Fed Vice Chair for Supervision’s Remarks on Bank Capital
Eight Things To Know

On Monday, July 10, 2023, Michael S. Barr, Vice Chair for Supervision of the Board of Governors of the Federal Reserve System, gave a speech detailing the results of a nine-month “holistic review” of capital for large banks and previewing changes to capital standards for large banks that he intends to pursue through the rulemaking process.

The OCC and the FDIC appear to be in step with the Federal Reserve on the changes Barr has described. On the same day as Barr’s speech, Acting Comptroller Mike Hsu said in an interview with the American Banker that the OCC is aligned with the other federal banking regulators with respect to enhanced capital requirements. In a speech given last month, FDIC Chair Martin Gruenberg strongly endorsed strengthening bank capital.

Below are eight key takeaways from Barr’s speech.

1 Barr will recommend more stringent capital requirements for banks and bank holding companies with $100 billion or more in assets, increasing their risk-based capital requirements by 2 percentage points on average.

Today, the most complex capital requirements apply only to the largest and most complex financial institutions – those that have $700 billion or more in assets or are internationally active. Nearly all of the changes that Barr outlines would apply to banks with $100 billion or more in assets, and it is not clear that there would be any tailoring of the new requirements for banks above that size. In support of this approach, he points to the recent series of bank receiverships, including Silicon Valley Bank, Signature Bank, and First Republic, as evidence that banks of this size can threaten financial stability.

Barr’s proposed changes would cumulatively raise these banks’ risk-based capital requirements by 2 percentage points on average, requiring them to maintain an additional $2 of capital for every $100 of risk-weighted assets. If 2 percentage points is an average, then some large banks would see even greater increases. Barr estimates that banks would be able to build the requisite capital through retained earnings in less than two years, even while maintaining their dividends, “assuming [banks] continue to earn money at the same rate as in recent years.”

2 Barr’s recommendations will include applying the Basel III endgame package to banks with $100 billion or more in assets.

Barr notes that an important aspect of his proposals will be to implement the so-called Basel III “endgame” package – a series of changes to risk-based capital requirements finalized by the Basel Committee in December 2017 – for banking organizations with $100 billion or more in assets. While the federal banking agencies have long indicated their support for implementing these changes in the United States, they have not previously discussed the size threshold they intend to propose for the applicability of these changes.

The Basel III endgame package would include the following key changes to the capital rules for large banks:

- End the practice of banks using their own internal models for estimating credit risk and instead use a standardized approach.
- Adjust the way that a firm measures market risk (*e.g.*, interest rate, equity price, foreign exchange, and commodities risk) by requiring banks to use standardized models for certain market risks that "are too hard to model," and by requiring more capital to support market risk positions that are less liquid.
- Replace internal models for operational risk, such as risk from trading losses or litigation expenses, with a standardized measure.

Barr notes that any changes to implement the Basel III endgame package would not be fully effective for "some years" and that any final rule would provide for an appropriate transition period.

3 Barr will recommend eliminating the accumulated other comprehensive income ("AOCI") filter for banking organizations with $100 billion or more in assets.

Under current regulations, banks with $700 billion or more in assets or $75 billion or more in cross-jurisdictional activity are required to account for unrealized losses and gains on their available-for-sale securities portfolio when calculating regulatory capital, which creates volatility in their regulatory capital depending on the market value of their securities holdings, whereas smaller banks have been eligible to filter out AOCI. Barr would eliminate the AOCI filter for banks with $100 billion or more in assets. In support of this position, Barr notes that the run on Silicon Valley Bank was triggered in part because the bank had not been required to include such losses in its regulatory capital calculation.

4 Barr's proposals would subject large bank holding companies to a long-term debt requirement.

Also based on the outcome at Silicon Valley Bank, Barr will recommend requiring bank holding companies with $100 billion or more in assets to maintain minimum amounts of long-term debt in order to mitigate run risk and help reduce resolution costs in the event of failure.

While Barr's speech is short on details in this regard, under existing regulations U.S. global systemically important banking organizations ("G-SIBs") are required to issue a minimum amount of "plain vanilla" unsecured long-term debt at the holding company level, and, relatedly, maintain so-called "clean" holding companies that have no "runnable" liabilities. The purpose of these requirements is to provide, through structural subordination, for all losses to be imposed on the holding company's equity and long-term debt-holders, which cannot run, before they are imposed on the creditors of the holding company's material subsidiaries, including short-term creditors that *can* run. While this strategy is untested in practice, in the event of the insolvency or bankruptcy of the holding company, the structural subordination of the holding company equity and long-term debt is intended to allow material subsidiaries such as banks and broker-dealers to continue to operate with a substantially reduced risk of runs or disruptions in funding.

