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Capital Supports Lending

Remarks by

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Board of Governors of the Federal Reserve System

at the

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Thank you for the opportunity to join you today.[1] Let me start by recognizing Indigenous Peoples' Day, and the proud history and ongoing contributions of Native Americans throughout the United States. Last month, I had the privilege to visit Native communities and Native lands in Montana to learn about the economic development opportunities and challenges in Native economies and gain a better understanding of how we can foster a financial system that works for all, including those in Indian Country.

I have spent considerable time throughout my career thinking about the potential of the financial system to make a difference in the lives of individuals and their communities. Access to credit and other financial services is key to families navigating the many challenges they face and building a better future. The pursuit of this goal inspires many of you in your jobs as well. But in order for the financial system to play this role, it must be able to weather unexpected stress and continue to serve its customers and communities. And this requires that banks have sufficient capital, the subject of a proposal that the agencies recently put out for comment.

Most of the banks represented in this room today—and the vast majority of banks in the country—would not be subject to the Board's recent "endgame" proposal on bank capital. The proposal affects only the very largest banks. Even so, I suspect that you have heard a lot about it! The bulk of the proposed changes have been a decade in the making, and, as the name implies, the proposal is the last major plank to address gaps in regulation dating from the Global Financial Crisis.

Since the Federal Reserve Board has just begun to receive comments on the proposed rules, I cannot say how those rules will evolve, but I can try to provide more background on why

[1] The views expressed here are my own and not necessarily those of my colleagues on the Federal Open Market Committee or the Federal Reserve Board.

I believe the benefits of the proposal would outweigh the costs. I will also discuss the importance we place on public engagement in the rulemaking process to ensure we strike the right balance between the costs and benefits of our rules.

The proposal is projected to raise capital for large banks. This may result in higher funding costs. But this is only half the story. Capital also enables banks to absorb more losses without risking their ability to repay their creditors.

The effective rise in capital requirements related to lending activities in the current proposal is a small portion of the estimated overall capital increase. The bulk of the rise in required capital anticipated in the proposed rule is attributed to trading and other activities besides lending—activities that have generated outsized losses at large banks and areas where our current rules have shortcomings. The estimated increase in capital required for lending activities on average—inclusive of both credit risk and operational risk requirements—is limited. Such a rise might be expected to increase the cost to banks for funding the average lending portfolio by up to 3 basis points—0.03 percentage points.[2] We recognize that the cost of funding for a specific loan would depend on the specific risk weight for that activity, and that there may be other channels by which higher capital requirements could matter. This is an area where commenters can shed light on additional considerations for the cost and benefits of the rule.

The private costs of capital must be weighed against the social benefits of higher capital in creating a healthier, more resilient financial system, and reducing the likelihood of financial crises. As we indicated in the preamble to the endgame proposal, historical experience—

[2] As noted in the preamble to the proposal, the agencies estimated that the capital increase for lending activities due to the proposal was roughly equivalent to a 30 basis point rise in required risk-based capital ratios across large banking organizations A 30 basis point rise in the required capital ratio would lead to an increase of 15 to 30 basis points in additional capital required for typical loan portfolios with risk weights between 50 percent and 100 percent. Assuming conservatively that the cost of equity capital is roughly 10 percent greater than the cost of debt funding, this would lead to a rise of 1.5 to 3 basis points in the cost to fund each dollar of a typical loan portfolio.

particularly our experience during the Global Financial Crisis—demonstrates the severe impact that distress or failure at individual banking organizations can have on the stability of the U.S. banking system. Fifteen years ago, the Global Financial Crisis starkly revealed the cost to society of a banking system that had held insufficient capital. In the lead-up to the financial crisis, the rules didn't fully capture the credit and operational risks of asset classes like subprime mortgages, securitizations, and derivatives, which led to enormous losses at banks. Banks were woefully undercapitalized for these losses. The financial crisis upended lives and did severe damage to the economy, causing the worst and longest recession since the Great Depression. It took six years for employment to recover, during which time long-term unemployment ran for long periods at a record high, and more than 10 million people fell into poverty. Six million families lost their homes to foreclosure. And these costs occurred even with an unprecedentedly large response by government.

