BETTER MARKETS

BANKING

FACT SHEET

Capital Rule Critics Proved Wrong by Facts and Data

May 1, 2024

Wall Street biggest banks and their supporters have staged a widespread resistance effort in recent months to convince the American people, community organizations, and financial regulators that modestly higher capital requirements (called the "Basel Endgame") (the "Proposal") will have far-reaching dire consequences. Along with lobbying, media campaigns, television advertising, billboards, and websites, those capital critics have used seemingly limitless resources to fill the public comment file with letters opposing the Proposal. By count, the comment letters opposing the Proposal certainly outnumber those in favor of it. However, a bunch of banks and their allies saying similar things many times doesn't make them accurate and quantity isn't a substitute for merit.

This fact sheet will show that the industry's anti-capital claims lack a valid basis and provide facts and data to prove how these messages are misleading and wrong, and will actually lead to weaker economic growth, less lending, greater instability, and more volatility. Moreover, the industry's unsupported arguments and fearmongering, if successful, will shift the burden of a bank failures to taxpayers and Main Street Americans, while Wall Street's biggest banks are allowed to continue to reap higher profits without being accountable for the risk they undertake to generate those profits.

What's at Stake

Well-capitalized banks are essential for a strong banking sector, financial system, and economy where Main Street families, businesses and community banks can thrive. Well-capitalized banks are strong enough to continue providing credit to the American people through the ups and downs of the business cycle, which keeps the economy growing and creates jobs. Appropriately capitalized banks reduce the depth, length, and cost of recessions that large bank failures usually cause. The only thing standing between a failing large bank, taxpayer bailouts and an economic downturn—if not catastrophe—is the amount of capital that a large bank has to absorb its own losses. As was clearly demonstrated in the 2008 Financial Crisis ("2008 Crash") and again with the regional bank failures in 2023 ("2023 Crisis") when megabanks do not have enough capital to absorb their own losses that stem from their risky activities, the government has to step in with a bailout, that the American people ultimately pay for.

Undercapitalized banks, crashes, contagion, recessions and economic downturns—***not more capital***—are the threat and disproportionately hurt underserved communities and organizations that exist to support them:

Minorities

Evidence shows that minorities suffered large losses during and after the 2008 Crash. These losses hurt incomes, asset building, and overall economic and financial well-being for years after the downturn and continue to negatively affect generations to come. Black and Latino workers, for example, experience higher unemployment rates during recessions. Minorities were disproportionately hurt by foreclosures and declines in property values in the 2008 Crash. One study estimated that minorities shouldered about $1 trillion in losses from home foreclosures and related financial losses from the 2008 Crash. Importantly, this does not include the range of non-financial costs such as increased crime, reduced school performance, and neighborhood blight. Minorities also had larger declines in savings accounts (including retirement savings) due to pressures from the 2008 Crash, including the need to withdraw money in order to cover the rising costs.

Researchers show that the 2008 Crash will continue to negatively impact minority families for years to come. By 2031, White wealth is forecast to be 31 percent below what it would have been without the 2008 Crash, while Black wealth is estimated to be down almost 40 percent. Put differently, for a typical Black family, median wealth in 2031 will be almost $98,000 lower than it would have been without the 2008 Crash.

Small Business

Small firms and newly established businesses are vitally important to job creation and future recovery because they tend to grow faster than large businesses. During the 2008 Crash, job losses were concentrated in the smallest businesses: job losses in small businesses exceeded job gains in those same businesses by 800,000.

Community Support/Philanthropy

The 2008 Crash had a significant negative impact on community organizations whose primary mission is to support underserved communities. Between 2007 and 2008, the top 40 foundations in the U.S. together lost more than $43 billion in assets. At the same time, charitable giving by high-income individuals fell by $31 billion from 2007 to 2009.

It is imperative to consider these facts when Wall Street banks claim that the Proposal will hurt minorities, small businesses, and other vulnerable populations. The truth is that these groups have been most hurt by undercapitalized banks, financial crises, and economic downturns, so stronger capital requirements will actually help, not hurt, these communities and other Main Street Americans.

