

Protecting Our Economy by Strengthening the U.S. Banking System Through Higher Capital Requirements

December 22, 2022

Dennis Kelleher, Cofounder, President and CEO
Tim P. Clark, Distinguished Senior Banking Advisor
Phillip Basil, Director of Banking Policy

What is Bank Capital?

- ▶ Similar to customer deposits, capital is a source of funding that banks use to invest in assets, such as loans and securities.
- ▶ Capital is not required to be repaid to the shareholders, and so can absorb losses when bank assets lose value—e.g., a borrower defaults, asset prices decline, etc.
- ▶ In concept it is like a down payment on a home, i.e., the down payment serves as a buffer to the mortgage lender if the home price declines.
- ▶ Contrary to the way many have misdescribed it, banks do not *hold* capital in the sense that it is money they are unable to use. It is simply another source of funding that comes from the owners/shareholders of the bank rather than from depositors and creditors.

Introduction

The largest banks in the U.S. remain subject to insufficient capital requirements that undermine the stability of the financial system and leave the possibility of future banking crises too high. Capital standards must be strengthened to fully support the benefits to society that come from a strong and resilient banking system, especially during period of financial and economic stress. None of the industry's arguments against higher requirements are supported by real-life experience or research, while the costs of insufficient capital requirements has been real and devastating for the American people. Capital requirements were irresponsibly low prior to the 2008 Crash, resulting in bank failures, massive taxpayer bailouts, and a catastrophic financial and economic collapse with a [\\$20 trillion impact](#) to the economy.


It's clear that capital requirements must be strengthened for our largest banks, and that this would benefit the American people. [Our report](#) discusses the reasons those requirements must be increased, the baselessness of industry talking points, and two key aspects in which the capital framework must be strengthened.

Industry Arguments Against Higher Capital Requirements Are Wrong

The banking industry's main public argument against higher capital requirements is the claim that this would force them to reduce lending or greatly increase the cost of credit, thus harming economic growth. This argument was repeated by the CEOs of the largest banks in the U.S. in [hearings](#) this year before Congress.

The reality is there is no real-life evidence of this. In fact, according to [data from the Bank for International Settlements](#), both the amount of lending and the share of lending coming from banks to the non-financial sector has actually *increased* between 2013, when higher capital requirements started taking effect, and the 2020 pandemic.





Other industry arguments have been shown to be wrong:

- Banks claiming they were a “[source of strength](#)” during the 2020 pandemic-related market stress when in fact they benefited massively from trillions of dollars of support from the Fed and Congress.
- Higher capital levels reduce the overall cost of capital by as much as 50%.
- U.S. banks have outperformed their European counterparts despite having higher requirements.
- Financial activities and risks in the shadow banking financial sector are an argument for more capital at banks not less.

Capital Requirements Must be Stronger

The argument for higher capital requirements is simple and obvious: better capitalized banks create a stronger, more resilient, and stable financial system that is less likely to cause or exacerbate economic and financial downturns. When large banks are undercapitalized, such downturns are not only more likely, but also more likely to become severe financial and economic crises that can cause tremendous harm to Americans from coast-to-coast and lead to taxpayer-funded bailouts. Additionally, [research shows](#) that higher bank capital “significantly lower[s] the cost of a crisis by sustaining bank lending during the resulting recession.”

Many estimates from academics and regulatory organizations of optimal capital requirements indicate that substantially stronger capital standards are both necessary and would be beneficial:

- The [Federal Reserve Bank of Minneapolis](#) estimates capital requirements should be **23.5% of risk-weighted assets and 15% of total assets**.
- [Federal Reserve Board analysis](#) showed the most severe loss of a bank holding company during the 2008 Crash was 19% of risk weighted assets.
- Economists at the International Monetary Fund [estimated](#) capital requirements should be **23% of risk weighted assets**.
- Economists Anat Admati and Martin Hellwig, in their 2013 book [The Banker’s New Clothes](#), estimated capital leverage requirements of at least **20% - 30% of total assets**.
- The Basel Committee on Banking Supervision (BCBS), in a [2010 paper](#) estimated risk-based capital requirements of 16% would be appropriate.

There are two parts of the framework whose strength must be a priority: (1) the Federal Reserve supervisory stress test, which is the basis for the most important and binding U.S. large bank capital requirements, and (2) any potential Basel Endgame modifications, which must not be driven by a goal (that has been misguidedly promoted by many) to maintain capital requirements at approximately the same level as those currently in place. These are discussed in more detail in our report.

Learn more in our [full report on strengthening capital requirements](#).



BETTER MARKETS

Better Banks | Better Businesses Better Jobs | Better Economic Growth Better Lives | Better Communities

Better Markets is a public interest 501(c)(3) non-profit based in Washington, DC that advocates for greater transparency, accountability, and oversight in the domestic and global capital and commodity markets, to protect the American Dream of homes, jobs, savings, education, a secure retirement, and a rising standard of living.

Better Markets fights for the economic security, opportunity, and prosperity of the American people by working to enact financial reform, to prevent another financial crash and the diversion of trillions of taxpayer dollars to bailing out the financial system.

By being a counterweight to Wall Street's biggest financial firms through the policymaking and rulemaking process, Better Markets is supporting pragmatic rules and a strong banking and financial system that enables stability, growth, and broad-based prosperity. Better Markets also fights to refocus finance on the real economy, empower the buy-side and protect investors and consumers.

For press inquiries, please contact us at press@bettermarkets.com or (202) 618-6430.

