Capital and the U.S. Economy

Capital is an important tool to ensure banks are able to withstand losses and continue to support the economy. But higher requirements would have very real impacts, leading to increased costs and reduced availability for credit to consumers and businesses while harming the competitiveness of the U.S. economy.

What is capital?

Capital is the difference between the value of a financial institution's assets and its liabilities. It acts as a financial cushion to absorb losses.

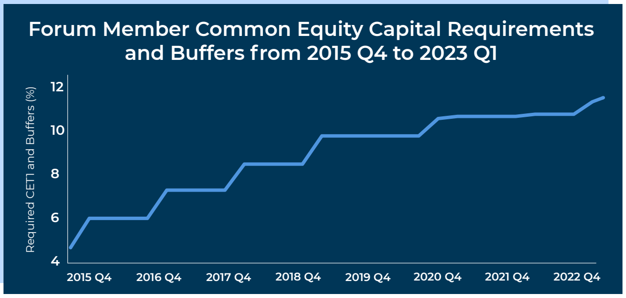
To illustrate this concept, a family's assets include money in its checking and/or savings accounts as well as their home and perhaps other investments. Liabilities include what the family owes, such as a mortgage or a car loan. As a family manages its finances, it generally is more financially secure and stable when the value of all of its assets exceeds the value of the debt it carries to finance those assets.

Capital is one part of a bank's requirements that ensure it does not pose a financial stability risk. The largest U.S. banks are held to the highest standards, adhering to liquidity, leverage, supervision, resolution planning and other requirements.

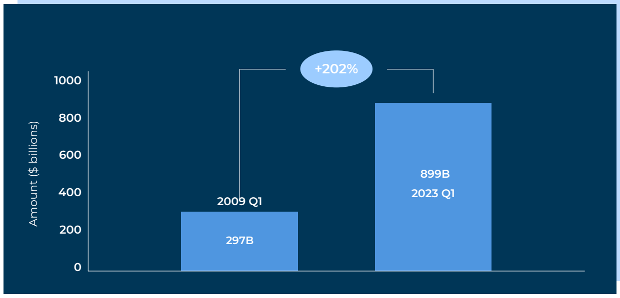
Source of Strength

In concert with regulators, the largest U.S. banks in the post-Dodd-Frank era have greatly increased both the quality and quantity of their capital over the past two decades. Capital at these banks has more than tripled since 2007 and requirements have continued to rise.

The 8 U.S.-based Global Systemically Important Banks, or GSIBs, have acted as a source of strength during the COVID-19 pandemic and the banking turmoil of 2023, facilitating credit to small and large businesses and providing billions in deposits to First Republic Bank to help stem contagion within the banking industry.

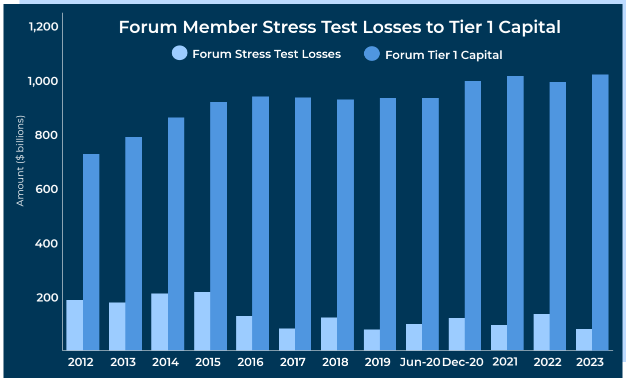


Capital Requirements Increasing



Capital at Largest Banks Has More Than Tripled

The largest banks in the country undergo stress tests at least once a year that measure their ability to absorb losses and continue to support the economy during a severe economic downturn. The Federal Reserve uses a hypothetical economic loss scenario substantially worse than the 2008 financial crisis. While the theoretical losses to banks in the tests are significant, they are consistently a fraction of the capital maintained by Forum member banks. From 2012 to 2023, the average amount of estimated stress test losses was $132 billion compared to an average of $915 billion in Tier 1 capital maintained by Forum member banks, the equivalent of 14 percent.



