

## Michael S Barr: The next steps on capital

Speech by Mr Michael S Barr, Vice Chair for Supervision of the Board of Governors of the Federal Reserve System, at the Brookings Institution, Washington DC, 10 September 2024.

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Thank you for inviting me to speak today.<sup>1</sup> Since I joined the Federal Reserve Board as Vice Chair for Supervision, I have spoken many times about the importance of bank capital to the safety and soundness of banks and the stability of the financial system.<sup>2</sup> It is critical that banks have the capacity to continue lending to households and businesses through times of stress. Bank capital is a key component of this resilience. And bank capital rules help to ensure that banks are holding capital commensurate with the risks of their activities and the risks that they pose to the U.S. financial system. But capital has costs too. As compared to debt, capital is a more expensive source of funding to the bank.<sup>3</sup> Thus, higher capital requirements can raise the cost of funding to a bank, and the bank can pass higher costs on to households, businesses, and clients engaged in a range of financial activities. These activities are critical to a well-functioning economy that works for everyone. That's why it is important to get the balance between resiliency and efficiency right.

Today, I'll return to these themes in the context of two rules of great public interest: The Basel III endgame proposal and the proposal to adjust the capital surcharge for global systemically important banks (G-SIB).<sup>4</sup>

### The path forward

A little over a year ago, the Board sought comment on those two proposed rules, which would modify risk-based capital requirements for large banks. We received a great number of comments on the provisions in the proposal, as well as on the justifications and analysis that underlie those provisions.

Since that time, we have been hard at work analyzing the comments and the data we collected to evaluate the combined impact of these proposals. We have spoken with a wide range of stakeholders, including banks, academics, public interest groups, consumers, businesses, other regulators, Congress, and others. As you would expect in a project as technical and consequential as this one, I have had many productive meetings with Board colleagues and our fellow federal bank regulatory agencies, the Federal Deposit Insurance Corporation (FDIC) and the Office of the Comptroller of the Currency (OCC).

This process has led us to conclude that broad and material changes to the proposals are warranted. As I said, there are benefits and costs to increasing capital requirements. The changes we intend to make will bring these two important objectives into better balance, in light of the feedback we have received. The changes to the endgame proposal have been a joint effort with my counterparts at the FDIC and the OCC.

I intend to recommend that the Board re-propose the Basel endgame and G-SIB surcharge rules. This will provide the public the opportunity to fully review a number of key broad and material changes to the original proposals and provide comment. We will accept public comments on any aspect of the Basel endgame and G-SIB surcharge proposals.

The changes in the endgame re-proposal will cover all major areas of the rule: credit risk; operational risk; and market risk. Banks with assets between \$100 and \$250 billion would no longer be subject to the endgame changes, other than the requirement to recognize unrealized gains and losses of their securities in regulatory capital.<sup>5</sup> These changes reflect the feedback we have received from the public, improve the tiering of the proposal, and better reflect risks. I will also recommend changes to the G-SIB surcharge proposal to better align the capital surcharge for a G-SIB with its systemic risk profile.

Taken together, the re-proposals would increase aggregate common equity tier 1 capital requirements for the G-SIBs, which are the largest and most complex banks, by 9 percent. For other large banks that are not G-SIBs, the impact from the re-proposal would mainly result from the inclusion of unrealized gain and losses on their securities in regulatory capital, estimated to be equivalent to a 3 to 4 percent increase in capital requirements over the long run. The remainder of the re-proposal would increase capital requirements for non-GSIB firms still subject to the rule by 0.5 percent.

While these proposed changes affect some of the most important aspects of the proposals, the agencies have not made final decisions on any aspect of the re-proposals, including those that are not explicitly addressed in the re-proposal. The public should not view any omission of a potential change in these re-proposals as an indication that the agencies will finalize a provision as proposed. We continue to consider comments already received on the 2023 proposal, and we will consider those comments together with any comments submitted on the re-proposals as part of any final rulemakings. This is an interim step. Let me reiterate that we are open to comments on any aspect of the proposals. Now, I will turn to the changes.

## **Credit risk**

I will begin with an overview of the changes I will recommend to the capital requirements for credit risk, which protect against the risk that a bank's loans will not be fully repaid. These changes include reducing the risk-weights for residential real estate and retail exposures, extending the scope of the reduced risk weight for certain low-risk corporate debt, and eliminating the minimum haircut for securities financing transactions.

