

Capital Requirements for the Largest U.S. Banks – Separating Fact from Fiction

Dispelling Twelve Myths

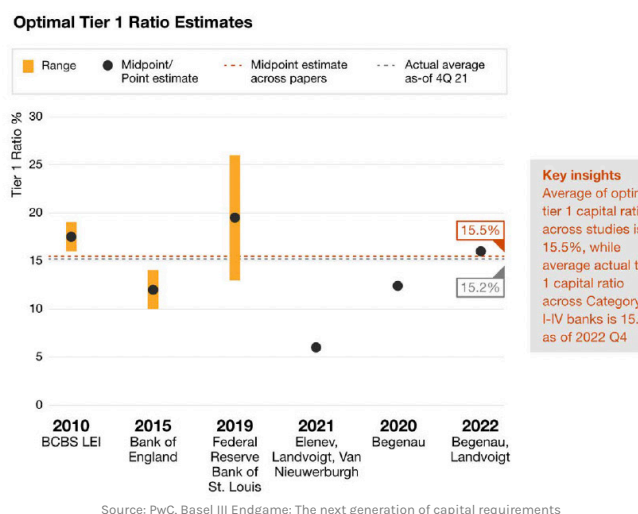
In 2023, U.S. regulators issued a proposal to implement an international accord, known as Basel III Endgame, that would significantly raise requirements for the largest U.S. banks. As the conversation around this proposal continues, it is important that everyone understand the facts.

Myth #1: The largest U.S. banks need more capital.

Fact: The largest banks are already highly capitalized and policymakers have regularly attested to their strength and resiliency.

Policymakers across the political spectrum have stated repeatedly that the nation’s largest banks are well capitalized and have been a source of strength during times of economic and financial disruption, including during the pandemic and the regional banking issues last year.

The Federal Reserve in its annual stress test [assessment last year](#) underscored this strength and resiliency, “Large banks are well positioned to weather a severe recession and continue to lend to households and businesses even during a severe recession.” Further, consulting firm PwC [found](#) the capital levels of the largest U.S. banks were in line with academic research on optimal capital.



Myth #2: Large banks are trying to weaken capital requirements.

Fact: 86% of public comment letters opposed to the Basel III Endgame proposal were from organizations and individuals outside the banking industry.

According to a recent Latham & Watkins [analysis](#), of the 356 comment letters submitted – 97% of the letters (347) were opposed to the rulemaking with the majority of the comment letters coming from outside the banking sector. Outside opposition came from a diverse array of stakeholders, including public and private pension funds, retirement accounts, mutual funds, asset managers, manufacturers, the energy sector, agricultural interests, small businesses, medium and large corporations, real estate companies and mortgage stakeholders, market infrastructure providers, exchanges and insurers, and academics. A substantial number of individuals, including members of civil rights organizations, also voiced their opposition.

Myth #3: Higher capital requirements on the largest U.S. banks will not impact the economy.

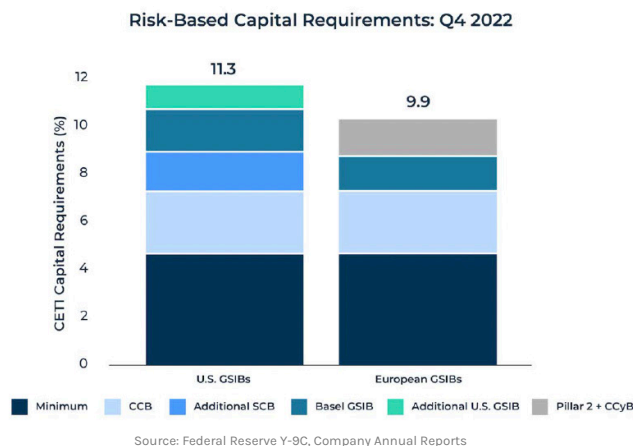
Fact: Capital is connected to activity throughout the economy.

