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Statement on Large Bank Capital Requirement Proposals
by Governor Christopher J. Waller

I want to thank the staff who worked on the proposals and made the presentation today.

I agree that a well-capitalized banking system is critical to the resilience of our financial system, but increases in capital requirements are not free. As such, we must ensure the resiliency benefits from increases in capital requirements outweigh the costs to bank customers and to the real economy. And we must recognize that, at some point, well-intended actions to improve financial resiliency can undermine the indispensable role banks play in providing financial intermediation. In my view, the Basel III proposal crosses that line. I am concerned that today's Basel III proposal will increase the cost of credit and impede market functioning without clear benefits to the resiliency of the financial system.

As an economic policymaker, I always ask, "What problem is solved from this proposal? What are the benefits of the proposal?" If the answer is improved resiliency, then I want to know why the current capital framework does not provide an adequate level of resiliency. What empirical evidence shows that the current level of resilience is insufficient, particularly for the U.S. G-SIBs? Will increasing requirements for those banks indeed improve the resiliency of the entire financial system? Or will it just narrow the banking system and push more activities to the unregulated nonbank sector?

We have put in place what is referred to as a "gold-plated" capital structure for the largest banks and more than a decade of stress tests and real-world events have shown that these banks are resilient to very large macroeconomic shocks. Over the past decade, we have both increased

the quality of regulatory capital to make it more loss absorbing and increased the quantity required to be held through the adoption of the G-SIB surcharge, stress capital buffer, and supplementary leverage ratio. These reforms have resulted in a doubling of loss absorbing capital at the largest banks, which has significantly bolstered their ability to weather material stresses. For example, the U.S. G-SIBs, which are subject to the most rigorous parts of our current regulatory capital framework, were a source of strength during the pandemic.[1] More recently, during the regional banking stress earlier this year when depositor confidence was fractured, those banks actually experienced deposit inflows. As a result, I am led to ask, "What are the glaring failures in the current capital framework for U.S. G-SIBs that require the proposed changes?"

The proposal would materially increase requirements for the largest banks. In total, staff estimate the proposal would require all large banks to increase capital by 16 percent. That would be in large part driven by an increase in the capital required for operational and market risks—risks that we have already been capturing in our stress testing for the past decade.

Just to put some numbers on it, consider operational risk. Operational risk expense projections in the stress test have been just under $200 billion over the past few years.[2] The impact analysis in the proposal suggests the enhanced standardized capital stack will have operational risk weighted assets that are nearly $2 trillion higher than in the current U.S. standardized stack, which could lead to a more than doubling of the operational risk capital required relative to just the stress test-based requirement.

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[1] Randal Quarles, "What Happened? What Have We Learned From It? Lessons from COVID-19 Stress on the Financial System" (speech at the Institute of International Finance, Washington, D.C., October 15, 2020), https://www.federalreserve.gov/newsevents/speech/quarles20201015a.htm.

[2] For example, in the 2022 supervisory stress test, which included the full set of 33 banks, operational risk losses were $188 billion; see https://www.federalreserve.gov/publications/files/2022-dfast-results-20220623.pdf.

More importantly, there is no discussion on why operational risk capital needs to be an additional charge as opposed to just using the existing capital stack to absorb operational losses. Having an additional layer of operational risk capital would make sense if large operational risk losses tend to occur contemporaneously with credit and market losses. But there is little evidence of that. For example, some of the largest operational risk expenses U.S. banks have incurred were those owing to fines and lawsuits associated with mortgage underwriting and securitization leading up to the 2008–09 financial crisis. But banks didn't incur those losses until years after the financial crisis because it takes time to recognize fiduciary failings, bring forward legal claims, and adjudicate those claims. That is typical for these sorts of losses, which often stem from litigation. An important question, therefore, is why do banks need to sideline separate buckets of operational risk, credit risk, and market risk capital when those risks are unlikely to manifest at the same time? It is similar to asking individuals to establish separate emergency funds for shocks to their income, such as losing their job, and shocks to their expenses, like a fire in their house or their car breaking down. Households understand it is exceedingly unlikely that they will experience a month where all these shocks hit simultaneously, so their emergency funds are less than the sum of those individual expected expenses.

