Michelle W Bowman: The consequences of bank capital reform

Speech by Ms Michelle W Bowman, Member of the Board of Governors of the Federal Reserve System, at the International Swaps and Derivatives Association (ISDA) Board of Directors, London, England, 26 June 2024.

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I would like to thank the International Swaps and Derivatives Association (ISDA) for the invitation to speak to you today.[1] I appreciate the opportunity to engage with you on matters that affect the swaps and derivatives industry, specifically how we can best consider and address the potential consequences of bank capital reform measures, both in the United States and around the world. Before doing so, I will share my views on the economy and monetary policy in the United States.

Update on the Economy and Monetary Policy Outlook

Over the past two years, the Federal Open Market Committee (FOMC) has significantly tightened the stance of monetary policy to address high inflation. At our meeting earlier this month, the FOMC voted to continue to hold the federal funds rate target range at 5-1/4 to 5-1/2 percent and to continue to reduce the Federal Reserve's securities holdings.

After seeing considerable progress on slowing inflation last year, we have seen only modest further progress this year. The 12-month measures of total and core personal consumption expenditures (PCE) inflation have moved roughly sideways or slightly down since December and remained elevated at 2.7 percent and 2.8 percent, respectively, in April. The consumer price index (CPI) report for May showed 12-month core CPI inflation slowing to 3.4 percent from 3.6 percent in April. However, with average core CPI inflation this year through May running at an annualized rate of 3.8 percent, notably above average inflation in the second half of last year, I expect inflation to remain elevated for some time.

The recent pickup in inflation in the first several months of 2024 was evident across many goods and services categories, suggesting that inflation was temporarily lower in the latter half of last year. Prices continue to be much higher than before the pandemic, which is weighing on consumer sentiment. Inflation has hit lower-income households hardest since food, energy, and housing services price increases far outpaced overall inflation throughout this episode.

Economic activity increased at a strong pace last year but appears to have moderated early this year. First-quarter gross domestic product growth was slower than in the second half of last year, though private domestic final purchases continued to rise at a solid pace. Continued softness in consumer spending and weaker housing activity early in the second quarter also suggest less momentum in economic activity so far this year.

Payroll employment continued to rise at a solid pace in April and May, though slightly slower than in the first quarter, partly reflecting increased immigrant labor supply. Despite some further rebalancing between supply and demand, the labor market remains tight. The unemployment rate edged up to 4.0 percent in May, while the

number of job openings relative to unemployed workers declined further to near its pre-pandemic level. Labor force participation dropped back to 62.5 percent in May, which suggests no further improvement in labor supply along this margin, as labor force participation among those aged 55 and older has been persistently low.

At its current setting, our monetary policy stance appears to be restrictive, and I will continue to monitor the incoming data to assess whether monetary policy is sufficiently restrictive to bring inflation down to our target. As I've noted recently, my baseline outlook continues to be that inflation will decline further with the policy rate held steady. And should the incoming data indicate that inflation is moving sustainably toward our 2 percent goal, it will eventually become appropriate to gradually lower the target range for the federal funds rate to prevent monetary policy from becoming overly restrictive. However, we are still not yet at the point where it is appropriate to lower the policy rate, and I continue to see a number of upside risks to inflation.

First, much of the progress on inflation last year was due to supply-side improvements, including easing of supply chain constraints; increases in the number of available workers, due in part to immigration; and lower energy prices. It is unlikely that further improvements along this margin will continue to lower inflation going forward as supply chains have largely normalized; the labor force participation rate has leveled off in recent months below pre-pandemic levels; and an open U.S. immigration policy over the past few years, which added millions of new immigrants in the U.S., may become more restrictive.

Geopolitical developments could also pose upside risks to inflation, including the risk that spillovers from regional conflicts could disrupt global supply chains, putting additional upward pressure on food, energy, and commodity prices. There is also the risk that the loosening in financial conditions since late last year, reflecting considerable gains in equity valuations, and additional fiscal stimulus could add momentum to demand, stalling any further progress or even causing inflation to reaccelerate.