Qualifying long-term debt for U.S. G-SIBs must be unsecured, have a maturity of at least one year from the date of issuance, and be governed by U.S. law. Qualifying debt cannot be a structured note, have a credit-sensitive feature (such as an interest rate reset periodically based on the company's credit quality), include a contractual provision for conversion into or exchange for equity in the company, or provide the holder a contractual right to accelerate payment except in certain limited circumstances such as the company's insolvency or its failure to make payment on the instrument when due.

5 Barr will recommend adjusting the G-SIB surcharge; not finalizing a proposal to tailor the enhanced supplementary leverage ratio (“eSLR”); and not changing the countercyclical capital buffer framework (“CCyB”).

Barr would change the G-SIB surcharge that applies to the eight U.S. G-SIBs. The changes he will recommend include: a more graduated framework (measuring G-SIB surcharges in 10-basis point increments instead of the current 50-basis point increments); basing the indicators on average quarterly balances rather than year-end balances; and other unspecified changes to “make improvements to the measurement of some systemic indicators to better align them with risk.” Barr will not endorse eliminating the fixed coefficients of the G-SIB surcharge, which industry advocates have criticized for failing to take account of inflation.

Barr also will not recommend finalizing the 2018 proposal to tailor the eSLR, despite criticism that the eSLR, as currently calibrated, incentivizes banks to engage in more risky activity and reduce their intermediation in the Treasury markets. He notes that the Federal Reserve may consider adjustments in the future if there are any problems with Treasury market intermediation.

Barr will not recommend changing the framework of the CCyB, which has not been activated in the United States since its inception.

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6 The framework for stress testing may change in largely unspecified ways.

Barr’s speech indicates, without providing detail, that he is contemplating changes to the global market shock and operational risk components of the stress tests to “better capture the range of salient risks that banks face.”

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7 Additional changes to regulation and supervision are in the works.

Barr also notes that he will be pursuing further changes in the coming months to regulation and supervision in response to the recent banking stress, including how the Federal Reserve regulates and supervises liquidity, interest rate risk, and incentive compensation, and improving the “speed, agility and force” of the Federal Reserve’s supervision. Since these areas tend to be areas where the federal banking agencies act on an interagency basis, changes in the Federal Reserve’s approach to regulation and supervision likely would be taken up by the OCC and the FDIC as well.

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8 Barr’s recommendations could have sweeping impacts on the industry – impacts that would vary based on bank size.

While Barr’s recommended changes to capital standards would take several years to implement, their potential effects on the banking industry may be felt well before approval and implementation.

The changes Barr outlines would likely not directly impact banks with less than $100 billion in assets. But supervisory teams may informally require all banks, including those with total assets below $100 billion, to engage in certain liquidity or interest rate stress testing that aligns with regulatory changes for larger banks. If this were to occur, these proposed changes would indirectly impact banks below $100 billion in total assets.

For banks that are between $100 and $250 billion in total assets, or even for banks slightly below $100 billion in total assets, the changes that Barr will recommend could have a significant impact in many different ways, regardless of whether the proposed changes are implemented at a measured pace or not, particularly if the proposed changes are not tailored for institutions of different size categories as is currently the case for most enhanced prudential standards. As banks seek to meet additional capital needs that would result from increases in capital requirements, their cost of capital could, depending on the economic cycle, be significantly higher than banks have enjoyed in recent years. And banks in this asset size range may need to acquire new or additional technology and hire additional personnel and/or advisors to manage compliance with these proposed requirements, resulting in further costs.

The proposed changes could have a bifurcated effect on consolidation in the banking industry, which has been generally robust over the past 40 years or so. Banks that are over $100 billion in total assets but not yet subject to the most stringent capital requirements may seek to acquire or merge with a like-sized institution in order to achieve the necessary scale to absorb additional capital costs and expenses, assuming prevailing market and regulatory conditions permit such a transaction. These banks also may seek to sell themselves to a larger institution, though the pool of interested potential buyers will be more limited.

For banks below $100 billion in total assets, the costs of capital they would incur and the level of readiness they would need to cross the $100 billion total assets threshold will be significantly elevated. As a result, it is likely that banks looking to cross the $100 billion total assets threshold through consolidation will be more selective in the types of transactions in which they are willing to engage to cross the threshold. These institutions are also likely to be more sensitive to the timing of such transactions vis-à-vis their willingness and readiness to absorb the costs of crossing the threshold.

Should you have questions regarding the content of this alert, please contact the members of Covington's Financial Services practice.

Randy Benjenk	+1 202 662 5041	rbenjenk@cov.com
Michael Nonaka	+1 202 662 5727	mnonaka@cov.com
Michael Reed	+1 212 841 1294	mreed@cov.com
Karen Solomon	+1 202 662 5489	ksolomon@cov.com
Janie Faulkner	+1 202 662 5757	jfaulkner@cov.com