Benefit #1: Financial Stability and Resilience

Commenters assert that the Proposal will harm economic growth and banking sector resilience:

- The Business Roundtable claims that the Proposal will “reduce innovation and economic growth” and says that large U.S. banks are already resilient as demonstrated by “real life stress tests—including the COVID-19 pandemic, the Russian Invasion of Ukraine and the regional bank failures in spring 2023.”

- The Bank Policy Institute and the American Bankers Association, in a joint letter, says that the Proposal "would have a profound effect on the availability and cost of credit for nearly every American business and consumer, as well as on the resiliency of U.S. capital markets. The U.S. economy would suffer a significant, permanent reduction in GDP and employment; U.S. capital markets would become less liquid, and therefore more dependent on non-bank intermediation in normal times and on governmental support when those non-banks step away from financial markets during times of stress."
- The Coalition for Derivatives End-Users worries that the Proposal will indirectly harm the economy through capital markets, "financial regulatory reform measure should promote economic stability, transparency and resiliency without imposing undue burdens on derivatives end-users and the broader U.S. economy. Imposing unnecessary regulation directly on end-users or indirectly, through their counterparties as these Proposals do, will create more economic instability, restrict job growth, decrease productive investment and hamper U.S. competitiveness in the global economy. . ."

The Proposal Promotes Financial Stability and Increases the Banking Sector's Resilience to Shocks

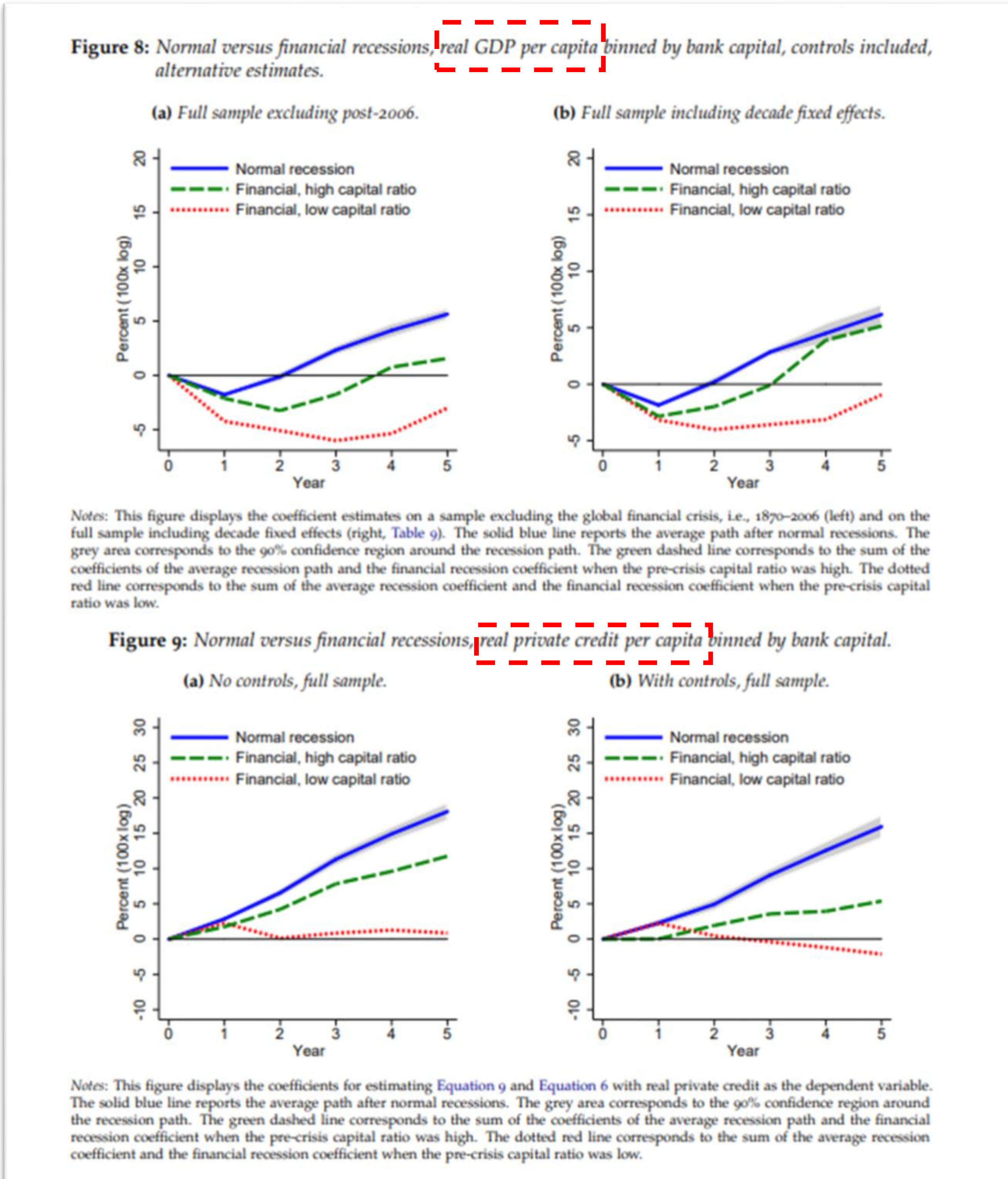
In the 2023 Crisis, Silicon Valley Bank, Signature Bank and First Republic Bank all failed because they did not have enough capital. This was also the case for bank failures in the 2008 Crash. In 2023, bank failures led to severe financial stress, enough to prompt a systemic risk exception, insure all bank deposits, and lead the Fed to create the Bank Term Funding Program to offer additional support to the banking system. This is exactly the type of scenario we need to avoid, and it could have been avoided if the banks that failed had enough capital to internalize and absorb the losses that their business activities created rather than falling short and shifting the burden to the government and all Americans.

