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Asset Management

Fed Proposes Bank Capital Regulation Changes

Neutral Effects on US Bank Creditworthiness

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In early April the US Federal Reserve proposed several new rules governing bank capital standards. These proposed rules are designed to maintain strong stress-testing and risk-based capital bases, while enhancing regulatory efficiency, transparency and simplicity. **Spectrum believes these proposals, if implemented, will have broadly neutral effects on the creditworthiness of major US banks.**

A key concept of the proposed rules is to more closely integrate capital rules and the Comprehensive Capital Analysis and Review (CCAR) stress testing required of bank holding companies with over $50 billion in assets. CCAR is an annual capital adequacy exercise linked to the Dodd-Frank Act Stress Test (DFAST). Under the quantitative aspects of these stress tests, large banks are subjected to challenges such as high unemployment, interest rate fluctuations and a weak economy. Today, there is a flat 2.5% of risk-weighted assets (RWA) capital conservation buffer (CCB) added to the 4.5% minimum capital requirement. Global Systemically Important Banks (GSIBs, such as JP Morgan, Bank of America and Wells Fargo – the very largest banks) have an additional CET1 capital requirement to these. Under the proposed rule, the CCB would be replaced by a Stress Capital Buffer (SCB), which would be equal to the difference between a bank's beginning and lowest Common Equity Tier 1 (CET1) capital level under the severe adverse scenario of the stress test, with a floor of 2.5% of RWAs. Thus, more complex and volatile banks would likely have higher CET1 capital requirements due to a higher SCB, and these requirements would fluctuate with economic cycles. According to the Fed, GSIBs would have flat to higher CET1 risk-adjusted capital requirements, whereas other large banks' capital requirements would generally "decrease modestly". The Fed also wants to modify some of the stress assumptions in CCAR to 'better align' them with expected behavior.

In addition, the Fed has proposed changes to the Supplementary Leverage Rule (SLR) for GSIBs. Under this proposal, the static 2% GSIB capital buffer over the 3% minimum for bank holding companies would be replaced by a buffer set at half of the bank-specific GSIB buffer assigned by regulators. These buffers reflect the unique risk aspects of each GSIB. Because the highest GSIB buffer is 3.5% (for JP Morgan), all the GSIBs would have lower leverage requirements. As assets are not risk-weighted under the leverage test, there is a strong disincentive for banks to hold low-risk assets such as repos and custody deposits. Regulators want to reduce this disincentive.

Spectrum believes these proposed capital rules will not weaken large US banks' strength, and that tying CET1 risk-based capital requirements more closely to the idiosyncratic risks of each bank is a good idea. US banks' capital bases are strong. In fact, the Fed notes in its release that banks subject to CCAR stress testing had CET1 capital of 12.1% at year-end 2017, up from 5.5% at 1Q2009 – more than double.

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