Hundreds of stakeholders and policymakers across the political spectrum have clearly stated higher capital requirements will make financing more expensive and raise costs for businesses of all sizes and for consumers. Academic analysis from PwC confirms this. A broad array of industries and their customers would face higher costs or reduced access to financing, including large, midsize and small businesses, farmers, manufacturing firms, energy providers, pension funds, and local governments. For example, the American Public Gas Association stated in its [comment letter](#) that the proposed rule would “burden consumers with higher utility bills due to the costs of upstream regulatory compliance obligations.”

Federal Reserve Chair Jerome Powell has also acknowledged that the proposed rule would negatively impact credit availability, [testifying in 2023](#), “It’s always a balance” and “you will at the margin provide less credit, the more capital you have to have.”

Higher capital requirements would also increase financial risk by pushing activity outside of the regulated banking sector, former Federal Reserve governor Randall Kroszner said in an [op-ed](#) in the American Banker in February. “Since the Global Financial Crisis, I and others have expressed significant concerns about migration of bank activity to the non-banks,” said Kroszner, currently the Norman R. Bobins Professor of Economics at the University of Chicago Booth School of Business. “As I describe in a recently published [paper](#), I am concerned that a proposal from the U.S. banking regulatory agencies called the Basel III Endgame will accelerate this migration to non-banks that face less, if any, regulation and supervision.”

In addition, increased capital requirements would harm the competitiveness of the U.S. economy, raising the cost of borrowing for U.S. companies as they compete overseas. U.S. banks already face higher [requirements](#) than foreign competitors and other jurisdictions have proposed requirements far less than that proposed by the U.S. regulators.



Myth #4: Raising bank capital is not costly because a “long transition period” will be provided to blunt the costs of complying with the higher requirements.

Fact: Costs are nearly instantaneous despite government transition periods.

Financial market participants respond as soon as regulatory changes are announced, irrespective of government transition periods. As a result, banks act to come into compliance with these new rules in a matter of months. The costs, therefore, are borne in full shortly after being announced.

Research from the Federal Reserve documents that in the case of the implementation of Basel III, banks began to increase their capital ratios “prior to the publication of the specific language applicable to US banks.” Additionally, “The bank responses we estimate take place well before the Basel III rules started to come into force....”

Myth #5: The Basel III Endgame proposal mainly impacts trading activities conducted by the largest banks.

Fact: New and higher capital requirements will impact a broad range of functions at the largest banks.

Basel III Endgame would impact a wide array of bank financing activities as it includes significant changes across the entire capital framework. In fact, the largest increase in the proposal requires that more capital be held against operational risk, which is applied across the entirety of a bank's balance sheet. Comment letters and academic analyses reflect significant concerns that the proposal would raise costs and reduce availability of a range of bank activities. Former Governor of the Federal Reserve Board Randall Kroszner expressed in a recently published white paper that higher capital requirements would increase banks' funding costs not only for trading activities but for credit provision, lending, and other financial services.

Policymakers in both parties have also expressed concerns with the proposal's changes. For example, 59 Democratic members of Congress signed a letter in opposition to the new charges for operational risk and a House Financial Services Committee bipartisan letter voiced concern with the "cumulative consequences of the proposed capital rule on capital markets" among other key activities like "underwriting, derivative hedging, securitization."

Myth #6: Large banks only serve large corporations.

Fact: The nation's largest banks hold roughly \$105 billion in small business loans, invest in CDFIs and MDIs, and meet more than half of the bank funding needs of other financial institutions.

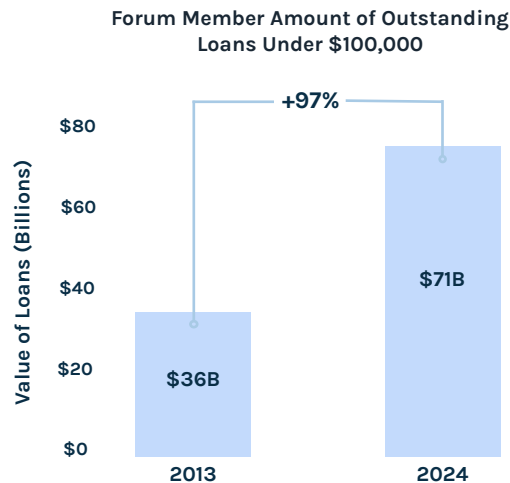
Forum members – the eight U.S.-based Global Systemically Important Banks – reach small and mid-size businesses across the country and in all industry segments. They hold roughly \$105 billion in small business loans, representing roughly one-third of all small business loans made by banks.

