New capital requirements for banks proposed by the Fed – untangling their effects on financial institutions, the future of credit and the US economy

Introduction

A new and ambitious proposal launched by U.S. regulators has taken the commercial banking industry by storm, with mixed reactions from bank executives, analysts and politicians. Fed Chair Jerome Powell came out in support of the proposal but admitted that regulators have a difficult task ahead of finding a balance between protecting the financial system and burdening banks.

Nevertheless, these proposals will have a strong impact on the banking sector and beyond, raising questions about the future of credit, the readiness of banks to adopt these rules and the effect on the overall economy.

The proposed new regulations

The Fed, Federal Deposit Insurance Corporation and Office of the Comptroller of the Currency put forward a 1000-page proposal on the matter in order to gain public feedback. The effort to tighten bank oversight, in wake of the failure of three financial institutions in spring of this year, will span a few years, as regulators plan to fully implement the new rules by the middle of 2028. The proposal is not completely new, being the implementation of a 2017 agreement from the Basel Committee on Banking Supervision.

The rules only apply to banks with over $100bn in assets, requiring them to set aside an additional 16% in capital, on aggregate. Regulators estimate that this figure will be as high as 19% for banks with over $100bn in assets, and only 6% for banks with assets valued between $100bn and $700bn. These buffers are aimed to protect against operational losses, such as cyber breaches, fraud and system failures, as well as against market losses in securities and derivatives trading.

The proposal also addresses the controversial internal ratings-based approaches used by banks to set their own capital requirements. These were central to the 2007-2008 Financial Crisis, as they incentivized banks to understate their risk and lower their capital requirements in order to increase returns. After the crisis, limitations were put on these systems, but they proved unreliable. This led regulators to resort to the virtual eliminations of internal models for setting capital requirements, and instead opting for standardized risk measures for all banks.

The reactions

Bank executives have come out against the rules, warning regulators of the implications that proposals would have on the economy. JPMorgan Chase [NYSE: JPM] CEO Jamie Dimon warned that the new capital requirements would make banking stocks uninvestable and would put the burden on borrowers, who will face higher interest rates on loans. He also claimed that the average American bank will have to hold 30% more capital than a European bank. Analysts for Morgan Stanley [NYSE: MS] and Goldman Sachs [NYSE: GS] have said it may take years for banks to set aside enough profits to comply with the rules. Goldman CEO David Solomon claimed the rules set by the Fed have "gone too far", while Bank of America [NYSE: BAC] CFO Alastair Borthwick criticized the proposal, saying that the new regulations mean that in some cases, risk-weighted assets will be double counted,

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further straining banks' abilities to make loans. Industry lobby groups such as the Bank Policy Institute and the Financial Services Forum have also claimed that the rules will burden consumers and will slow down the US economy.

A former Fed chair has come out in response to critics, saying that the new regulations will have a much less significant effect in reality. He claimed large banks, which will be affected most by the Fed's proposal, are profitable enough to offset the decrease in loans funded with leverage by funding them with equity capital. He also claimed that most banks already have enough capital to comply with the rules, and that they are mostly aimed at a certain group of banks that need to catch up to that figure. One concession he made is the complexity of the proposals, which could confuse investors and the overall public, as well as banks themselves.

Implications on banks

US banks will have to make amendments to the structure of their balance sheets in order to comply with the higher capital requirements set by regulators. This implies increasing their reserves in riskless assets, such as cash and treasury securities, and reducing lending, which, on the contrary, bears risk. According to Bank of America CEO, Brian Moynihan, a 100-basis point increase in reserve requirements would "stunt the bank's ability to extend $150bn worth of loans". This will, of course, lead to a rise in the cost of credit, making mortgages and small-business loans less affordable, specifically for low-credit score individuals and firms. The increased capital requirements could, indeed, lead to an increase in interest rates for low- and moderate-income and other underserved borrowers who cannot always afford a 20% down payment, making it that much harder for these households to achieve homeownership.

According to Morgan Stanley's predictions, some banking giants might take up to 4 years to set aside profits to meet the new capital regulations. The new rules also view high-revenue business lines as higher risk: some fee-based businesses, such as wealth management, will need to allocate more capital even if there is no balance sheet risk. This might weigh on trading in capital markets. For example, JP Morgan officials said that the bank would likely have to drop a derivatives product tied to the US Treasury yield curve as holding it would no longer be economical due to the increased capital required to back the trade up. Moreover, many are concerned that higher capital charges might also be applied to other non-interest revenue, which includes the fees lenders charge on credit cards and investment banking services. This might harm several large banks' profitability as they have a high proportion of non-interest income, a crucial component of their growth strategies. Overall, the fundamental idea behind the new regulations is to put in place a standardized model for risk management that would be common to all banks and more conservative than the risk assessment measures banks are currently undertaking. Banks will have to replace their internal lending and operations risk strategies and develop strategies to comply with the more cautious model.

