation buffer agreed to by the Basel Committee.

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[5] Board of Governors of the Federal Reserve System, *Temporary Exclusion of U.S. Treasury Securities and Deposits at Federal Reserve Banks from the Supplementary Leverage Ratio*, 85 Fed. Reg. 20578 (Apr. 14, 2020) (interim final rule) at 20580.

These various points of current and potential future divergence in international consistency and comparability would have been good topics for a holistic review of capital standards.

8. Vice Chair Barr on forthcoming proposed changes to capital standards for credit risk:

> "[F]or a firm's lending activities, the proposed rules would end the practice of relying on banks' own individual estimates of their own risk and instead use a more transparent and consistent approach. Currently, large banks use their own internal models to estimate certain types of credit risk. These internal models for credit risk suffer from several deficiencies. Experience suggests that banks tend to underestimate their credit risk because they have a strong incentive to lower their capital requirements. In addition, the data doesn't lend itself to robust modeling and back testing in some cases because defaults are relatively infrequent. And estimates of credit risk for similar exposures can vary substantially across firms. So, skepticism is in order. Standardized credit risk approaches—meaning we apply the same requirements to each bank and not let each bank develop their own requirements—appear to do a reasonably good job of approximating risks. And we have the additional rigor of a supervisory stress test to assess the credit risk of lending activities."

BPI analysis:

These statements (all without supporting citations) are troubling on multiple fronts. First, the statement that "[credit risk] data doesn't lend itself to robust modeling and back testing in some cases because defaults are relatively infrequent" is a sweeping overgeneralization, and simply inaccurate as concerns many types of loans. There is a wealth of default and other relevant data for many lending segments (corporate loans, credit cards, mortgage loans, etc.) – for example, data from banks' own experiences as well as data that can be purchased from Moody's, S&P and others – that have formed the basis of responsible credit risk management for some time.[6] The Federal Reserve is clearly aware of these data, as they presumably underpin the credit risk models that the Federal Reserve develops and utilizes in its own supervisory stress tests. Indeed, it is particularly difficult to reconcile Vice Chair Barr's characterization of credit risk models as unreliable in one part of this paragraph with his latter reference to the "additional rigor" that is provided the Fed's stress test, given that the stress test relies extensively on credit risk modeling.

Second, Vice Chair Barr fails to note that *the* primary objective of the 2017 Basel Agreement was to remedy the very concern about credit risk modeling that he describes. As a result, in other countries, banks will be permitted to continue modeling credit risk for purposes of their risk-based capital requirement, subject to a minimum requirement or "output floor" set at 72.5% of the capital calculation under the Basel standardized approaches. It is apparently only U.S. regulators who are prepared to rely solely on the standardized model, in a departure from the models-based approach contemplated by the Basel standards and adopted or proposed in every other major banking center. And that result is impossible to reconcile with the claim elsewhere in the speech that one of the purposes of the forthcoming proposal is to ensure international consistency.

Third, while these remarks on the purported conceptual limits of credit risk modeling, they fail to acknowledge at all the considerable *practical* experience that U.S. banks and regulators have gained in recent years. Over the past decade, the Federal Reserve and other banking agencies have required large banks to implement advanced approaches for credit risk, build relevant models and overhaul their model risk management frameworks, and U.S. examiners have comprehensively vetted and supervised those models and frameworks. One would think this

[6] For an example of analysis using such data provided by Credit Benchmark, see Francisco Covas and Barbora Stepankova, *Consistency in Risk Weights for Corporate Exposures Under the Standardized Approach* (Jan. 2022), *available at* https://bpi.com/consistency-in-risk-weights-for-corporate-exposures-under-the-standardized-approach/#_ftn2.

experience would be highly relative to the question of whether or not to walk away from the advanced approaches, yet Vice Chair Barr cites no data, examples or evidence from this experience that suggests that the advanced approaches have understated credit risk in actual practice. Instead, Vice Chair Barr appears ready to disavow over a decade of supervisory practice, and models that the Federal Reserve has now been regulating and supervising for years, on the basis of theory alone.

Each of these issues would have made good topics for a holistic review of capital standards.

9. Vice Chair Barr on capital requirements and buffers:

> "In sum, I believe that the existing approach to capital requirements is sound. As a result, my proposals build on that foundation. The existing approach includes the risk-based requirements, stress testing, the risk-based capital buffers, and the leverage requirements and buffers."

BPI analysis:

There is voluminous evidence that so-called capital "buffers" function – in both the capital and liquidity realms – as de facto minimum requirements and thus fail to serve their function;[7] indeed, some now jokingly refer to the buffers as "concrete airbags." In the U.S., failure to meet a "buffer" requirement triggers restrictions on capital distributions, and would certainly invite further restrictions by examiners behind the veil of examination secrecy. With that failing in mind, the Financial Stability Board has already begun an investigation into how buffers can be reformed.[8] Thus, Vice Chair Barr's satisfaction with the role of buffers in capital regulation is unusual, and perhaps unique, among international regulators.

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[7] *See, e.g.*, Berrospide, Gupta, and Seay, *Un-used Bank Buffers and Credit Supply Shocks at SMEs During the Pandemic*, Finance and Economics Discussion Series Divisions of Research & Statistics and Monetary Affairs Federal Reserve Board (Apr. 16, 2021), https://www.federalreserve.gov/econres/feds/files/2021043pap.pdf; Kodres, Wetzer and Kleinnijenhuis, *Usable Bank Capital*, Centre for Economic Policy Research (Jun. 30, 2020), https://cepr.org/voxeu/columns/usable-bank-capital.

[8] *See* Financial Stability Board, *Financial policies in the wake of COVID-19: supporting equitable recovery and addressing effects from scarring in the financial sector* (Nov. 14, 2022), *available at* https://www.fsb.org/wp-content/uploads/P141122.pdf (noting the "functioning of capital and liquidity buffers" as one of several "areas that warrant attention going forward").