Research suggests the costs of a financial crisis are sizable. While estimates vary widely, the cumulative loss in economic activity is consistently estimated to lie above 20 percent of annual GDP—and in some estimates up to 100 percent of GDP. For the United States, these estimates imply losses from financial crises of $5 trillion to $25 trillion based on current GDP.[3] The macroeconomic benefit of increased capital comes from reducing the likelihood of such a costly event. Better capitalized banks are better able to absorb losses and continue to lend to

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[3] *See* Simon Firestone, Amy Lorenc, and Ben Ranish, "An Empirical Economic Assessment of the Costs and Benefits of Bank Capital in the U.S.," Federal Reserve Bank of St. Louis *Review* 101, no. 3 (2019), https://research.stlouisfed.org/publications/review/2019/07/12/an-empirical-economic-assessment-of-the-costs-and-benefits-of-bank-capital-in-the-united-states. *See also* Basel Committee on Banking Supervision, 2010, ''An assessment of the long-term economic impact of stronger capital and liquidity requirements'' (BCBS, 2010) and Macroeconomic Assessment Group, ''Assessing the macroeconomic impact of the transition to stronger capital and liquidity requirements' (2010).

households and businesses through times of stress, which in turn, helps to ensure that we have a healthy and strong economy.

The Strength of the Initial Reforms

Following enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) in 2010, the Board adopted an initial set of reforms to increase the quantity and quality of capital, run an annual supervisory stress test, and set a capital surcharge on global systemically important banks (G-SIBs) to reflect the greater risk these firms pose to U.S. financial stability. These initial reforms have greatly strengthened our banking system and the common equity capital ratio of the largest banking organizations more than doubled, from 5.5 percent in 2009 to 12.4 percent at the end of last year.

As these initial reforms were being put in place, many in the banking sector claimed that the changes would harm lending and the broader economy. Since then, the U.S. economy has grown substantially, and the U.S. banking system has grown from $12 trillion in assets to $23 trillion. Bank profitability measures—which dropped dramatically in the Global Financial Crisis—have mostly recovered and are close to historical averages. So as banks increased their capital cushions, their profitability grew, as did their market valuation. The increased strength has enabled banks to support the economy. U.S. banks have maintained their position at the top of the league tables of global capital markets activity.

This is not to dismiss arguments that higher capital could harm the economy—just to note that similar warnings were not borne out in recent experience.

The Case for Building on the Initial Reforms

When the initial reforms were put in place, bank regulators acknowledged that these changes were a partial measure and that there were further elements of the capital rule that needed adjusting: Less reliance on internal models for credit risk; operational risk should be captured in a standardized way; and capital requirements did not fully capture market risk.[4] The agencies' proposed rule attempts to address these issues.

First, the proposal would remove the use of banks' internal models to set credit risk capital requirements. In the agencies' experience, the subjective choices made for internal models have produced unwarranted variability across banking organizations in requirements for exposures with similar risks.[5] This can weaken confidence, reduce transparency, and challenge comparisons of capital adequacy across banking organizations.

For these reasons, the proposal would replace the internal models approach for credit risk with a non-modeled approach. This so called "expanded risk-based approach" would be sensitive to important drivers of credit risk but would be standardized, transparent and consistent across banks. The proposal contains adjustments relative to the international Basel Capital Accord to ensure that on average small and large banks are required to hold similar levels of capital for key credit portfolios. The large banks subject to the proposal would continue to also be subject to the same U.S. standardized approach as applicable to all firms, in order to maintain competitive equity across the full range of providers of credit. The agencies have sought comment on this approach to competitive equity in light of the U.S. standardized approach requirement and the generally higher overall calibration of the proposed requirements.

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[4] Press release: Reports on measures to reduce risk-weighted asset variability and on Basel III implementation by the Basel Committee (bis.org).

[5] The Basel Committee has published analysis illustrating the variability of credit-risk-weighted assets across banking organizations. See https://www.bis.org/publ/bcbs256.pdf and https://www.bis.org/bcbs/publ/d363.pdf. One result of these analyses is that across banking organizations, for an identical portfolio of wholesale loan exposures, required capital based on banks' internal models could vary by as much as 15 percent in either direction around a benchmark level.

Second, turning to operational risk, large banks have experienced significant losses due to operational weaknesses over the past two decades. Experience shows that operational risk is inherent in all banking products, activities, processes, and systems and that losses at the largest banking organizations can be substantial.

