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Memorandum

Federal Reserve Vice Chair Michael Barr Outlines Forthcoming Changes to Bank Capital Requirements

July 11, 2023

In a speech on July 10, 2023, Federal Reserve Vice Chair for Supervision Michael Barr outlined long-awaited proposed changes to the regulatory capital requirements for banks and bank holding companies. The proposed changes, as outlined by Vice Chair Barr (which have yet to be approved for issuance by the full Board of Governors of the Federal Reserve and would be subject to a lengthy public comment period prior to finalization), would complete a "holistic review" of U.S. capital standards initiated by Vice Chair Barr shortly after his Senate confirmation. Although this holistic review began well before March 2023, Vice Chair Barr noted that, from his perspective, the events of that month further justify the enhancements to, and expanded applicability of, regulatory capital requirements that the Federal Reserve is expected to propose.

As described below, the proposed changes outlined by Vice Chair Barr most notably include the enhancement of risk-based capital requirements through the implementation of so-called "Basel III endgame" standards and the introduction of a long-term debt requirement for large regional banks, while also including possible updates to stress testing standards and scenarios and calibrations to capital buffers and leverage requirements.

Basel III Endgame–Risk-Based Capital Requirements

Vice Chair Barr signaled that the forthcoming proposed rules would largely implement "Basel III endgame" standards, which were finalized by the Basel Committee on Banking Supervision ("BCBS") in 2017 to better reflect credit, trading and operational risk in the calculation of minimum regulatory capital ratios.

- *Credit Risk*: The proposed rules would end the practice of relying on large banks' internal credit risk models and instead use a more standardized credit risk approach across applicable banks. The international standardized approach to credit risk adopted by the BCBS includes risk weightings for various asset classes with higher degrees of granularity and risk sensitivity than is reflected in the current U.S. standardized risk weightings.
- *Trading Risk*: The proposed rules would continue to permit firms to use internal models to capture most market risks, but would generally apply heightened standards for the quality of internal models, introduce a standardized approach of measuring market risk for use where internal modelling is not feasible (rather than relying on internal models for certain market risks that are "too hard to model"), and require banks to develop internal models at the level of individual trading desks for particular asset classes (rather than at the firm level).

- *Operational Risk*: The proposed rules would replace the current approach of relying on internal models of operational risk with a standardized measure of operational risk, based on the organization's activities and with possible upward adjustment based on its historical operational losses.

Significantly, in direct response to the events that triggered the March 2023 bank failures, the proposed rules would also require applicable banking organizations to account for unrealized losses and gains in their available-for-sale securities when calculating regulatory capital.

As indicated by Vice Chair Barr, the proposal would apply these enhanced capital requirements to all banking organizations with at least $100 billion in total assets. This scope would represent a significant expansion of the applicability of the most risk-sensitive capital rules as compared to the current framework, under which the "advanced" internal ratings-based approaches for credit risk and operational risk (as well as requirements to recognize unrealized losses on AFS securities in regulatory capital) apply only to banking organizations that are internationally active or have at least $700 billion in total assets.

Vice Chair Barr estimated that the proposed changes would result in a 2 percentage point increase in risk-based capital requirements for the largest banks. He noted that most banks already have enough capital today to meet the new risk-based requirements, and that the other banks should be able to build the necessary additional capital through retained earnings in less than two years.

Long-Term Debt

Since at least October 2022, when the Federal Reserve and FDIC jointly issued an Advance Notice of Proposed Rulemaking indicating that the agencies were exploring whether to require large regional banks to hold minimum amounts of qualifying forms of long-term debt ("LTD"), the industry has anticipated that such LTD requirements would be expanded to cover certain large banks not currently subject to LTD requirements. Vice Chair Barr confirmed in his speech that the Federal Reserve will introduce, through a separate rulemaking, a long-term debt requirement for all banking organizations with at least $100 billion in total assets.

This proposed scope of applicability would be a major expansion of LTD requirements, which currently apply only to the largest and most systemically important banking organizations (GSIBs). Significant questions remain, however, regarding the application of LTD requirements for large regional banks, including whether such the minimum amounts of LTD would be calibrated based on differences in size, complexity and resolution strategies, whether the issuance of such LTD would be required at the holding company level (in an external issuance) or at the bank subsidiary level (either in an internal or external issuance), and whether the terms of the LTD would be required to be "plain vanilla."

Stress Testing, Capital Buffers and Enhanced Supplementary Leverage Ratio

In addition to the fundamental changes previewed with respect to risk-based capital and long-term debt requirements, Vice Chair Barr also previewed certain technical adjustments to other aspects of the U.S. regulatory capital regime, including stress testing, capital buffer and leverage ratio requirements.

- *Stress Testing*: While noting that the existing stress testing framework "generally remains sound," Vice Chair Barr stated that stress testing requirements should continue to evolve to better capture risk and would be adjusted to complement changes to the risk-based capital framework. In particular, Vice Chair Barr acknowledged industry concerns that certain of the proposed changes to risk-based capital requirements may result in "double counting" risks that are already captured in existing capital requirements via stress tests (*e.g.*, through the Federal Reserve supervisory stress tests' "global market shock" component or estimation of operational risk). Although he indicated some disagreement with these "double counting" concerns, Vice Chair Barr stated that the Federal Reserve would seek public comment on this matter.
- *GSIB Surcharge*: Vice Chair Barr indicated that he is not recommending "fundamental changes" to the GSIB surcharge framework, but previewed several technical adjustments to the surcharge scoring methodology, including updates to measure systemic risk indicators on a full-year average basis (rather than only as of year-end) and to apply surcharges in 10-basis point increments instead of the current 50-basis point increments (to reduce "cliff effect" changes in an organization's surcharge), as well as certain unspecified updates to the measurement of some systemic indicators to "better align them with risk."
- *CCyB and eSLR*: Vice Chair Barr stated that he had evaluated whether to adjust the countercyclical capital buffer ("CCyB") framework and the enhanced supplementary leverage ratio as part of his holistic review of capital standards, but that he is not recommending changes to either the CCyB framework or the enhanced supplementary leverage ratio at this time.

Timing and Public Comment

As noted above, the proposed changes outlined in this speech have not been approved by the full Board of Governors. However, we expect that the full Board of Governors will consider the proposal and issue it for public comment shortly. As emphasized by Vice Chair Barr in his speech (as well as by other Federal Reserve Governors in other public statements), any proposed rules will be subject to a long public comment period as well as "appropriate transition times" after finalization. Accordingly, we would not expect any final changes to regulatory capital requirements to take effect for several years.

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