Throughout the pandemic, Forum members facilitated \$94 billion in loans to nearly 1.25 million small businesses through the government Paycheck Protection Program (PPP). More than a quarter of these loans were made in low-to-moderate-income communities and 91 percent of the PPP loans made by Forum members went to businesses with 20 or fewer employees.

Nicole Elam, president of the National Bankers Association, which represents minority owned banks, noted in a comment letter how the largest banks support banks that serve historically underserved communities:

"U.S. GSIBs have invested more than \$9.5 billion in MDIs and CDFIs and provide technical assistance and employee training to maximize the important reach MDIs and CDFIs have into underserved communities. The MDIs that receive investments from larger banks, which are subject to the proposed capital increases, directly support economic activity and growth in the communities that they serve. As we encourage banks to do more to address challenges in their local communities, including closing the racial wealth gap and responding adequately to climate change, it is important that prudential regulations are consistent with those policy goals." whether large banks could have weathered an additional \$300 billion in COVID related losses he responded "which they would have met. Which they would have been able to absorb without difficulty."

Moreover, U.S. GSIBs meet more than half of the bank funding needs of other financial institutions. This supports the ability of institutions such as community banks, insurance companies, and mortgage finance companies to provide important services to businesses and households.



Source: FDIC Call Report data, available at <https://cdr.ffiec.gov/public/>

Myth #7: The pandemic was not a true “stress test” due to extraordinary government actions that were taken to reduce the economic fallout.

Fact: Large banks easily absorbed heightened losses during the pandemic and could have easily absorbed losses that were multiples of those experienced.

Banks have consistently shown they hold ample capital when subjected to annual stress tests performed by the Fed, which assume no government support. In fact, the eight U.S.-based GSIBs maintain capital far in excess of the losses projected by the Fed’s stress tests. Again, these tests, including the second test conducted by the Fed in 2020, assumed no government support during a severe recession.

When asked during congressional testimony if large banks could have weathered an additional \$300 billion in COVID-related losses, Federal Reserve Chair Jay Powell said, “they would have been able to absorb (that amount) without difficulty.”

Myth #8: Basel III Endgame must result in significantly higher capital requirements.

Fact: Higher capital requirements were explicitly not a goal of the Basel Committee when it approved the Basel III Endgame standard and other jurisdictions are avoiding significant increases in capital.

Then Federal Reserve Chair Janet Yellen said when the international agreement for Basel III Endgame was concluded in 2017, “Our banking organizations are operating with very high capital standards, and this is mainly a matter of ensuring that other countries put into place appropriate capital regulation so that we have a level playing field.”

This was reinforced by the then head of the Basel Committee on Banking Supervision, who said Basel III Endgame are “reforms related to reducing excessive variability in risk-weighted assets” and are not designed to increase capital levels.

Official representatives of other jurisdictions have also made this point. For example, the Council of the EU asserted in its own assessment of Basel III Endgame revisions that “the reform package would not be expected to result in a significant increase in the overall capital requirements for the banking sector, therefore, not resulting in significant differences for specific regions of the world.” In fact, the Bank of England announced in December 2023, its proposal would only lead to an increase in Tier 1 capital of about 3.2 percent.

Myth #9: Because the proposal only affects 37 banks, the impact will be limited.

Fact: The U.S. banks subject to Basel III Endgame account for 81 percent of U.S. banking assets.