In 2023, even regional bank failures were significant enough to cause significant stress throughout the financial system. This supports the Proposal's extension of more stringent capital standards to banks with $100 billion or more in total assets and disproves the notion that this change violates requirements to tailor rules by bank size. Importantly, the Proposal does not apply to banks with less than $100 billion in total assets.

Federal Reserve Bank of Minneapolis analysis shows that capital requirements must be higher to prevent future bailouts. Bank capital levels rose during the COVID-19 shock because of Fed actions that prevented stock buybacks and restricting dividends beginning in third quarter 2023. Then, extensive government support amounting to trillions of dollars shifted risks away from banks and to the federal government, through a number of programs that were put in place to reduce the impact of the pandemic on the financial sector. Therefore, assertions that banks' performance during the pandemic illustrates their strength and resilience are incorrect. Instead, the degree of federal support that was required during the pandemic actually justifies the need for the Proposal.

Additional research from Fed economists and others shows that ***higher capital limits the economic fallout of financial crises and actually leads to stronger economic recovery and increased lending to the nonfinancial sector in the years that follow the recession***. Using data from 17 countries from the 1870–2015 period, economists compare both the degree and speed of economic recovery after financial sector recessions under both high (green, large dashed line) and low capital (red, dotted line) scenarios (See Chart 1). The results are clear. Banking systems with higher capital ratios recover faster and more significantly after financial recessions, increasing both economic growth and lending several years before financial systems with lower capitalized banks.