First, I intend to recommend that the Board lower the proposed risk-weighting for loans secured by residential real estate and loans to retail customers. The original proposal introduced more risk-sensitive approaches for residential real estate and retail exposures, but calibrated them to be higher than the Basel standard to promote domestic competitive equity. The agencies received significant comments on the proposed calibrations. Some commenters argued that the elevated risk weights would overstate the risk for these loans given their loss history. Others argued that the risk weighting would affect home affordability and homeownership opportunities, particularly

for first-time homebuyers, minority communities, and low- and moderate-income borrowers, and could reduce the availability and affordability of retail credit.

I will recommend that we reduce the calibration for residential real estate exposures so that it is in line with the calibration developed in the Basel process. With this change, all-in capital requirements, including for operational and credit risk, will be lower on average than they are currently for mortgages up to 90 percent loan-to-value ratio, and about the same as they are now for mortgages up to 100 percent loan-to-value. With respect to loans to retail customers, I intend to recommend that we adopt the Basel standard, with two exceptions – first, we would lower the capital requirements for credit card exposures where the borrower uses only a small portion of the commitment line, and second, we would lower the capital requirement for charge cards with no pre-set credit limits.

The second proposed change related to credit risk would extend the reduced risk weight for low-risk corporate exposures to certain regulated entities that a bank judges to be investment grade and that are not publicly traded. The original proposal provided this preferential treatment only to investment-grade corporates that were publicly traded because the financial disclosure requirements for these entities facilitate market participants' assessments of their financial condition, which in turn provide additional information for banking organizations to use when assessing these entities' credit risk. There were many comments that the preferential treatment should be extended further, including to regulated entities that are also subject to substantial regulatory discipline and substantial transparency requirements. Consistent with our objective of increasing risk sensitivity in capital requirements, I plan to recommend to the Board that we extend the reduced corporate risk weight to regulated entities – including regulated financial institutions that are not banks, such as pension funds, certain mutual funds, and foreign equivalents – that are investment-grade but not publicly traded.

Third, I intend to recommend that the Board not adopt the capital treatment associated with minimum haircut floors for securities financing transactions. The proposal included heightened capital requirements for repo-style transactions and eligible margin loans that did not meet minimum margin requirements. While consistent with the Basel standard, several other major jurisdictions have not adopted this approach. Not adopting the minimum haircut floors will allow time to seek greater international consensus on this important topic before deciding on whether and how to implement such an approach in the United States.

## **Equity Exposures**

Let me speak to the treatment of tax credit equity financing exposures. I plan to recommend that we significantly lower the risk weight for tax credit equity funding structures, given the lower inherent risk in these structures compared to many other equity investments. The revised lower risk weight for these exposures of 100 percent would reflect this lower risk and be consistent with the approach we take for other tax credit investments, such as the low-income housing tax credits.

## **Operational risk**

Next, let me speak about three changes I intend to recommend for the proposed capital treatment of operational risk, which is the risk of losses from inadequate or failed processes, such as from fraud or cyberattacks. First, I plan to recommend that we no longer adjust a firm's operational risk charge based on its operational loss history. This change will reduce fluctuations in a bank's operational risk capital requirements over time.

Second, I plan to recommend to the Board that we calculate fee income on a net basis in calculating its contribution to the operational risk capital requirement. The original proposal would have measured the contribution of fee-based activities based on gross revenues, instead of net income, which is revenues minus expenses. Moving to net income for fee-based activities-specifically, by netting noninterest income and expenses (except for operational losses)-would produce more consistency in how operational risk is measured across bank activities, as interest and trading income and expenses are already measured on a net basis under the proposal. This change would also produce more consistent operational risk capital requirements across banks because the approach is less sensitive to the differences in accounting practices across banks.

Third, I plan to recommend to the Board that we reduce operational risk capital requirements for investment management activities to reflect the smaller historical operational losses for these activities relative to income. The agencies received comments suggesting that some fee-based business lines have incurred meaningfully lower operational losses than other business lines. We have found evidence that investment management has historically experienced noticeably low operational losses relative to income produced.

