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Statement by Governor Michelle W. Bowman
At the Board Meeting considering proposed rules to implement the Basel III endgame agreement for large banks and adjustments to the surcharge for U.S. global systemically important banks

I appreciate the staff's hard work in preparing the proposals and presentation for the Board today. Considering these matters in an open Board meeting supports transparency and accountability to the public and provides greater context for these policy proposals.

Risk-Based Capital Standards

The first proposal under consideration would substantially increase risk-based capital requirements for banks with more than $100 billion in assets. In my view, there is insufficient evidence that the benefits produced by this proposal would justify the costs. The proposed revisions under consideration have not been directed by Congress and are not compelled by a new evolution or identified weakness in the U.S. banking system. Although this proposal is intended to implement the Basel III agreement, in light of the many deviations from internationally agreed standards it is not clear that today's proposal would improve international consistency in capital requirements for large, internationally active banks.

Today, the U.S. banking system remains strong and resilient. The system is much better capitalized than after the 2008 financial crisis, with substantially more liquidity. And U.S. banks are subject to a range of new supervisory tools that did not exist prior to 2008. The current framework represents a risk-based, tailored approach, with the goal of aligning regulation with risk. To be very clear, I am open to considering proposals to improve capital regulation, particularly evidence-based proposals that would address known deficiencies and shortcomings. When the Board is considering changes to the capital framework, particularly significant increases in capital, we must carefully weigh the trade-offs of increased safety from higher capital levels, and the costs to banks, consumers, businesses, and the broader economy. We must also factor in the broader regulatory landscape, and how changes to capital regulations may complement, overlap, or conflict with other regulatory requirements.

Departure from a Tailored, Risk-Based Approach

A core strength of our current bank regulatory framework is risk-based, tailored regulation. Today's proposal represents a reversal of this longstanding approach. In my view, the proposal fails to sufficiently take into account differences in capital structure, riskiness, complexity, financial activities, size, and other risk-related factors among firms with more than $100 billion in assets, and instead reverts to a one-size-fits-all approach.[1] Although it is currently unclear and unsettled what other changes may be proposed to the regulatory capital framework, or more broadly to other prudential regulations, I am concerned that pushing down capital and other standards designed for larger banks to those that are significantly smaller and less complex could lead to harmful, unintended consequences. I am also concerned that today's proposal moves one step closer to eliminating the tailoring required by S. 2155 from the prudential capital framework.[2] The consequences of increasing capital requirements for all firms above $100 billion in assets may be to force smaller firms to merge or consolidate, to achieve the necessary economies of scale to comply with higher capital requirements. Ultimately, this may have harmful effects on competition, and may reduce banking options in some geographic or product markets.

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[1] See 12 U.S.C. § 5365(a)(2)(C).

[2] Economic Growth, Regulatory Relief, and Consumer Protection Act, Pub. L. No. 115-174, 132 Stat. 1296 (2018).

Costs of the Proposal

Today's capital proposal could give the impression that undercapitalization of large banks is a major vulnerability in the U.S. banking system, or that higher capital levels would have addressed the management and supervisory shortcomings that contributed to the recent bank failures earlier this year. I do not see evidence to support these views. The current level of capital in the U.S. banking system is a strength, not a weakness, and is complemented by liquidity regulations and other prudential requirements that have contributed to the resilience of U.S. banks.

While there is more to learn about the recent bank failures, it seems apparent that these failures were caused primarily by poor risk management and deficient supervision, not by a lack of capital. I am concerned that today's proposed rule, and other yet to be proposed regulatory changes, will add to the challenges facing the U.S. banking system, and impose real costs on banks, their customers, and the economy without commensurate benefits to safety and soundness or financial stability.

The costs of this proposal, if implemented in its current form, would be substantial. As the proposal describes, these changes are estimated to result in an aggregate 20 percent increase in total risk-weighted assets across bank holding companies subject to the rule. While the actual impact on binding capital requirements will vary by firm, it is apparent even with the incomplete information available today that this will represent a large increase in capital requirements.

These increases will have a tangible effect on banking activities and may have a detrimental impact on U.S. market liquidity and lending. Today's proposal argues that the increase in capital requirements for trading activities could enhance market liquidity, especially during times of stress. I am interested to hear from the public whether this would be the case. I am concerned that claims of this nature fail to appreciate the predictable effects of the proposal: higher costs, less availability, and increased concentration as firms without sufficient scale exit certain markets. Increased capital requirements for certain types of loans may also lead to a reduction in credit availability or increased prices, which could disproportionately harm underserved markets, businesses, and communities. Ultimately, bank customers will bear the cost of these capital requirement increases.