Chart 1



Benefit #2: Increased Lending

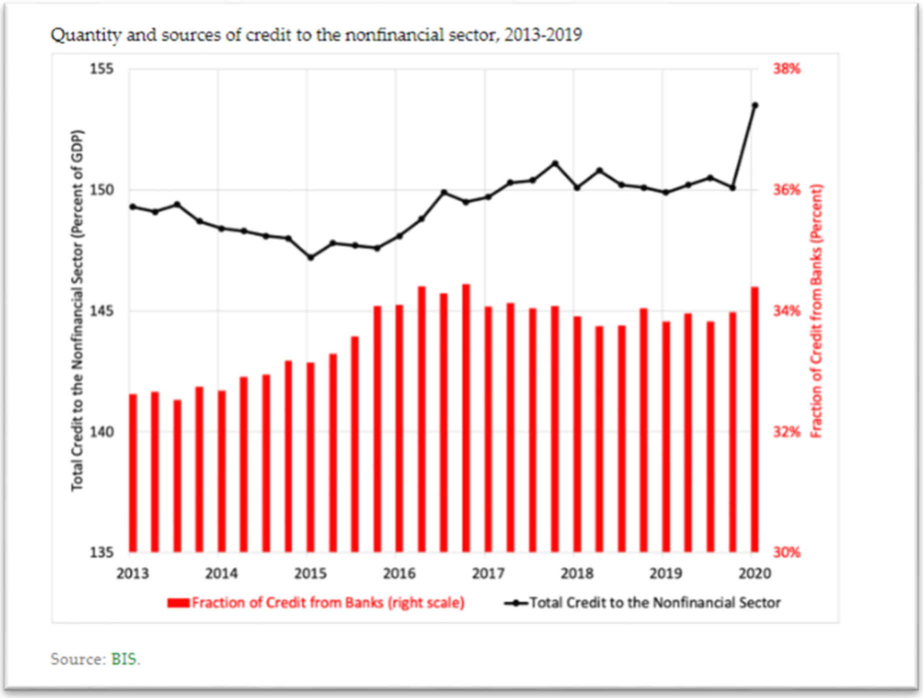
Commenters assert that the Proposal will have direct and negative consequences on borrowers, particularly in underserved communities:

- The National Community Reinvestment Coalition ("NCRC") agrees that the Proposal is necessary because "many institutions were revealed to have hidden their undercapitalization [during the 2008 financial crisis] through intentional artifice" and praises the Proposal because it will "introduce sensitivities to source of funds for repayment, create uniform and transparent guidelines for measuring capital requirements, and generally ensure banks have enough capital on hand to weather economic crises." However, NCRC is concerned that the Proposal will "undermine homeownership and certain community reinvestment activities" particularly for underserved communities.
- The Mortgage Bankers Association ("MBA") also agrees that capital requirements must ensure that there is a "cushion against losses under stressed financial conditions, thereby reducing the likelihood of bank failures and protecting the financial system." However, MBA opposes portions of the Proposal that would result in further bank withdrawal or exit from the mortgage market.
- The National Association of Realtors claims that negative impacts will transfer from the largest banks to community and local institutions. As a result, "consumers will face increased borrowing costs and a severe reduction in credit" and "will hit underserved markets and those borrowers with low and moderate incomes the hardest, those [for] whom the American Dream has already started to become nothing more than a hopeful wish."
- Goldman Sachs' 10,000 Small Business Voices worries that the Proposed "capital requirements for lending will make it more expensive for banks to loan to small businesses, and those added costs will no doubt be passed on to us. . . . [W]e are concerned that the new calculations in this proposal will make borrowing costs unaffordable and capital inaccessible."