### **Market risk and derivatives**

Now, I'll speak to the capital treatment for a bank's trading activities and its derivatives activities. The endgame proposal included a number of important improvements relative to the current market risk capital framework, including to incorporate lessons learned from the 2007-09 financial crisis that have not been sufficiently addressed in the current framework. It would permit firms to use internal models to capture the complex dynamics of most market risks but would put certain constraints on banks' models and provide fallbacks in areas where modeling practices are not adequate.

We received numerous comments on ways to improve this part of the proposal. I plan to recommend that we make changes to facilitate banks' ability to use internal models for market risk. For example, the re-proposal will introduce a multiyear implementation period for the profit and loss attribution tests that are used to confirm that models are working as intended. This extended transition period would allow banks to gain experience with the tests and provide time to improve their systems and processes and address any potential gaps in data and model performance. In addition, the re-proposal would contain a few additional adjustments to improve incentives for a firm to model its exposures.

Moreover, we will clarify that uniform mortgage-backed securities positions would be treated as having a single obligor, regardless of whether they were issued by Freddie Mac or Fannie Mae. This change will enable firms to recognize hedging across these securities.

With respect to derivatives activities, I plan to recommend that the Board adjust the capital treatment for client-cleared derivatives activities by reducing the capital required for the client-facing leg of a client-cleared derivative. This change would better reflect the risks of these transactions, which are highly collateralized and subject to netting and daily margin requirements. This also would avoid disincentives to client clearing, which I'll return to later.

## **Tiering**

Let me turn to tiering. The largest, most complex firms should be subject to the most stringent requirements, in light of the costs that their potential failure would impose on the broader financial system and thus on businesses and households. Under the re-proposal, G-SIBs and other internationally active banks would be subject to the most stringent set of requirements, including the new credit risk and operational risk requirements, and the revised frameworks for market risk and CVA frameworks.

Capital requirements for large banks that are not G-SIBs can be simpler while still supporting resilience. I am recommending a number of changes to better reflect this principle. For firms with assets between \$250 and \$700 billion that are not G-SIBs or internationally active, the re-proposal would apply the new credit risk and operational risk requirements; however, it would apply the frameworks for market risk and CVA frameworks only to firms that engage in significant trading activity. Further, the re-proposal would revert to the simpler definition of capital – the numerator in the capital ratio – for these firms that is currently in place, with the exception of applying the requirement to reflect unrealized losses and gains on certain securities and other aspects of accumulated other comprehensive income (AOCI). The re-proposal would maintain this element to better reflect interest rate risk in capital, a problem that played a major role in last March's bank failures.

For large banks with assets between \$100 and \$250 billion, the re-proposal would not apply the credit risk and operational risk frameworks of the expanded risk-based approach to these banking organizations, maintaining a simpler capital framework for these less complex firms. For these firms, the re-proposal would also revert to the simpler definition of capital for these firms that is currently in place, with the exception of applying the requirement to reflect unrealized losses and gains on certain securities and other aspects of AOCI.

## **G-SIB surcharge proposal**

As I noted, last July, we sought comment on proposed revisions to the G-SIB surcharge, to better reflect the systemic risk of each G-SIB. In particular, the proposal would make adjustments to limit "window dressing" by requiring banks to report indicators as average values instead of on a point-in-time basis. It would also reduce "cliff effects" by calculating a G-SIB's capital surcharge in 0.1 percent increments

instead of 0.5 percent increments. And the proposal would adjust how we measure some systemic indicators to better align them with risk.<sup>6</sup>

The goal of the 2023 proposal was to improve the risk sensitivity of the G-SIB surcharge. Commenters provided helpful feedback regarding the proposal's potential impact on certain types of activities, such as client clearing of derivatives. We are still considering these comments, but let me speak to areas where I will recommend making changes to the original proposal.

First, I'll speak to the treatment of cleared derivatives. The proposal would have increased the extent to which client-cleared derivatives contribute to a bank's G-SIB surcharge, to promote consistency of the measure. However, commenters argued that the measure might result in higher costs and more volatility for derivative end users and might reduce incentives to provide clients' access to central clearing. While it is important for our capital rules to be risk-sensitive, it is also important that we consider the impact of our rules in the broader market context. Central clearing of derivatives is a critical tool that can help improve transparency and reduce systemic risk. To avoid disincentives for client clearing, I intend to recommend to the Board that we not adopt the proposed changes to capital requirements associated with client clearing.