Today's proposal also adopts a punitive treatment for noninterest and fee-based income through the proposed operational risk requirements, exacerbated by the use of an internal loss multiplier that may result in an excessive overall capital charge for operational risk. Diversification in revenue streams can enhance the stability and resilience of a bank, and excessive capital charges for these revenue-generating activities could create incentives for banks to roll back the progress they have made to diversify revenues. The treatment of operational risk also seems like an inefficient tool to address a broad supervisory concern. The proposal suggests that calibrating operational risk requirements based on historical losses creates incentives for bank management to mitigate operational risk.

However, capital charges are an indirect and inefficient tool to encourage strong risk management, particularly in the area of operational risk. I would appreciate hearing from the public on this issue, but in my mind, it would be preferable to address risk management concerns through improved supervision, demanding prompt remediation of risk management shortcomings, and taking enforcement actions when firms fail to remediate known issues.

Rather than considering piecemeal changes to risk-based capital rules, in my view, regulators should review the entirety of these rules, and where possible, find ways to rationalize requirements. This is also an area that would be helpful to solicit comments from the public.

Today's proposal is intended to improve risk capture, but in some circumstances, leaves in place and even introduces new regulatory redundancies, as with changes to the market risk capital rule, credit valuation adjustments, and operational risk that overlap with stress testing requirements and the stress capital buffer. It is not clear whether or when we will revisit the broader set of capital rules to address redundancy and overlap, but doing so could significantly improve the efficiency of the capital framework.

Changes to the GSIB Surcharge

The second proposal under consideration today would revise the GSIB surcharge, proposing changes that are informed by experience with the operation of the rule. Some of the proposed changes, like measuring GSIB surcharges in 10 basis point increments as opposed to 50, could helpfully reduce cliff effects within the current rule. In some instances, such as the daily measurement of certain systemic indicators, it may be that there are less burdensome alternatives, like weekly or monthly measurement, that we should explore. I think it is important that we understand how the GSIB surcharge may overlap with other capital requirements and evaluate whether the end-state aggregate capital level for GSIBs is appropriate. This review should also consider the impact of the GSIB surcharge method two calculation, and whether it may discourage low-risk activities or result in other unintended consequences, or whether the calculation methodology should be updated periodically to reflect economic growth and inflation. In my view, the only way to address this question is through a more comprehensive and granular understanding of all proposed capital changes. I support publishing the proposed revisions to the GSIB surcharge for comment and believe that we should be receptive to making improvements in response to public feedback. We should also consider how the implementation of the US GSIB surcharge aligns with other jurisdictions.

Closing

In conclusion, we should continue to pursue the goal of creating a level international playing field. Many of the largest and most systemic banks operate internationally, and promoting international parity in capital standards applicable to global banks with international operations could help make the global financial system more resilient and competitive. Today's proposal deviates significantly from international standards and perpetuates differences in implementation across international jurisdictions. Ultimately these differences call into question whether the international standards are appropriate.

I look forward to reviewing public feedback on both proposals. And I would again like to thank the staff for their work on the proposals and for today's presentation. My remarks today and an addendum requesting comment from the public on specific provisions from the Basel III proposal are included as a public statement for the record for today's Board meeting.

Addendum

I strongly encourage broad public review and comment on the Basel III and GSIB Surcharge proposals from today's Board Meeting. I look forward to receiving and reviewing these comments, and invite comments on the matters discussed below.

Calibration of Aggregate Capital Requirements

Today's Basel III proposal represents a significant aggregate increase in capital requirements for firms with more than $100 billion in assets. But it does not explain how these changes fit within the existing regulatory framework, or provide sufficient context about the adequate level of capital requirements as an end-state. Both are critical questions that would benefit from public input, particularly in evaluating the potential impact on different products and services, and how those impacts may affect businesses, consumers, and the broader economy.

When implementing regulatory reforms, particularly capital reforms, U.S. regulators have long adopted "gold-plating," setting regulatory requirements above levels of international agreement established in foreign jurisdictions. Much of this gold-plating occurred while the full set of prudential regulations including capital and liquidity rules were still under development. To some degree, the lack of a complete framework provided additional support for the conservatism inherent in these standards. But with the proposed implementation of final Basel III capital reforms, we should also revisit whether the aggregate amount of capital is appropriate. Focusing on a standalone capital element like the new risk-based standards could discourage further discussion or analysis of the appropriate, aggregate end-state.

Two Standardized Capital Stacks

Under the proposal, firms subject to the new risk-based capital rule would remain subject to the standardized approach applicable to all firms, resulting in a "dual-stack" capital calculation, with the firm required to use the lower capital ratio. In my view, this approach is unnecessarily burdensome.

The burdens of this approach may be more pronounced for smaller firms subject to the proposal. Subjecting category 3 and 4 firms to two risk-based capital requirements does not seem commensurate with their risk, size, business models and complexity, and could result in costs that outweigh the benefits. What added clarity and benefit would be provided by this approach? What operational challenges and compliance costs would result from implementation of this requirement?

