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Fed Vice Chair Barr Delivers Results of Holistic Capital Review

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In a speech made at the Bipartisan Policy Center ("BPC") on Monday, the Federal Reserve's Vice Chair for Supervision, Michael S. Barr, communicated preliminary recommendations stemming from the holistic review of capital requirements for large banks that he has undertaken since being appointed. The results of Vice Chair Barr's review have been widely anticipated in the wake of the banking turmoil earlier this year, and, as expected, are largely referential to how Silicon Valley Bank ("SVB") and others could have been more resilient in the face of market stress. While Vice Chair Barr noted that this holistic review began well before the market stress that occurred related to SVB's failure, he pointed to the SVB review in May and his speech on the importance of capital from December as important background for the recommendations he made in his BPC speech.

Depending on a bank's size, most banks over $100 billion in assets are today subject to a combination of risk-based regulatory capital minimums, leverage capital ratios and capital buffer requirements. Vice Chair Barr's recommendations are largely in line with the latest set of recommendations for risk-based capital rules for globally active banks set by the Basel Committee that were finalized in 2017, largely known as "Basel III Endgame" by the regulators, but often referred to as Basel IV by the industry. Basel III Endgame standards have already begun to go into effect in the UK and the EU. While the U.S.'s proposal for their implementation has not yet been released, the industry expects U.S. implementation to be more stringent than other jurisdictions. Monday's remarks provide a preview of what's to come in that respect.

Of most significance is that Vice Chair Barr's recommendations, if instituted, would apply heightened standards to and increase capital requirements for banks and bank holding companies ("BHCs") with at least $100 billion in total assets – currently, the most stringent U.S. capital requirements and reliance on internal models only apply to banks with over $700 billion in total assets. A broad overview of the reforms Vice Chair Barr recommends for banks and BHCs with more than $100 billion in assets includes:

- Stress testing, which forms the basis for a bank's Stress Capital Buffer requirements, should test for a wider array of risks.
- Technical changes made to the G-SIB surcharge, including measuring system indicators throughout the year instead of just at year-end and lowering the surcharge calculation to increase in 0.1 percentage point increments instead of 0.5 percentage point increments to reduce cliff-effects.
- Banks should no longer be allowed to rely on their internal models and should instead use standardized approaches to model their counterparty credit risk and operational risks, as well as certain market risks that are too difficult to model. Operational risk charges should be based on a firm's activities and historical losses, and market risk should be modeled at the level of individual trading desks for particular asset classes, as opposed to at the firm level.
- Banks should have to account for unrealized losses and gains in their available-for-sale securities when calculating their regulatory capital requirements (no AOCI opt-out).
- A new long-term debt requirement framework similar to the current requirement for the largest BHCs should be adopted for all BHCs with more than $100 billion in assets.

However, any proposals to institute Vice Chair Barr's recommendations will still need to be voted on by the Federal Reserve Board and then go through the standard notice-and-comment rulemaking process. In particular, Vice Chair Barr indicated that the Fed will seek comments on whether the recommended reforms to the risk-based capital framework and stress testing regime would result in double counting risks for minimum capital requirements. The Bank Policy Institute ("BPI"), a leading trade association for the largest banks, didn't wait for the comment period to open – the BPI released a statement on Monday that Vice Chair Barr's speech did not seem to adequately consider the costs of additional capital requirements.

Separately from the proposals set forth above, additional reforms related to liquidity, interest rate risk and executive incentive compensation are likely to be pursued at a later date. However, Vice Chair Barr indicated that he will not recommend changes to the Counter-cyclical Buffer ("CCyb"), nor to the Enhanced Supplementary Leverage Ratio ("eSLR"), as his proposed risk-based capital requirement reforms (and the accompanying estimated additional $2 in capital for every $100 in risk-weighted assets) would make it so that the eSLR should be less likely to be the binding constraint, and thus lessen the likelihood Treasury market intermediation would be affected, as critics of the eSLR have warned against.

While Vice Chair Barr asserted that "most banks already have enough capital today to meet the new requirements," banks should begin to undertake analyses of how the heightened capital requirements might apply to them and their level of risk exposure.