Bank Capital Requirements and Economic Performance

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Subcommittee on Financial Institutions and Monetary Policy

Marc Jarsulic
Senior Fellow and Chief Economist
Center for American Progress

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Thank you, Chairman Barr and Ranking Member Foster, for the opportunity to testify on this important topic. I am Senior Fellow and Chief Economist at the Center for American Progress. Today I will attempt to outline the importance of adequate bank equity levels for financial stability and economic performance. I will also attempt to identify some important consequences of the newly proposed capital rules. To do so I would like to emphasize four points.

1. Our banking system and our economy benefit from strong regulatory capital rules

There are several facts that support this view:

- **Capital rules mandate that banks self-insure against losses on their assets[1]**

Bank "capital" requirements are sometimes depicted as requiring banks to hold "idle money" to cover potential losses, money that cannot be used for lending or other purposes. This characterization is fiction. Banks are free to finance the assets on their balance sheet—the loans they make and the financial instruments they buy, such as corporate bonds or Treasury bonds—using both debt and equity. Regulatory capital requirements simply set a floor on the share of bank assets that must be financed with bank owners' money. These capital ratios are intended to make banks self-insure against losses on their assets, which can lead to insolvency.

[1] The following text draws on analysis and calculations in Marc Jarsulic and Lilith Fellowes-Granda, "Regulators' Bank Capital Proposals Do Not Go Far Enough to Improve Financial Stability", January 16, 2024, available at https://www.americanprogress.org/article/regulators-bank-capital-proposals-dont-go-far-enough-to-improve-financial-stability/.

Debt includes the claims of depositors and other short- and long-term lenders to the banks, who purchase commercial paper or bond issues by the bank. Equity, meanwhile, refers to funding provided by bank owners through stock the bank issues or earnings it retains. When the value of a bank's assets declines, the losses are first deducted from the value of bank equity, since the value of debt contracts is fixed.

So long as assets have been financed with a sufficient share of equity, a bank subject to losses will remain solvent—that is, the remaining value of assets will be large enough to satisfy debt payments as they come due. Bank creditors will recognize this, and there will be no incentive for uninsured depositors and other lenders to withdraw their funds.

By preventing runs and the attendant fire sale of assets, sufficient equity finance increases the stability of individual banks and the financial system itself.

- **Increased bank equity raises overall economic performance and credit availability**

From the point of view of overall economic performance, increased equity finance has positive effects. Empirical evidence suggests that overall higher levels of bank equity improve both economic performance and the availability of credit. Indeed, research by economists at the Federal Reserve Bank of New York found that "an additional 100 basis points of bank capital reduc[es] the probability of negative GDP growth by 10 percent at the one-year horizon, even controlling for credit growth and financial conditions, and without a significant drag on expected GDP growth."[2] Other empirical work shows that banks with less leverage pay less for and get more funding, and make more loans.[3]

In short, claims that overall economic performance will suffer from increased equity requirements are questionable on empirical grounds.

[2] Nina Boyarchenko et al., "Bank Capital and GDP Growth", Staff Report 950, Federal Reserve Bank of New York, December 2022, available at https://www.newyorkfed.org/research/staff_reports/sr950.
[3] Leonardo Gambacorta and Hyun Song Shin, "Why bank capital matters for monetary policy", Bank for International Settlements, Working Paper No. 558, April 7, 2016, available at https://www.bis.org/publ/work558.htm.

- **Increasing equity may well have a limited effect on bank costs**

One frequent claim is that equity finance is more expensive than debt, so increased equity requirements mean significantly higher costs for bank-mediated finance. But this argument neglects the fact that lower leverage—that is, a lower share of debt in the bank's funding mix — can reduce the rate of return that both equity owners and lenders expect to receive, because bank solvency risk is reduced. These cost offsets must be considered when examining the effects of increased capital requirements. For example, Bank for International Settlements researchers concluded -- on the basis of an empirical study of a sample of 105 G10 banks holding 70 percent of worldwide banking assets, covering the period 1994-2016 -- that shifts in funding toward equity produce a change in funding costs that is "small or possibly even negligibly small." [4]

2. **The current risk-based capital proposal contains an important advance in the calculation of bank equity levels**

The proposed capital rules would require banks with assets above $100 billion to include unrealized gains or losses on securities when calculating regulatory capital ratios.[5] Unrealized gains and losses are increases and decreases in the market value of assets the bank holds but has not yet sold. According to FDIC data, there were large unrealized losses for securities on bank balance sheets—about $620 billion as of the fourth quarter of 2022.[6] That amounts to nearly 10 percent of the value of all securities held on depository balance sheets at the end of 2022.[7]

Moreover, recent academic research has shown that unrealized losses on securities and commercial and residential mortgages, taken together, amounted to as much as $2 trillion in 2023.[8] That is to say, the market value of assets on bank balance sheets was approximately $2 trillion less than the book or accounting value of those assets. If banks were forced to sell these

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[4] *Ibid*, pp. 13-16.
[5] Michael S. Barr, "The Next Steps on Capital", September 10, 2024, available at https://www.federalreserve.gov/newsevents/speech/files/barr20240910a.pdf.
[6] Federal Deposit Insurance Corporation, Quarterly Banking Profile, Fourth Quarter 2022, available at https://www.fdic.gov/quarterly-banking-profile/fdic-quarterly-banking-profile-8.
[7] Board of Governors of the Federal Reserve System, Assets and Liabilities of Commercial Banks in the United States, H.8, January 27, 2023, available at https://www.federalreserve.gov/releases/h8/20230127/.
[8] Ericaa Xuewei Jiang et al., "Monetary Tightening and U.S. Bank Fragility in 2023: Mark-to-Market Losses and Uninsured Depositor Runs?, SSRN, available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4387676.

securities or mortgages at market prices in 2023, they could have done so only at a discount to their nominal, or face, value—in other words, at a loss.