Second, let me speak to changes in the surcharge proposal that I will recommend to keep the measures we use up-to-date. The U.S. G-SIB surcharge was set nearly nine years ago, and the growth in the economy since 2015 has meant that G-SIBs' measures of systemic risk have increased, even for firms whose share of domestic or global economic activity has not increased. The Board noted the potential for this effect in the original 2015 G-SIB rule. While it did not provide a mechanism to automatically adjust for economic growth at that time, the Board stated that it would periodically reevaluate the framework.

As part of the G-SIB re-proposal, I intend to recommend that we improve the calculation of the capital surcharges for G-SIBs by reflecting changes in the global banking system since the Board adopted the G-SIB surcharge in 2015. In addition, for the future, I intend to recommend that we account for effects from inflation and economic growth in the measurement of a G-SIB's systemic risk profile. As a result, a G-SIB's surcharge would not change based simply on growth in the economy.<sup>7</sup>

## **Conclusion**

The journey to improve capital requirements since the Global Financial Crisis has been a long one, and Basel III endgame is an important element of this effort. These re-proposals bring us closer to completing the task.

The broad and material changes to both proposals that I've outlined today would better balance the benefits and costs of capital in light of comments received, and result in a capital framework that appropriately reflects the risks of bank activities and is tiered to the banking sector. They also bring the proposals broadly in line with what other major jurisdictions are doing. And what does this all mean? A safer and fairer banking system. My goal, throughout my nearly 30 years in this field, has always been to help ensure that the banking system can support households and businesses of all types, during good times and bad.

In addition to the re-proposals outlined today, we are looking carefully at how our stress test complements the risk-based capital rules to help ensure our overall framework supports a resilient and effective banking sector. We are attentive to the interactions across all components of our capital framework as well as the combined burden and benefits, and we take these issues seriously. In all of our work, we will continue to seek an approach that helps to ensure financial system resiliency and supports the flow of credit to households and businesses. It is most imperative that we get this right.

Thank you.

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<sup>1</sup> The views I express here are my own, and not necessarily those of my colleagues on the Board of Governors of the Federal Reserve System or the Federal Open Market Committee.

<sup>2</sup> See Michael S. Barr, "Why Bank Capital Matters" (speech at the American Enterprise Institute, Washington, DC, December 1, 2022), and Michael S. Barr, "Holistic Capital Review (PDF)" (speech at the Bipartisan Policy Center, Washington, DC, July 10, 2023).

<sup>3</sup> Under standard corporate finance theory, a firm should be indifferent between debt and equity, but in practice, as compared to debt, equity is a more expensive source of funding to a bank given the structure of our laws and markets, the presence of deposit insurance and other government support, and other factors. See, e.g., Franco Modigliani and Merton H. Miller, "The Cost of Capital, Corporation Finance and the Theory of Investment," *The American Economic Review* 48 (June 1958): 261–297, and Ron J. Feldman, Gary H. Stern, and Paul A. Volcker, *Too Big to Fail: The Hazards of Bank Bailouts* (Washington: Brookings Institution Press, 2009).

<sup>4</sup> The G-SIB surcharge is an additional layer of capital just for the G-SIBs, and it is measured on several factors of each G-SIB, specific to their individual risks.

<sup>5</sup> To the extent that such a firm has large trading operations, it would also be subject to the revised market risk framework.

<sup>6</sup> With regard to the adjustments to address window dressing and cliff effects, these will have a one-time impact on banks that carefully manage their operations to lower surcharge buckets, but should improve the efficiency and risk-sensitivity of the measure over time.

<sup>7</sup> The re-proposal would update the method 2 coefficients to reflect changes from 2015 until the present using a methodology that is consistent with the Board's original calibration in 2015. Specifically, the supplemental proposal would update the method 2 coefficients for each of the systemic indicators for the size, interconnectedness, complexity, and cross-jurisdictional activity categories from 2015 until the present using the most recent available two-year average of aggregate global indicator amounts and the corresponding three-year average of euro/U.S. dollar exchange rates. Going forward, it would also include a mechanism to annually adjust the method 2 coefficients for each of the systemic indicators for the size, interconnectedness, complexity, and

cross-jurisdictional activity categories based on U.S. inflation and real economic growth. This mechanism would use a three-year moving average of annual nominal U.S. gross domestic product (GDP) growth to adjust these coefficients on an annual basis.