Finally, there is a risk that increased immigration and continued labor market tightness could lead to persistently high core services inflation. Given the current low inventory of affordable housing, the inflow of new immigrants to some geographic areas could result in upward pressure on rents, as additional housing supply may take time to materialize. With labor markets remaining tight, wage growth has been elevated at around or above 4 percent, still higher than the pace consistent with our 2 percent inflation goal, given trend productivity growth.

In light of these risks, and the general uncertainty regarding the economic outlook, I will continue to watch the data closely as I assess the appropriate path of monetary policy. The frequency and extent of data revisions over the past few years make the task of assessing the current state of the economy and predicting how the economy will evolve even more challenging. I will remain cautious in my approach to considering future changes in the stance of policy.

It is important to note that monetary policy is not on a preset course. In my view, we should consider a range of possible scenarios that could unfold when considering how the FOMC's monetary policy decisions may evolve. My colleagues and I will make our decisions at each FOMC meeting based on the incoming data and the implications for

and risks to the outlook. While the current stance of monetary policy appears to be at a restrictive level, I remain willing to raise the target range for the federal funds rate at a future meeting should the incoming data indicate that progress on inflation has stalled or reversed. Restoring price stability is essential for achieving maximum employment over the longer run.

Grappling with the Unintended Consequences of Bank Capital Reform

I will turn now to the issue of bank capital reform, and the implications of adopting and implementing the Basel III "endgame" standards both in the United States and around the world.

Considering capital and debt requirements in the aggregate
Capital requirements are an important component of the prudential regulatory frameworks and interconnected banking and financial systems around the world. As you know, the U.S. has lagged our E.U. and U.K. counterparts in fully implementing the Basel III capital standards. In July 2023, the U.S. federal banking agencies issued a public consultation on implementing what the U.S. calls the Basel III "endgame" capital reforms.[2] The response to the U.S. capital proposal has been overwhelmingly negative, including from a broad range of stakeholders. I have previously spoken at length about my concerns with the proposal, and as public commenters have reviewed it, they have identified additional areas of concern.[3]

In my view, the concerns are well-founded. The proposal acknowledged that the revisions, if implemented, would result in an estimated 20 percent aggregate increase in total risk-weighted assets across bank holding companies subject to the rule. Individual impacts would vary not only by firm, but also by business line. For any particular business line or product, the aggregate impact of the proposed capital changes could result in a more significant increase, depending upon the firm's characteristics. Consider the impact on business lines subject to the market risk capital rule. As noted in the proposal, the revisions to the market risk rule alone would increase risk-weighted assets from $430 billion to $760 billion for Category I and II firms, and from $130 billion to $220 billion for Category III and IV firms.[4]

Even this example ignores the additive capital increases from other aspects of the rule, such as the operational risk charge "overlay" that may separately result in a higher capital charge for the same business line, if that line is also generating fee income. The changes that may affect any particular financial product or service vary but could include impacts across all aspects of the proposal. For many of the derivatives and swaps activities in which banking entities engage, the aggregate impacts on different business lines could result from changes to the market risk rule, the calculation of credit valuation adjustments, and the treatment of securities financing transactions, among others.

So far, what I have described are just the aggregate effects of capital increases that would appear within the four corners of the U.S. Basel III endgame proposal. We know that these changes do not exist in a vacuum. A particular firm can also be impacted by changes to the global systemically important bank (G-SIB) surcharge and long-term debt requirements. The firm's business planning would also need to consider existing

requirements, such as leverage and "total loss-absorbing capacity" requirements. By design, these elements are intended to be complementary, often seeking to capture different risks, operate as "backstop" capital standards, promote resiliency, and be available for recapitalization in resolution.

Despite the goal that the capital framework operates in a holistic fashion, the rulemaking process in the United States has taken a fragmented approach. This process has seemed to ignore the interrelationships of the requirements. We cannot fully understand the intended and unintended consequences of any regulatory reform, including capital reform, without using a broader lens to consider the interconnections and interrelationships among different capital and debt requirements that apply in the banking system.

