PROANALYSIS

WHAT YOU NEED TO KNOW ABOUT

Bank Capital

BY **VICTORIA GUIDA AND MADI ALEXANDER** | 05/18/2023 05:00:00 AM EDT

PRO POINTS

- **Regulators led by the Federal Reserve are considering higher capital requirements for big banks,** which would reduce the extent to which they can rely on debt and deposits to finance their operations.
- **The elements at play: standards developed by the Basel Committee on Banking Supervision, an** international consortium of regulators; a holistic review of existing requirements launched last year by Fed regulatory chief Michael Barr; and reaction to the fallout of Silicon Valley Bank's failure in March.
- **It will likely be years before these new regulations take effect.**

HOW WE GOT HERE

Bank regulators have been working on implementing the "Basel III endgame" since the updated standards were finalized in 2017. The new rules, part of an effort to wrap up unfinished business from the 2008 financial crisis, would put in place minimum capital requirements for operational risk (the risk that someone, or something, screws things up). They're also aimed at improving how capital requirements account for market volatility and the prospect that a given asset could default.

Much of the work was on pause between when Randal Quarles, the Trump-appointed Fed vice chair for supervision, left his post in October 2021 and when his Biden-appointed predecessor, Michael Barr, took office the following July. But now that work is nearing completion.

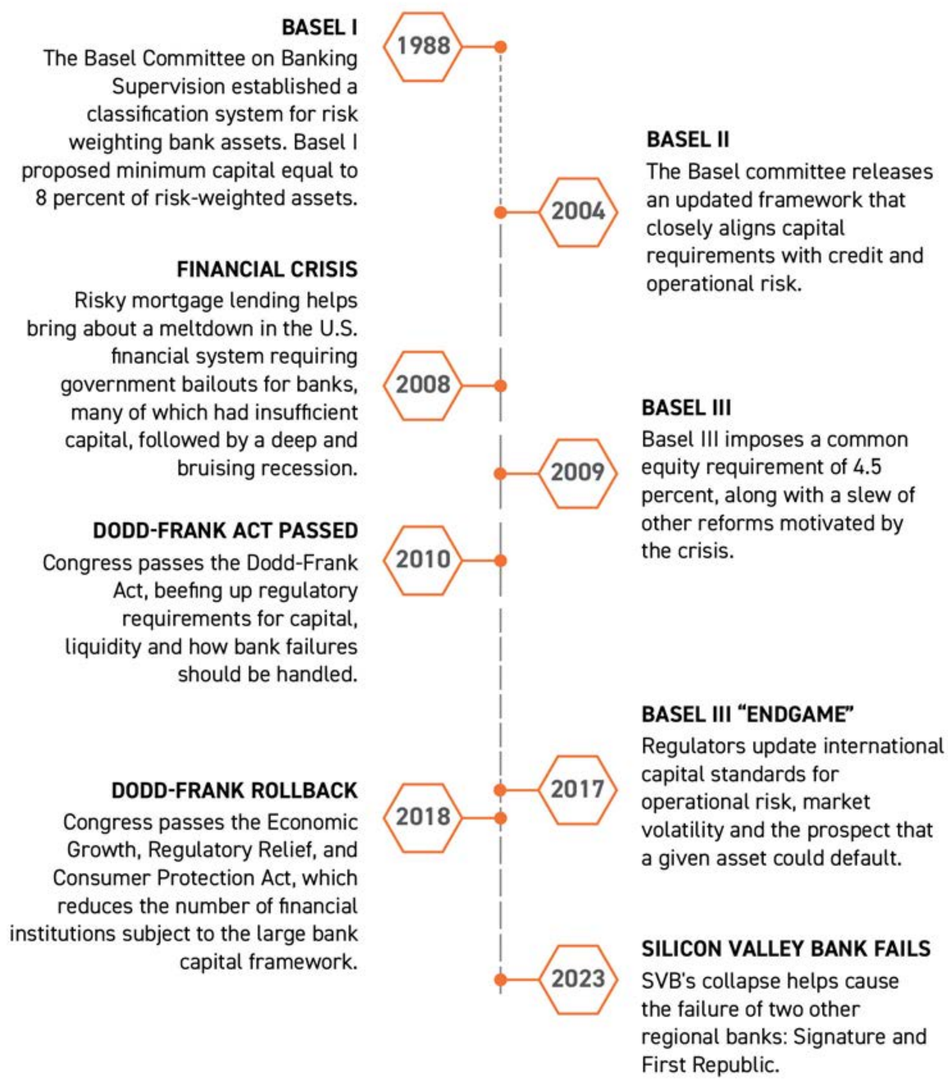
Barr has also undertaken a broader review of capital requirements that is aimed at ensuring that requirements work coherently with each other and that overall capital levels are properly calibrated. He's hinted strongly that this will mean higher capital standards overall.

The focus of that review has expanded since he took office. In March, Silicon Valley Bank imploded and ultimately took down two other regional lenders — and the fallout might not yet be over. That's put renewed focus from regulators on banks with between $100 billion and $250 billion in assets — banks that have faced lighter standards since the Fed implemented a 2018 deregulation law.

The bipartisan law is now a flashpoint for debate, with some Democrats citing rollbacks as a central cause of supervisory and regulatory failures around SVB, while Republicans argue that the previous status quo would not have prevented the firm's collapse. Regardless, the legislation gave the Fed considerable discretion over how it applied standards to various types of firms.

One policy shift that has gotten attention allowed banks with more than $250 billion in assets, but not considered important to the global financial system, to avoid higher capital standards for securities that have dropped in value — an issue that ultimately killed SVB. Now, Barr has said he's considering having banks with over $100 billion in assets face capital requirements that are more in line with their unrealized losses or gains.