The Proposal Will Not Reduce Bank Lending to Households and Businesses

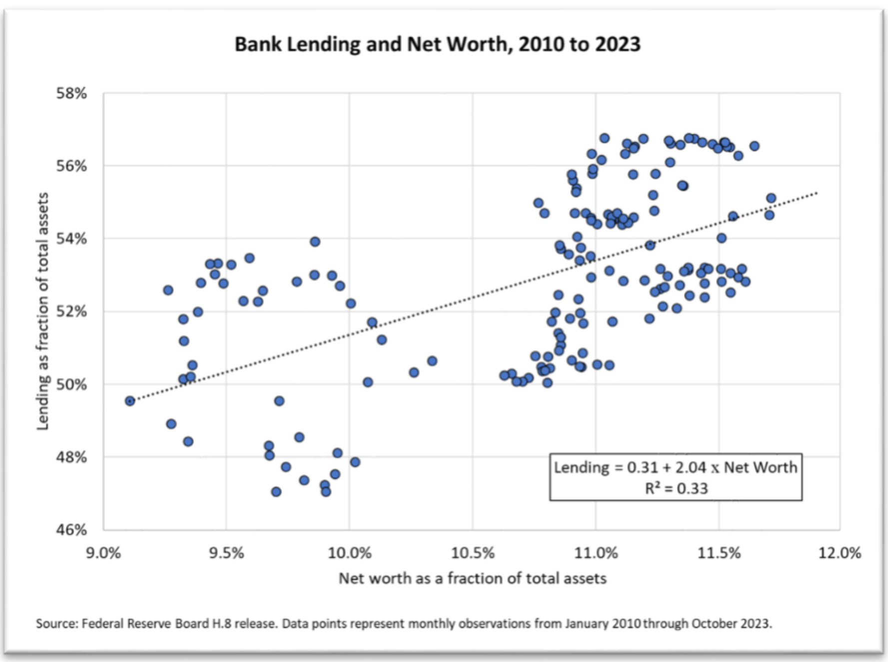
Increased capital requirements do not reduce lending; in fact as regulators required banks to increase their capital significantly after the 2008 crash, those very same banks increased their lending to the nonfinancial sector (see Chart 2).

Chart 2



Furthermore, [monthly data from 2010 through 2023 show that capital levels and lending are positively correlated](). As Chart 3 shows, for [every 1 percentage point increase in capital, bank lending increases by 2 percentage points]().

Chart 3



Mortgages and Small Business Lending

Many commenters expressed concern that certain borrowers—namely prospective homeowners and small businesses—will be hurt by the Proposal. This is not true. Higher capital will not hurt mortgage borrowers and small businesses. Quite the opposite, higher capital will protect the banking system, enabling banks to continue lending through the economic cycle, to households, small businesses, and other borrowers.

The Proposal does indeed include higher risk weights for mortgage loans with higher loan-to-value ("LTV") ratios, and this is warranted because of the higher risk inherent in these loans. Research and historical data proves that losses increase substantially for mortgage loans with higher LTV ratios. If banks are not held accountable for these higher-risk loans, policymakers are essentially requiring taxpayers to instead subsidize bank lending to higher risk borrowers and take on the added risk and cost of bank failures while the banks continue to increase their profits.

Megabanks and their advocates argue that higher capital requirements will automatically result in higher pricing for high LTV loans or a retreat by banks from lending in this market, resulting in reduced credit availability for high LTV borrowers (who are often low income or minority individuals or households). ***However, this is not true. The estimated cost resulting from changes in the Proposal that affect mortgage and small business lending is very small. Furthermore, passing along higher costs is a choice by the banks, not a requirement or an inevitable result of the rule.***

Fed Vice Chair for Supervision Michael Barr stated that the estimated increase in capital requirements for lending activity is on average only 3 basis points, or 0.03 percentage points. To put this in context, the four largest banks—JP Morgan Chase, Bank of America, Citibank, and Wells Fargo—have about $4 trillion in total loans and leases outstanding in 2023; 0.03 percent of this amount is about $1.2 billion. These same four banks paid out nearly $57 billion in dividends and stock repurchases in 2023 alone. Thus, a mere 2% reduction in dividends and repurchases would cover the entire cost of higher capital requirements for all types of lending activity and require none of the burden to be passed along to borrowers.

Moreover, the megabanks that will be subject to the Proposal have a relatively small mortgage and small businesses lending portfolio, especially compared to community banks, which further disproves claims of the Proposal's widespread negative impact on Main Street Americans. In fact, one study shows that the Proposal will only affect a fraction of all mortgage loans. It finds that **just 23 of the 62 banks that are subject to the Proposal even make mortgage loans**. Of all the mortgage loans made by these banks:

- **Only 13%** were **high-LTV and made to borrowers in LMI areas, and**
- **Only 21%** were **high-LTV and made to non-white borrowers.**