This narrow approach to rulemaking-focusing on a specific reform, without considering the broader framework-has created a corresponding narrowness when we think about the consequences of regulatory reform. This challenge has been particularly acute in the capital and debt space simply because there are so many requirements that are intended to operate in a complementary way, and that in the aggregate may overlap or conflict, generating unintended consequences. The Federal Reserve has expressly acknowledged the complementary nature of these requirements, for example in noting that some leverage ratio requirements operate as a backstop to risk-based capital requirements.[5] And yet, the discussions of costs and benefits of reform tend to disregard the aggregate impact across rules, even when related reforms are proposed at the same time and the aggregate impacts can be identified and assessed.[6]

Considering direct and indirect consequences

With respect to the Basel III "endgame" reforms, much of the discussion of consequences has focused on the direct consequences to the availability and price of credit, resulting from the proposed changes to risk-weighted assets. These issues resonate with households and businesses. Everyone understands the direct impact on their own household finances or their business's bottom line from higher costs of lending. Often overlooked are the direct and indirect consequences of capital reforms on financial products such as derivatives and swaps. These products can seem exotic to the public, but we know they play a significant role in the financial system and the broader economy, including commodities price hedging by end-users, such as agricultural producers. And it is certainly foreseeable that proposed capital reforms could impair market liquidity.

We also know that regulatory reforms-especially capital reforms with a direct link to particular products, services, and markets-can cause broader changes in firm behavior. Some banks may raise prices on particular products based on their internal allocation of increased capital charges. And some banks may discontinue certain products or services that cannot be offered in a cost-effective way. These choices will impact the competitive landscape into the future, and in some cases-such as where significant economies of scale are required to offer a product or service-the end result may be that some banks exit certain product markets, resulting in increased concentration and higher prices for households and businesses.

While I am acutely aware of our need to consider these costs and price effects, I am also aware that regulators sitting in Washington, D.C. are not well-equipped to query

and understand these real-world consequences of reform. In my view, the commenter feedback we have received on these issues has helped to illuminate these consequences. My hope is that we take them into account when moving forward to implement the Basel III endgame standards.

The path forward

I do see a path forward to implement Basel III, one that not only addresses the overall calibration and international consistency and comparability, but also makes more granular changes that will improve the effectiveness and efficiency of the rule. In terms of this path, I will briefly outline what I see as necessary procedural steps, while also providing a non-exclusive list of substantive changes that I believe are necessary to improve the proposal.

In October 2023, the Federal Reserve initiated a data collection to gather information from the banks affected by the U.S. proposal. I am hopeful that these data will allow regulators to better understand the proposal's impact and identify areas for revision. Any next step in this rulemaking process will require broad and material changes. It should also be accompanied by a data-driven analysis of the proposal and be informed by the significant public input received during the rulemaking process. This should assist policymakers in creating a path to improve the rulemaking. My hope is that policymakers pay closer attention to the balance of costs and benefits while considering the direct and indirect consequences of the capital reform.

I have previously identified a number of specific areas and procedural steps that would be necessary to address in any future efforts to revise this proposal. Some of these issues include

- addressing redundancy in the capital framework (for example, between the new market risk and operational risk requirements, and the stress capital buffer);
- recalibrating the market risk rule specifically, where some of the biggest outlier increases in risk-weighted assets would appear;
- adopting a more reasonable treatment for non-interest and fee-based income through the operational risk requirements, which could deter banks from diversifying revenue streams, even though such diversification can enhance an institution's stability and resilience;
- reviewing the impact of capital requirements, including leverage ratio requirements, on U.S. Treasury market intermediation and liquidity;
- incorporating tailoring in the applicability of Basel III capital reforms, specifically looking at whether each element of the Basel III capital proposal is appropriate for non-G-SIB firms that are not internationally active; and
- re-proposing the Basel III standards to address the broad and material reforms that I believe should be included in any final rule, including granular changes to address the specific issues raised by commenters, as appropriate.[7]

While these steps would be a reasonable starting place, they are not a replacement for a data-driven analysis and a careful review of the comments submitted. This would result in a better proposal that includes not only changes to address these concerns, but also the many other concerns raised by the public.