Because the proposal raises capital on the largest banks, it has a major impact on consumers, businesses, and the economy. The eight U.S. GSIBs alone are significant contributors to the economy, accounting for 38 percent of total lending by banks to businesses and households in the United States.

Smaller banks also would be impacted because they rely on larger banks for critical financial services such as borrowing, hedging and securities dealing. Available estimates suggest that the impact of the proposal on the entire U.S. banking sector is expected to result in an economywide reduction in output of between \$100 billion and \$150 billion per year.

Myth #10: The proposal would not have a significant impact on the cost or availability of credit.

Fact: By raising capital requirements for the nation’s largest banks by 30 percent, the proposal would inevitably lead to higher borrowing costs or reduced access to capital for individuals, families, a broad array of industries and businesses of every size.

The proposal would significantly impact credit offerings across consumer and business lending, in large part due to proposed capital charges for operational risk. This change is applied across the entirety of a bank’s balance sheet.

In addition, as noted by the Urban Institute, the National Housing Conference, the National Urban League, the NAACP, the Mortgage Bankers Association, and others, the proposal would negatively impact housing finance and homeownership, particularly for low- and moderate-income borrowers and communities as well as Black and Hispanic borrowers. The proposal would also handicap small businesses by assigning a lower capital charge to public companies with access to the capital markets than to smaller businesses that rely primarily on bank borrowing.

A letter signed by more than 100 companies, including AT&T, Hilton, Hertz, IBM, Marriott, PayPal, Southwest Airlines, Siemens USA, Volvo, Warner Bros. Discovery, Whirlpool and Yum Brands, urged regulators to reconsider the rulemaking given the impacts to consumers and economic stability. More specifically, the coalition’s letter highlighted serious concerns that “the increased transaction costs associated with prudent risk-management hedging practices by derivatives end-users” would materially impact the costs of goods, services and everyday necessities and/or become prohibitively expensive.

Further, organizations including the National Association of Manufacturers, the American Farm Bureau Federation, CalPERS, the American Benefits Council, the Business Roundtable, the American Public Gas Association, all submitted comments opposed to the rulemaking, highlighting significant concerns with the downstream impacts to their respective industries and customers if the proposal were to be finalized in current form.

Myth #11: Operational risk capital requirements represent a small portion of the increase in capital.

Fact: The new operational risk capital requirements account for 78 percent of the total proposed increase in required capital for the largest banks and would serve as a \$1.4 trillion tax on all products and services provided by large banks.

The new operational risk capital requirements would impact the cost and availability of all financial products and services provided by large banks, ranging from lending to securities underwriting to asset management services. Moreover, operational risks are already accounted for in the Federal Reserve's stress tests, making the additional requirements in the capital proposal duplicative.

There is no clear or compelling evidence to suggest that operational risks present a concern commensurate with a \$1.4 trillion dollar increase in risk-weighted assets that would represent the key driver of increased large bank capital requirements in the proposal.

Myth #12: Basel III Endgame would lead to harmonization of capital policies around the globe.

Fact: The U.S. proposal goes far beyond both the Basel agreement and what is being implemented by other jurisdictions.

The United States was a key negotiator in the agreement that led to the Basel III Endgame agreement in 2017, but the proposed approach from U.S. regulators would lead to an even wider gap in capital required of U.S. banks vs. their European competitors.

Currently, large U.S. banks are subject to a risk-based capital requirement of 11.3 percent versus 9.9 percent for large European banks. The central aim of Basel III Endgame was to increase the quality and quantity of European bank capital to improve the competitive landscape. However, the European Union is proposing to implement these reforms in a manner that deviates from the Basel standards. More specifically, the European Banking Authority estimates that the EU approach will result in 3.2 percentage points less capital than would be achieved if the reforms were implemented in line with the Basel agreement.

Further, the U.S. is gold-plating certain aspects of the Basel proposal such as the capital treatment of residential mortgage and retail credit exposures, which will further increase the significant capital standards disparity between the U.S. and Europe.

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

Watch our Policy Cents Video: *Large Bank Capital and the Economy*