In other words, the largest banks make relatively few loans to LMI or minority borrowers. While this is certainly a concern given these banks' promises to support minorities' goals of homeownership, it proves that the widespread damage feared as a direct result of the Proposal is certainly exaggerated. For example, in 2017, Wells Fargo, the megabank that has historically focused most on mortgage lending, announced $60 billion to create 250,000 Black homeowners within the next decade. In 2021, however, Wells Fargo underwrote 42% fewer mortgages to Black buyers than in the year it announced its target. Even counting mortgages purchased from other lenders (which is of questionable utility), Wells Fargo backed successively fewer mortgage loans in each of the past five years. In conclusion, while the banks' individual lending decisions may indeed be failing to support already underserved communities, this is a problem that is separate from and not attributable to the Proposal.

Benefit #3: Transparency

Commenters oppose the proposed changes that would reduce the ability for large banks to use internal models:

- The Financial Services Forum states that the Proposal would increase the disparity between U.S. banks and foreign counterparts "primarily because of the elimination of the use of internal models for credit risk and the addition of operational risk into the binding capital stack."

- The Bank Policy Institute and the American Bankers Association claim that "There is no evidence that internal models for credit risk have led to a systematic understatement (or overstatement) of risk at any bank. In fact, since 2014, banks have successfully used internal models to gauge credit risk for capital purposes, subject to backtesting and model approval from an independent risk function, an independent model validation group, internal auditors and agency examiners. The virtue of internal models is that they are inherently more granular and risk-sensitive than government-imposed, one-size-fits-all standardized methodologies; they can also be adjusted over time to reflect changing behavior."

The Proposal Increases Transparency Through Standardization of Measures and Models

Research proves that there has been significant variation in results when banks use internal models that allow for choice and variation of inputs such as reference data, methodology, and definitions. Results from internal models showed that capital ratios ***varied up to 15-20% in either direction around a common benchmark for portfolios of the same risk***, because of banks' different modeling choices. This is unacceptable. The use of standardized models is also more efficient. For standard models, regulators can save time and public resources by just focusing on the results of an approved standard model, compared to bank-specific internal models that require new understanding and evaluation for each bank's models, in addition to assessment of the results.

Benefit #4: Accountability for Risky Capital Markets Activities

Commenters oppose the proposed changes that would increase capital requirements for trading and other capital markets activities:

- The Coalition for Derivatives End-Users "has serious concerns that increased transaction costs associated with prudent risk-management hedging practices by derivatives end-users will result in two materially adverse impacts: (i) even further increased costs will flow through to consumers for goods, services and everyday necessities; and (ii) reduced capacity for derivatives end-users to hedge their commercial risks because the costs to hedge those risks could become prohibitively expensive, which would lead to greater price volatility. These results would be bad for consumers and bad for economic stability and neither result decreases risk to the broader U.S. economy."

- The Options Clearing Corporation supports the broad objectives of the Proposal to "increase the strength and resilience of the banking system" but worries new capital charges are "directly counter to the goal of promoting central clearing in financial markets that has long been supported by leading global economies, Congress, and U.S. financial regulators" and could disincentivize market activities such as clearing at banks.

The Proposal Delivers Benefits by Assessing and Pricing Risky Capital Markets Activities at Banks, Rather than Passing the Potential Cost of this Risk to Taxpayers

While some commenters worry about the Proposal harming capital markets and derivatives activity; others worry about adverse effects on businesses that rely on banks to manage financial risks and engage in capital markets transactions. The truth is that ***trading activities at banks do present risk that the banks that engage in them should be held accountable for that risk with higher capital requirements***. At the same time, careful consideration is warranted; this is long overdue, and the agencies have done that in the Proposal.