Even though the new capital requirements are mainly aimed at monitoring large banks, the regulations might also impact small and mid-sized banks. Firstly, the increased cost of borrowing might encourage some consumers to seek better rates across different banks. The new rules might allow smaller banks to offer more competitive rates than mega banks, expanding their customer base. Furthermore, the consequences of increasing capital requirements for all banks above $100bn in assets may force mid-sized banks to merge or consolidate to achieve the necessary economies of scale to meet this new capital requirement. Mid-sized bank consolidation might, however, harm competition and reduce banking options in some geographic or product markets.

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To sum up, the impact of higher capital requirements, coupled with the Fed's changing monetary policy stance, could profoundly reshape the US banking sector. Behavioural changes at the organizational and market level could be accompanied by structural shifts as stricter regulatory standards hit smaller banks and provide an impetus for consolidation.

Other implications

The reduction in banks' capacity to lend and to support capital markets activities, such as market-making, has raised concerns among experts as they are worried this might slow economic growth. The Financial Services Forum, a lobbying group for the largest US banks, has also argued that the new rules would hurt the United States' ability to compete with other economies, making various loans and other financial services more costly or less available than in Europe or elsewhere. However, when announcing the proposal, Fed Vice Chair for Supervision Michael Barr addressed this concern, stating that the benefits the new regulations will bring to the financial system outweigh the costs to economic activity that may come with holding more capital.

Many argued that these regulations will largely benefit non-bank lenders, such as private equity and venture capital firms. Banks might be forced to exit some businesses, which would require setting aside higher capital levels. Before ultimately deciding to leave some of these lending areas entirely, they will attempt to restore shareholders' value by raising prices on end-users of loans and products. However, they already said that if the repricing is unsuccessful, they will have to remix, meaning they will have to get out of certain products and services. These products and services leaving the regulated perimeter will look for financing opportunities elsewhere, mainly for non-bank players not subject to the new regulations. Some financial experts have raised concerns as non-bank lenders, sometimes referred to as the "shadow banking" industry, generally face lower federal scrutiny than commercial banks. Following the announcement of the new capital requirements, Blackstone [NYSE: BX] and Apollo's [NYSE: APO] share prices rose, reflecting the market belief that private credit lenders will largely benefit from the new situation.

Experts are not particularly worried that the new regulations might negatively impact the overall M&A market. Corporations and investment funds have been witnessing an increase in the cost of borrowing due to high interest rates for the past years, and they have developed strategies to finance their new deals. Once again, they might resort to private credit or European banks that do not have to comply with higher capital requirements.

Outlook

It has been more than two months since authorities made the first draft public, and it is now evident that banks do not wish to adapt, but rather fight against these restrictions. Big names in the banking sector have been vocal against the new capital requirements, with Jamie Daimon calling them "hugely disappointing" and "lacking transparency", implying that banks' shares will become unappealing to investors. With one of their core business segments and Return on Equity under jeopardy, banks and lobbyists are fighting back in a confrontation that appears to be escalating by the day. Therefore, on September 12th, a group representing JPMorgan Chase, Goldman Sachs, Morgan Stanley, and Citi Group [NYSE: C] accused the Federal Reserve and other regulators of violating the Administrative Procedure Act (APA), claiming that the proposal lacked adequate public data and analysis. With some estimates putting the impact on the financial sector at roughly $170bn in higher capital requirements, we

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should anticipate this unusually strong industry effort to continue and intensify as Republicans in Congress show support for the banks.

While banks are locked in a never-ending war with regulators, private credit businesses are booming and setting record after record in a market worth north of $1.5tn. On August 17th Oak Hill Advisors, Blue Owl Capital and HPS Investment Partners locked the biggest private credit scheme in history, providing a $5.3bn loan package to Finastra, a fintech company owned by Vista Equity Partners. The most intriguing aspect of this transaction is that Finastra will utilise the loan to refinance existing debt. This contrasts with the conventional wisdom that private credit firms primarily work on leveraged buyouts, such as the previous lending record, a $5bn loan for Hellman & Friedman and Premira on their acquisition of Zendesk [NYSE: ZEN]. Bearing in mind that a private lending scheme of more than $1bn was considered inconceivable just four years ago, the fight over new restrictions is making it less enticing for banks to lend to junk companies these days. However, not only are private credit companies filling a vacuum, but they are also stealing Wall Street's Business. In August 2019, New Media Investment Group picked Apollo Global Management over Goldman Sachs for its $1.25bn acquisition of Garnett, a media firm, marking a pivotal moment in the loans battle. According to John Zito, co-head of global corporate credit at Apollo, private lenders will capture more than 10% of the loan market, with the fund already working with conventional bank clientele such as Hertz, Bombardier, and Westinghouse.

Tags: Commercial banking, Bank, Fed, Private credit, US economy

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