Closing Thoughts

It has been a pleasure speaking with you today. Your industry plays an important role not only in the U.S. economy, but also in the broader world economy. It is imperative that regulators not lose sight of the practical implications of regulatory reform, even as the U.S. considers the next steps in moving forward to adopt the final Basel III capital reforms.

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

2 Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation (FDIC), and Office of the Comptroller of the Currency (OCC), "Agencies Request Comment on Proposed Rules to Strengthen Capital Requirements for Large Banks," news release, July 27, 2023; OCC, Board of Governors of the Federal Reserve System, and FDIC, "Regulatory Capital Rule: Large Banking Organizations and Banking Organizations with Significant Trading Activity (PDF)," 88 Fed. Reg. 64,028–64,343 (September 18, 2023).

3 See dissenting statement, "Statement by Governor Michelle W. Bowman" on the proposed rule to implement the Basel III endgame agreement for large banks, news release, July 27, 2023;Michelle W. Bowman, "Remarks on the Economy and Prioritization of Bank Supervision and Regulation (PDF)" (speech at the New York Bankers Association's Financial Services Forum, Palm Beach, Florida, November 9, 2023); Michelle W. Bowman, "The Path Forward for Bank Capital Reform (PDF)" (speech at Protect Main Street, sponsored by the Center for Capital Markets at the U.S. Chamber of Commerce, Washington, D.C., January 17, 2024).

4 OCC, Board of Governors of the Federal Reserve System, and FDIC, Notice of Proposed Rulemaking, "Regulatory Capital Rule: Large Banking Organizations and Banking Organizations with Signfiicant Trading Activity," 88 Fed. Reg. 64,028, 64,168, table 11 (September 18, 2023).

5 See, e.g., Board of Governors of the Federal Reserve System, Interim Final Rule and Request for Comment, "Temporary Exclusion of U.S. Treasury Securities and Deposits at Federal Reserve Banks from the Supplementary Leverage Ratio (PDF)," 85 Fed. Reg. 20,578, 20,579 (April 14, 2020) ("This interim final rule does not affect the tier 1 leverage ratio, which will continue to serve as a backstop for all banking organizations subject to the capital rule.").

6 See, e.g., OCC, Board of Governors of the Federal Reserve System, and FDIC, Notice of Proposed Rulemaking, "Long-Term Debt Requirements for Large Bank Holding Companies, Certain Intermediate Holding Companies of Foreign Banking Organizations, and Large Insured Depository Institutions (PDF)," 88 Fed. Reg. 64,524, 64,551, n. 97 ("The agencies recognize that their Basel III reforms proposal would, if adopted, increase risk-weighted assets across covered entities. The increased risk-weighted assets would lead mechanically to increased requirements for LTD under the LTD proposal. The increased capital that would be required under the Basel III proposal

could also reduce the cost of various forms of debt for impacted firms due to the increased resilience that accompanies additional capital (which is sometimes referred to as the Modigliani–Miller offset). *The size of the estimated LTD needs and costs presented in this section do not account for either of these potential effects of the Basel III proposal.*") (emphasis added). Even when the agencies estimate the effect of a proposal on other rules, the impact analysis tends to be narrow, such as focusing on the estimated shortfall that would be created by the interrelated rules and may overlook other pending rules. See, e.g., OCC, Board of Governors of the Federal Reserve System, and FDIC, "Regulatory Capital Rule: Large Banking Organizations and Banking Organizations with Significant Trading Activity (PDF)," 88 Fed. Reg. at 64,171 (noting that the proposed revisions to the calculation of risk-weighted assets under the Basel III endgame proposal would affect the risk-based TLAC and LTD requirements applicable to Category I bank holding companies but disregarding the pending proposal that would expand long-term debt requirements to a broader set of firms).

[7] See dissenting statement, "Statement by Governor Michelle W. Bowman" on the proposed rule to implement the Basel III endgame agreement for large banks, news release, July 27, 2023; Michelle W. Bowman, "Remarks on the Economy and Prioritization of Bank Supervision and Regulation (PDF)"; Michelle W. Bowman, "The Path Forward for Bank Capital Reform (PDF)."