The evolution of modern banking standards



Source: Congressional Research Service

WHAT'S NEXT

Barr has suggested the Basel standards are the immediate priority and that other reforms will follow later. It's unclear whether any of those later reforms would temper capital increases from the Basel changes.

One big unfinished piece of the Basel agenda is what's known as the fundamental review of the trading book, or FRTB. Implementation of FRTB will mean more stringent standards for how firms treat and classify trading assets, and it is expected to lead to significant increases in capital requirements, especially for market-focused banks like Goldman Sachs and Morgan Stanley.

Other aspects of the Basel standards could also lead to higher capital requirements. One outstanding question is what the threshold will be for whether those standards apply to a bank or not. Fed General Counsel Mark Van Der Weide indicated that the regulators were still undecided on that point, even before the SVB collapse.

Regardless of how the Basel standards are applied, tougher standards are undoubtedly coming for regional banks with between $100 billion and $250 billion in assets. Barr made this much clear in his postmortem of the SVB episode.

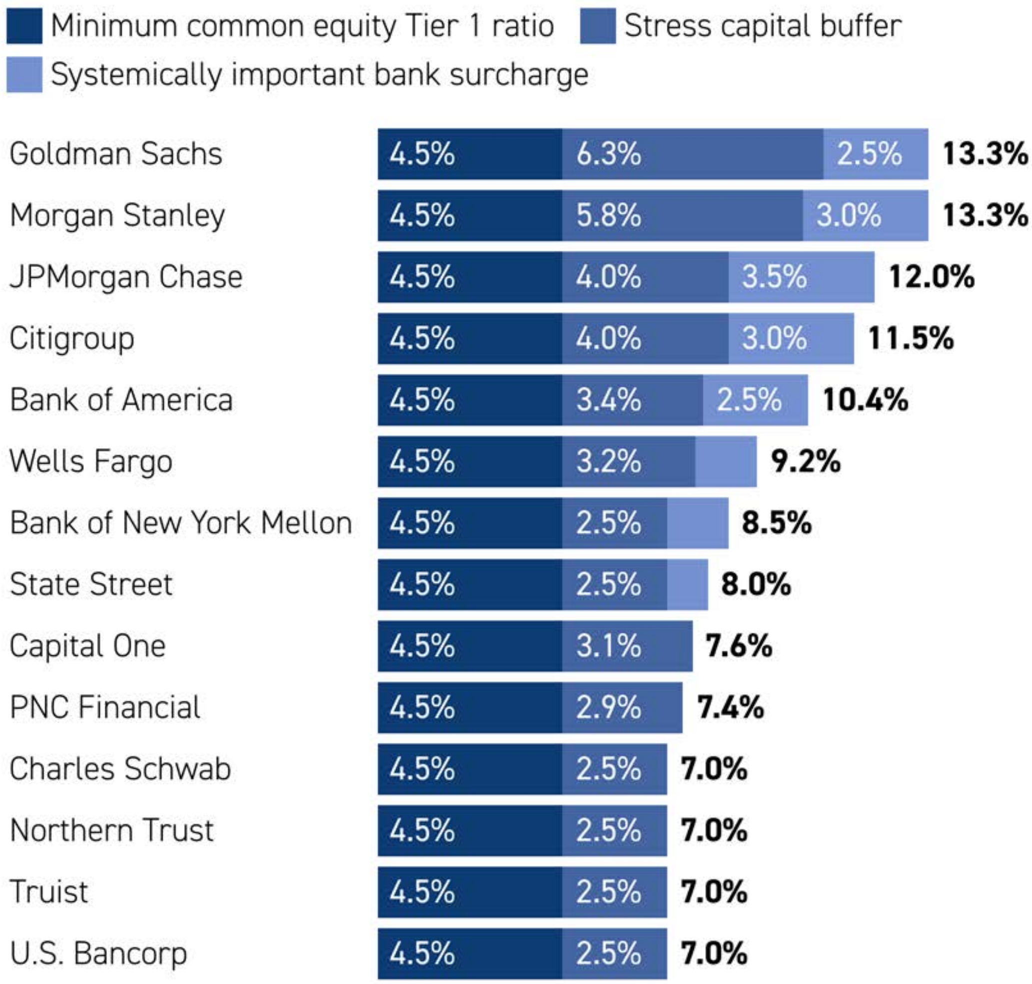
Broader changes are also on the horizon for the Fed's annual stress test of big banks. Barr suggested that the central bank would move to multiple severe recession scenarios that banks will have to run through to determine their capital requirements. The exercise this year seems to be a step in that direction, with a new "exploratory market shock," although it only applies to megabanks and won't affect their capital requirements.

Changes to other capital rules, such as a backup capital rule known as the supplementary leverage ratio or the surcharge faced only by global systemically important banks, could also be in store. But Barr has not yet formally announced the takeaways from his review, which will give a clearer signal of where things are headed next.

Both the proposal implementing the new Basel standards and an update on the Fed's capital review should come this summer, according to Barr.

Goldman Sachs, Morgan Stanley have highest capital requirements among large U.S. banks

Capital requirements among domestic financial institutions over $250 billion in assets, by component



Note: Requirements effective as of Oct. 1, 2022.
Source: Federal Reserve

POWER PLAYERS

- **Mark Van Der Weide:** The Federal Reserve's general counsel has been at the central bank in various roles since 1998 and will play a key role in advising the central bank's board on lessons learned in capital regulation over that time period.

- **Greg Baer:** The head of the Bank Policy Institute, a powerful lobbying group for big banks, has been a key player in efforts to push back on higher capital requirements for big banks.

- **Rep. Andy Barr:** The Kentucky Republican is one of the most engaged lawmakers on the issue of bank capital and runs the subcommittee that leads oversight of the issue.