It would be preferable to calibrate the new requirement to be capital neutral, and perhaps to apply the new requirement to a smaller set of firms than proposed under the regulations, excluding firms at the smaller end of the size spectrum. We should consider whether the dual-stack structure and the inclusion of category three and four firms are necessary.

Process

As a threshold matter, I am pleased that the agencies issued today's capital proposal with a reasonable comment period, which will extend through November 30, 2023. While the proposal is long and complex, I am hopeful that a longer comment period will better allow the public to review the proposal and provide meaningful feedback.

The comment period is only the first step. We need to be humble and willing to make adjustments—even material ones—to address identified concerns. Capital requirements could have a meaningful effect on consumers, businesses, and the economy, so it is important that we make the best-informed capital framework calibration and design choices possible. To the extent the public comment process brings to light significant areas of concern, we should be willing to issue a new, revised proposal, if necessary, to address those concerns. Not only is the process of notice-and-comment rulemaking legally required, but it can also produce better results if regulators are open to feedback.

The agencies also should not give preferential treatment to any set of commenters or concerns, but instead should consider each comment and substantive issue raised based on its merit. The proposal considered by the Board today reflects a few last-minute revisions, circulated less than a week before today's public Board meeting, that are apparently intended to address policy concerns raised by some stakeholders late in the process. While these concerns may have merit and be worth addressing during the rulemaking process, if the agencies wished to take into account public feedback prior to issuing a proposal for comment it would have been more appropriate to publish an advanced notice of proposed rulemaking and give all commenters an equal opportunity to influence the design of the proposal.

Finally, the proposal would rely on a phase-in period to temper the more extreme impacts of the significant capital increases contemplated. While I support reasonable transition periods for new rules, we know that firms move quickly to implement new regulatory requirements, including capital requirements. As a result, I take little comfort that transition periods will help mitigate the significant effects of the proposed revisions and I believe a better approach would be a more holistic analysis and recalibration of all of our capital regulations.

Other Areas of Concern

Capital Markets Activities

The proposed revisions would disproportionately affect capital markets activities, with significant consequences for customers and end-users. The estimated proportional increase in aggregate capital levels, which for some firms will exceed 20%, is dwarfed by the proportional increase in capital for trading activities. As noted in the proposal, the revisions to the market risk rule alone will 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.[1] The magnitude of these increases is startling. We must consider whether this increase—combined with all of the capital and other prudential requirements that address the risks of these activities—is justified by the underlying risks of these activities.

The United States has deep debt and equity markets and supports businesses with a wide range of other products and services, including risk-management tools. These products and services are central for business financing and risk management and contribute to an efficient economy. Those who rely on these products and services will bear the cost of capital increases. For example, when a local government issues municipal bonds to finance local infrastructure, they may find that financing is more expensive, or in some cases unavailable. Manufacturers may find it harder to get loans to invest in equipment or facilities. Companies that operate on the international stage may find it more challenging to hedge their foreign exchange risks. Businesses may find it difficult to manage their interest rate risk exposures, or manage the risks of fluctuating commodity prices.

We should be cautious about the disruption that capital increases could cause and look critically at whether these increases are justified by risks. And we should ask whether there are more efficient alternatives—like improved supervision—that could address some of the same underlying concerns.

Improving Recognition of Credit Risk Transfers

The proposal today includes a number of revisions intended to better capture risk transfers, including internal credit risk transfers from a bank to a trading desk to hedge credit risk arising from the bank's exposures. Among banks that engage in this activity, it is common bank practice to use other vehicles for credit risk transfer to manage credit risk, and many of these will continue to be excluded for risk hedging under today's proposal. In my view, capital rules should give greater recognition to bona fide transfers of risk that achieve the same economic outcome as a permitted risk transfer under the rules. Elevating the form of a risk transfer over substance is contrary to the proposal's stated goal of improving risk capture.

Leverage Ratio Requirements

We should also take this opportunity to address known shortcomings in leverage requirements, including the enhanced supplementary leverage ratio (eSLR). In stressed conditions during the pandemic, the operation of the eSLR disrupted Treasury market intermediation, and required ad hoc, short-term changes to address these unintended consequences and to give banks more flexibility to engage in lending.[3] I supported the unanimous decision of the Board to make those adjustments during stress. However, we should not wait until the next period of stress to reform leverage rules that we know may disrupt market functioning.

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[3] Federal Reserve System, Interim Final Rule "Temporary Exclusion of U.S. Treasury Securities and Deposits at Federal Reserve Banks From the Supplementary Leverage Ratio" 85 Fed. Reg. 20578 (April 14, 2020).