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Potomac Perspective

Last week, a key Fed official gave a speech on bank capital requirements. Federal Reserve (Fed) Vice Chairman for Supervision Michael Barr did not offer details on what changes will be made to capital rules, but he offered some hints. This note reviews his comments and opines on how banks and investors should think about the process and the politics of bank capital regulations.

The release of the National Defense Authorization Act (NDAA) has been stalled over disputes regarding various amendments to the bill. The bill could be released as early as Tuesday, which would give clarity to the future of the SAFE Banking Act and a credit card payments bill, but these delays could drag on for a few more days.

Barr Speech on Bank Capital – Last week, Federal Reserve Board Vice Chairman for Supervision Michael Barr gave a speech on bank capital requirements. Barr reiterated that the Fed is engaged in a holistic review of bank capital requirements. He did not indicate when the Fed would finish its work and propose changes to bank capital rules, but banks and investors should probably expect a proposal in early or mid 2023, a comment period that lasts into late 2023, and a final rule in 2024, followed by a transition period for any new requirements. Vice Chairman Barr did not explicitly endorse or propose higher capital requirements, but he clearly signaled his preferences for higher capital. Here are a few observations about Vice Chairman Barr's speech.

- **Academic citations** – In his speech, Mr. Barr referenced numerous academic studies that claim bank capital requirements are too low. The cited studies included a range of optimal capital levels, but they all call for higher capital – some calling for significantly more capital. For example, a 2022 study claims the optimal capital level is "around 16%." Barr did not endorse any approach, and he could use the academic research as a stalking horse so that when the Fed issues a proposal for new capital requirements, Barr says "see, it could have been much worse." It seems unlikely that the Fed will propose increased capital requirements as suggested by academics, the reference to the research is a clear signal of Barr's preference. See more on this below.
- **Comprehensive Capital and Review (CCAR) and Stress Tests** – Mr. Barr referenced a recent speech by former Fed Governor Daniel Tarullo (who served the de facto head of Supervision at the Fed) in which Tarullo suggested using multiple scenarios as part of stress testing. Similar to the broad academic research on capital levels, Barr did not explicitly endorse Tarullo's suggestion, but Barr is clearly thinking about it. In the speech, Barr did not mention reinstating the qualitative assessment as part of the CCAR, but this could be another possible change in the stress-testing regime. Both of these changes would need to be issued for public comment, so the chances of them being included in the 2023 CCAR seem low.
- **Countercyclical Capital Buffer (CCyB)** – During Q&A, Barr was asked about possible changes in the Fed's countercyclical capital buffer. He said it was part of the Fed's holistic review of the capital rules so the Fed probably "won't be taking action on (the CCyB) in the short term."
- **Supplementary Leverage Ratio (SLR)** – Barr also indicated that possible adjustments to the leverage ratio is part of the Fed's holistic review. He acknowledged the view that leverage requirements for large banks (i.e., the SLR) could be "overly binding and may contribute to lower liquidity in Treasury markets, especially in stressed scenarios."

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- **Barr's Role** – As Vice Chairman for Supervision, Mr. Barr holds a key position at the Fed and is in a unique position to propose changes to bank capital requirements, but it is worth noting that Federal Reserve Board Chairman Jerome Powell remains a critical player, too. As Chairman, Mr. Powell not only votes on regulatory proposals, he also sets the agenda, which gives him leverage in crafting banking regulations. Chairman Powell can delay proposals he does not support, so without Powell's backing, changes to bank capital rules face high hurdles. Powell and Barr (as well as the five other Fed Board members) will likely collaborate on any proposal to change bank capital rules which could mitigate the possible impact to banks.

  While this is a significant factor in how capital rules are written broadly, banks and investors should also keep in mind that Barr can also exert influence over capital requirements at individual banks through the supervisory process. In his position, Mr. Barr oversees the Fed's Division of Supervision and Regulation which gives him influence over how the Fed supervises bank holding companies and state member banks. Through the supervisory process, regulators can push individual banks to hold more capital in a less public way than raising capital requirements industrywide. The supervisory approach has less of an impact on equity prices since it is less public and it is on a case-by-case basis, but this factor should not be overlooked by banks and investors.

Click here to access Vice Chairman Barr's prepared remarks.

NDAA Update – The release of a compromise NDAA has been delayed due to unresolved disputes regarding several issues. The delay seems mostly connected to whether to include energy permitting reform proposed by Senator Joe Manchin (D-West Virginia) and opposed by progressives, plans to end the military's COVID vaccine mandate, and the possible inclusion of the Journalism Competition and Preservation Act (which seems to be attracting fire from both sides).

Negotiators appear to have amended the SAFE Banking Act to include legislation to protect gun rights for cannabis users in states where the product is legal and another bill to provide grants to states to help expunge marijuana-related criminal records. In theory, these additional provisions could help attract more support from the right and left and improve the chances that lawmakers will include the SAFE Act in the NDAA. However, there has been no clear signal as to whether or not the amended SAFE Act has been added to the NDAA. That question could be answered today, but delays on the broader bill could drag on for several more days, which would probably also delay an answer to the question regarding SAFE's status.

Odds of attaching Senator Richard Durbin's (D-Illinois) credit card payments bill to the NDAA remain low.

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