Higher capital requirements for trading activity are justified to keep the broader financial system safe. The Proposal states that new capital requirements for capital markets activities will add about 67 basis points (2/3 of a percent) to large holding companies' capital ratio. This is a relatively small and reasonable cost when considered alongside the extreme cost of the 2008 Crash: $20+ trillion in lost GDP, about 27 million Americans unemployed within a year of Lehman's collapse, 15 million foreclosure filings, $2.8 trillion in lost retirement savings, and countless other human costs (disengagement from the labor force and society because of extended unemployment, for example). Holding banks accountable for the costs and risks of their business activities (that produce their revenue, profits, and bonuses) is fair and appropriate. The moral hazard of not doing so is evident in innumerable ways leading up to the 2008 Crash. Furthermore, the cost does not HAVE to be passed on to the end user. As discussed earlier, banks could reduce their ample shareholder payouts or retain earnings by just a very small amount to meet the increased requirements. Finally, if the risk and cost is not borne by the banks, it will by default be passed along to taxpayers when banks fail and require bailouts: that enshrines privatizing gains and socializing losses.

Research from the Federal Reserve Bank of New York, which is also cited in the Proposal, examines market liquidity in the post-crisis era in light of concerns that regulatory changes could reduce dealers' ability and willingness to make markets. The researchers find that bond market liquidity remained resilient and within historical norms ***even after regulatory changes***, suggesting that it is reasonable to think that the Proposal will also have limited negative effects on capital markets. Additional research shows that average market liquidity metrics ***improved*** after the 2008 Crash and were better after more reforms were implemented, than before the 2008 Crash. The improvement from 2010-2012 to 2013-2014 occurred across both investment grade and high yield bonds, also supporting the fact that financial markets were helped, not hurt, by prior policy reform.

Benefit #5: Accountability for Operational Risk

Commenters oppose proposed changes that impose capital requirements for operational risk at banks:

- The Securities Industry and Financial Markets Association and the Futures Industry Association say that the Proposal "could have adverse effects on the U.S. capital markets by over-calibrating relatively low-risk services" and "would contravene decades of U.S. financial services policy, which has encouraged diversification in banking organizations' business models." The organizations also assert that the "Agencies have not provided sufficient rationale in support of the proposed approach or conducted an economic analysis to justify the departure from established U.S. financial services policy goals."
- The Bank Policy Institute and American Bankers Association say that the operational risk component of the Proposal is "massively overstated, and the agencies provide no basis for it in the proposal." The organizations also reject Federal Reserve research cited in the Proposal which supports the fact that that past operational loss events are an indicator of future loss events.

The Proposal Appropriately Assesses and Prices Megabanks' Operational Risk

Opponents of the Proposal criticize the new operational risk component for two main reasons:

- It unfairly burdens banks with business lines that rely on fee income, and
- It would require more capital than historical loss experience.

Neither of these reasons are supported by the data or valid enough to not move ahead with the Proposal. The truth is that operational risks are evolving and increasing from historical periods. Greater instances of cyberattacks, for example, are occurring each year so comparing operational losses relative to historical benchmarks is not the correct yardstick.

Research from the Federal Reserve Board and the Federal Reserve Bank of Richmond offers additional perspective that supports the Proposal. The results of this research shows that past operational losses lead to future losses, even after controlling for a wide range of factors. So, basing capital charges on banks with concentrations in business activities that are vulnerable to operational losses is appropriate, not an unfair burden. Furthermore, research from the Federal Reserve Bank of Dallas, grounded in about 400,000 individual loss events from 2001 through 2018, shows that there is high variability in losses from operational risk, also known as fat tails. Therefore, calibrating capital requirements by average losses is not enough to account for potential future loss events.

Conclusion

An assessment of criticism of the Proposal with independent facts and data demonstrate that the criticism is without basis. In fact, those facts and data show that the Proposal is well grounded, fully supported, and would be highly beneficial to the American people. It would unwise and wrong to allow the megabanks to continue to underprice risk and not be required to take actions to account for the wide range of potential harm that their business decisions and activities present to Main Street Americans. Undercapitalized banks are the threat, not alleged but unproved overcapitalized banks' impact on lending generally or to specific sectors or individuals. The undeniable truth is that the Proposal brings significant benefits that promote financial stability and economic growth while reducing moral hazard in the banking industry at the largest banks. It would be a grave mistake to miss the chance to achieve those essential goals.

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 buyside and protect investors and consumers.

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