Though the changes to the market risk weight framework affect fewer banks, they will likely be material for those banks and capture certain risks already accounted for in the stress test. For example, the proposal would replace the existing market risk measure with a new one that is intended to better account for extreme losses. Similarly, the market shock component of the stress test is designed, in part, to mimic the effects of a sudden market dislocation.[3] And the market shock in the stress test is meaningful in terms of requirements. For example, in the 2023

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[3] See the "Policy Statement on the Scenario Design Framework for Stress Testing" (12 C.F.R. pt. 252, appendix A)

stress test, it contributed to $94 billion in losses for the largest firms and those losses result in higher stress capital buffers.[4] It is not clear to me why our large banks should face a further roughly 70 percent hike in market risk capital requirements, on top of the existing post-crisis requirements to address risks in the trading book, including market risk capital requirements plus the stress test. And I worry that doing so could discourage those banks from engaging in certain market making activities, which could impede market functioning.

So what else might we be trying to achieve with this proposal? One goal of the Basel III endgame agreement was to standardize risk assessment and not rely on internal bank models in the regulatory capital framework. But that goal had already been largely achieved in the United States through enhancements to the standardized approach, including the addition of the stress capital buffer, which resulted in an existing standardized capital requirement that is generally more binding than the requirement determined by the firms' own models.

Another goal of Basel agreements generally is to harmonize requirements around the world. Unfortunately, this proposal does the opposite. In the United States, we have already gold-plated our regulatory capital regime relative to other parts of the world with the stress capital buffer and a more stringent G-SIB surcharge. If the Basel standards are implemented in other parts of the world in a less stringent way than envisioned in this proposal, U.S. banks would be put at a disadvantage relative to international banks. For all the talk of harmonizing regulations, I'm afraid this proposal may do the opposite.

Up to this point, I've been focused on how the proposal would affect the resiliency of U.S. banks. But there is not a one-to-one relationship between bank resiliency and financial system resiliency. Even if we were to further increase our requirements, are we sure it would

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[4] See the 2023 supervisory stress test results at https://www.federalreserve.gov/publications/files/2023-dfast-results-20230628.pdf.

actually improve the resiliency of the financial system and health of the U.S. economy? There is an upper limit, of course, where costs outweigh the benefits.

An increase in capital requirements forces banks to hold more capital against the services they provide to families and businesses, which is equivalent to imposing a tax on those services. Someone must bear the cost of that tax; the only question is who will bear it. One possibility is that banks will absorb the cost themselves. Another possibility is that banks will attempt to mitigate those profit reductions by passing the cost of higher capital requirements along to their customers. This will raise costs for American families and businesses, which could harm many of them and hinder economic growth. Banks may also simply stop providing more capital-intensive services, which could impede market functioning. It is possible some of those services could migrate outside of the banking system to less regulated entities that can provide them. But as we saw during the pandemic, a lot of problems can emerge from nonbanks that operate outside of our view. That is why I believe a safe but needlessly narrow *banking* system doesn't necessarily result in a safe *financial* system and vibrant economy.

Finally, as this proposal applies to all firms with more than $100 billion in assets, I am concerned that we are headed down a road where we would be no longer in compliance with section 165 of the Dodd-Frank Act, as amended by the Economic Growth, Regulatory Relief, and Consumer Protection Act, which mandates tailoring for firms above $100 billion in assets and provides that firms with between $100 billion and $250 billion in assets are not subject to enhanced prudential standards unless a standard is affirmatively applied to such firms based on specific factors set out by Congress. It is unclear to me whether this proposal meets that statutory bar.

Again, I appreciate the work that staff has done on this Basel III proposal, but I am not convinced that it improves the resiliency of the financial system. At the same time, it will increase costs for families and businesses and could impede market functioning. I don't think those costs are worth bearing without clear benefits to the resiliency of the financial system. For that reason, I cannot vote for it.

I am in favor of the proposed calculation changes to make the G-SIB surcharge more risk sensitive and reduce cliff effects. I note, however, there has not been a broader comprehensive assessment of the calibration of the G-SIB surcharge since it was established in 2015 and I believe we should undertake such an assessment, with changes as appropriate.