Under the current capital rule, the very largest, most complex banking organizations calculate risk-weighted assets for operational risk using internal models. These models can present substantial uncertainty and volatility.[6] In the agencies' proposal, the operational risk capital requirements would be standardized rather than modeled and would be a function of a banking organization's business volume and historical operational losses. Research suggests that banking organizations with higher overall business volume are likely to have exposure to higher operational risk.[7] Further, higher operational losses are associated with higher future operational risk exposure.[8]

Third, the Global Financial Crisis taught regulators and banks many difficult lessons about the importance of robust capital requirements for trading and market making activities. Banks at the time were undercapitalized, in particular, for the large losses that occurred in

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[6] See, e.g., Eric W. Cope, Giulio Mignola, Gianluca Antonini, and Roberto Ugoccioni, "Challenges and Pitfalls in Measuring Operational Risk from Loss Data," *Journal of Operational Risk* 4, no. 4 (2009): 3–27; and J.D. Opdyke and Alexander Cavallo, "Estimating Operational Risk Capital: The Challenges of Truncation, the Hazards of Maximum Likelihood Estimation, and the Promise of Robust Statistics," *Journal of Operational Risk* 7, no. 3 (2012): 3–90.

[7] Recent research connecting operational risk to higher business volume includes W. Scott Frame, Ping McLemore, and Atanas Mihov, "Haste Makes Waste: Banking Organization Growth and Operational Risk," Federal Reserve Bank of Dallas, Research Department Working Papers no. 23 (2020), https://www.dallasfed.org/research/papers/2020/wp2023; Filippo Curti, W. Scott Frame, and Atanas Mihov, "Are the Largest Banking Organizations Operationally More Risky?" *Journal of Money, Credit and Banking* 54, no. 5 (2019): 1223–59, https://doi.org/10.1111/jmcb.12933; and Azamat Abdymomunov and Filippo Curti, "Quantifying and Stress Testing Operational Risk with Peer Banks' Data," *Journal of Financial Services Research* 57 (2020); 287–313, https://link.springer.com/article/10.1007/s10693-019-00320-w.

[8] See Filippo Curti and Marco Migueis, "The Information Value of Past Losses in Operational Risk," Finance and Economics Discussion Series 2023-003 (Washington: Board of Governors of the Federal Reserve System, 2023), https://doi.org/10.17016/FEDS.2023.003.

securitizations and other illiquid assets. Although the current capital rule was updated to better reflect this risk following the crisis, the current approach has some material shortcomings. Most notably, the current framework could result in capital requirements increasing during stress, rather than requiring firms to hold sufficient capital in advance of the stress to be manage through a stress period. The framework also did not account for the large range of liquidity profiles across trading exposures.[9]

The aim of the revised market risk framework is to comprehensively address the lessons of the Global Financial Crisis. The revised framework would permit banks to use their own models to compute elements of the market risk capital requirements only when such risk can be modeled well. Models under the new framework would need to better account for the possibility of large outlier events—tail risk—and for the illiquid nature of some trading exposures. The framework would also recognize that diversification that is beneficial in quiet times may not materialize under stress. The framework would backstop internal modeling with a new standardized approach to market risk, to be applied to trading portfolios where banks are unable to demonstrate that their models adequately capture risk.

Importance of Comments and the Comment Period

The comment period is an important part of the rulemaking process. As I have said before, I want to reiterate that we are very interested in public input. The 120-day comment period reflects our commitment to public engagement and openness to views and goes beyond the standard comment period length.

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[9] The Basel Committee has published three consultative documents on the review and to address the structural shortcomings identified: "Fundamental Review of the Trading Book," May 2012, www.bis.org/publ/bcbs219.pdf; "Fundamental Review of the Trading Book: A Revised Market Risk Framework," October 2013, www.bis.org/publ/bcbs265.pdf; and, "Fundamental Review of the Trading Book: Outstanding Issues," December 2014, www.bis.org/bcbs/publ/d305.pdf.

We have already heard concerns that the proposed risk-based capital treatment for mortgage lending, tax credit investments, trading activities, and activities that generate fee-based income might overestimate the risk of these activities. We welcome all comments that provide the agencies with additional data and perspectives to help ensure the rules accurately reflect risk.

Thank you.