Fed's Stress Tests Show Banks' Resiliency

"Large banks are well positioned to weather a severe recession and continue to lend to households and businesses even during a severe recession."

Federal Reserve Board Press Release , June 2023

The proposal

Despite the demonstrated strength of the largest banks, the Federal Reserve, Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency, on split votes, issued a proposal in July to increase capital requirements. This proposal is directly based on a revised capital framework known as Basel 3 Endgame, or Basel 3 Finalization, that was agreed to by a group of global bank regulators, known as the Basel Committee on Banking Supervision in 2017. While it will take some time to review the 1,087-page proposal, it is expected to increase required capital by approximately 20 percent for the largest banks, with significant impacts on the economy.

Impact on Households, Businesses, and Economy

The impact of higher capital requirements is expected to be broad based:

Savers: Americans saving for retirement and investors in college funds and other long-term savings will likely see increased costs and reduced returns as investment companies such as those offering mutual funds and pension plans are expected to face higher borrowing costs based on the new requirements.

Small and mid-size businesses: Smaller business owners would likely pay higher interest rates for loans and potentially see reduced opportunities to borrow based on the way the proposal requires banks to use more of their capital for lending to nonpublic companies.

Other companies and their customers: Pension funds, insurance companies, and other businesses, such as airlines, retailers, and energy companies, are expected to experience higher costs and reduced availability when seeking to obtain hedges, which are important to keeping costs low and predictable. Such higher costs could get passed along to consumers.

Farmers and consumers: Farmers also use hedging in their operations and will also face higher costs and fewer options. These higher costs likely will be passed along to consumers.

Governments and taxpayers: States and local governments are expected to face higher costs when issuing municipal securities, which are used to fund government projects such as the building and upkeep of roads, schools, and other services. The increase in these costs will likely be passed along to taxpayers.

Mortgage borrowers: Households seeking to obtain a mortgage, particularly first-time homebuyers with smaller downpayments, would face challenges obtaining a mortgage and would also likely see higher costs.

Auto loan customers: Auto loan customers will continue to see added costs and reduced availability due to the U.S. approach of assigning higher capital requirements for these loans than that agreed to internationally.

"Such a significant increase in capital standards will lead to reduced credit availability for all types of lending and undermine economic growth. If these standards are adopted, they will have a devastating impact on our efforts to increase Black homeownership and disadvantage all first-time, and, in particular, first-generation homebuyers."

NAACP, National Urban League, National Housing Conference, Mortgage Bankers Association, National Association of REALTORS, July 2023

Community development programs:

Investments that benefit communities - including those in green energy projects, Minority Depository Institutions, and early-stage, innovative companies - would face a more difficult time obtaining funding due to proposed changes in the way banks must use their capital to support these investments.

Other Impacts

There are two other important ways the proposed rule would harm the U.S. economy if implemented:

U.S. Competitiveness: Although the United States actively participates in the Basel agreements, U.S. banking regulators have required even more capital than they agree to in international negotiations. This has led to a significant disparity in capital standards, and U.S. regulators appear to be doing the same this time around. That means U.S. banks and their customers will be at an even larger disadvantage than their overseas competitors.

Migration of Financial Services: There has already been a significant migration of financial activity outside of the banking sector to less regulated financial companies, or shadow banks. According to the Federal Reserve, two-thirds of loans are already originated outside of the regulated banking sector. Nonbank companies are not subject to the same bank capital and liquidity rules. When the cost of working with a bank is higher or when it becomes more difficult to obtain a loan from a bank, customers are likely to seek alternative sources of credit. But the risk does not leave the financial system. Instead, it is simply transferred to a less-monitored and less-regulated sector.

"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."

Federal Reserve Governor Christopher Waller, July 2023

For specific questions on the capital proposal, please contact **capital@fsforum.com**.

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