The proposal's requirement that unrealized gains and losses on securities be included in calculating regulatory capital is a welcome change. It would prevent banks from avoiding recognition of losses by classifying securities as "held to maturity." Instead, they would have to mark their securities holdings to market when calculating equity ratios. This will make those ratios more meaningful.

3. **The proposed risk-based capital requirements will not raise minimum bank equity sufficiently**

This view is supported by two observations:

- **Recent history illustrates banks of any size can experience double-digit losses in a financial crisis**

We know from the 2007–2008 financial crisis that large shocks can reduce the value of bank assets by a far greater percentage. Quantitative estimates, based on data for the nine largest banks, show that had interventions by federal regulators not been successful, the potential loss of asset value from bankruptcy-producing runs would have been around 22 percent.[9] In addition, we know that when Washington Mutual failed in September 2008, its losses amounted to 13 percent of its $310 billion in assets.[10]

When Silicon Valley Bank (SVB) failed in 2023, its losses amounted to nearly 10 percent of its assets.[11]

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[9] Pietro Veronesi and Luigi Zingales, "Paulson's Gift", NBER Working Paper No. 15458, October 2009, available at https://www.nber.org/papers/w15458.

[10] At the end of June 2008, Washington Mutual assets were $309.7 billion, and the accounting value of equity was $26.08 billion. After it was placed in receivership by the FDIC, unpaid claims to debt holders and other creditors were $14.08 billion. Hence losses were 13 percent of assets. *See*, Washington Mutual, Inc., "FORM 10-Q," June 30, 2008, Securities and Exchange Commission, available at https://www.sec.gov/Archives/edgar/data/933136/000104746908009146/a2187197z10-q.htm; See also, Washington Mutual Bank - Receivership Balance Sheet Summary (Unaudited):For Period Ending September 30, 2023," Federal Deposit Insurance Corporation, available at https://receivership.fdic.gov/drripbal/bank/10015?FIN=10015.

[11] *See*, "Remarks by Chairman Martin J. Gruenberg on "Oversight of Financial Regulators: Financial Stability, Supervision, and Consumer Protection in the Wake of Recent Bank Failures" before the Committee on Banking, Housing, and Urban Affairs, United States Senate, May 18, 2023, available at https://www.fdic.gov/news/speeches/2023/spmay1723.html#:~:text=The%20cost%20estimate%20for%20the,to%20the%20initial%20estimate%2C%20higher.

Moreover, during the runs created by the failure of SVB and other banks, many other banks turned to Federal Reserve facilities, including a specially-created "term funding facility", and to the Federal Home Loan Banks, to borrow large amounts. This borrowing reached a peak of nearly $1 trillion in the second quarter of 2023, before declining to more than $850 billion in the third quarter.[12] This indicates that many banks lacked sufficient equity to weather the spillover effects of other bank failures.

- **The equity requirements in the current risk-based proposal are well below observed loss rates**

The proposed 9 percent increase in risk-weighted capital for U.S. Globally Systemically Important Banks (GSIBs) would leave the existing Supplementary Leverage Ratio (SLR) only a few basis points above 6 per cent[13] -- not enough to cover the loss rates in the 2008 financial crisis.[14] The proposed 3 to 4 percent increase in risk-weighted capital for banks similar in size to Silicon Valley Bank and Signature would have left their Tier 1 leverage ratios unchanged at 8.1 and 8.8 percent, respectively.[15] The proposed capital requirements would not have prevented the insolvency of these two banks.

Therefore, it is reasonable to conclude that the increase in equity delivered by the recent agency proposals would not markedly improve the chances that the GSIBs and other banks would remain solvent in the face of shocks in the range of those historically observed.

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[12] These totals include borrowing from Federal Reserve primary, secondary, and seasonal credit facilities, the net payroll protection program, the bank term lending facility, other credit extensions, and from Federal Home Loan Banks. Data from Federal Reserve Bank of St. Louis FRED, available at https://fred.stlouisfed.org/graph/?graph_id=1221346&rn=140.

[13] SLR calculations will change in an unspecified manner under the forthcoming proposal, as indicated in Barr, *op. cit.*

[14] This conclusion is based on the analysis in in Jarsulic and Fellowes-Granda, *op. cit*. That analysis of the earlier risk-based capital proposal showed that the 19 percent increase in GSIB risk-based capital would result in a SLR a few basis points above 6 percent. The 9 percent aggregate increase in the current proposal would raise the SLR by even less.

[15] This conclusion also is based on the analysis in in Jarsulic and Fellowes-Granda, *op. cit*. That analysis showed that the 6 percent increase in risk-based capital in the earlier proposal would have left required capital for Silicon Valley and Signature unchanged. Hence the 3-4 percent aggregate increase in the current proposal would do the same.

4. **Bank regulators should take effective action to substantially reduce leverage**

Bank equity has trended in the wrong direction for some time. While equity ratios for large banks and GSIBs rose measurably after the 2008 financial crisis, they have since declined. The SLR for GSIBs in particular has declined from about 7 percent in 2017 to around 6 percent now, indicating that the very largest banks are less prepared to endure large economic shocks.[16]

These trends need to be reversed. Doing so would increase financial stability and help the overall economy by supporting credit creation.

The current risk-based proposals will not do what is needed. Strong leverage requirements -- which complement risk-based capital rules -- are an obvious next step.

Thank you for your attention.

[16] *See* Sabrina Pellerin, "Bank Capital Analysis Semiannual Update", Federal Reserve Bank of Kansas City, April 19, 2024, available at https://www.kansascityfed.org/Research/documents/10123/Bank_Capital_Analysis_Report_-_4Q_2023_-_final.pdf.