Bank Regulatory Capital – Regulatory Update Initiative

Hu Benton | hbenton@aba.com | 202-663-5042 August 2023

Issue Update

FDIC-insured banks are subject to minimum regulatory capital requirements set by their primary Federal regulators. The basic requirement currently has two parts – a leverage ratio comparing the bank's Tier 1 capital to the bank's average total consolidated assets and risk-based ratios that weight assets based on perceived risk. The minimum leverage ratio for most banks is 4%, but larger banks must meet additional requirements. "Tier 1 capital" includes common equity, retained earnings, and a limited amount of other equity instruments that meet regulatory terms, less certain intangibles and other specified assets. Most banks must also meet a set of risk-based capital ratios, comparing various different capital components (common equity Tier 1 capital, total Tier 1 capital, total capital) to total risk-weighted assets. These calculations apply various factors reflecting the relative riskiness of different asset types and other credit exposures to calculate the appropriate capital cushion for the bank in light of its overall risk profile. The risk-based ratios, which involve many complex calculations, range from 4.5% to 8%.

To reduce compliance burdens, in the 2018 regulatory tailoring legislation, Congress created an option for qualifying community banks to elect a "community bank leverage ratio," which allows them to avoid computing capital based on risk-weighted assets. For banks that have (a) less than $10 billion in average total consolidated assets, (b) off-balance-sheet exposures of 25 percent or less of total consolidated assets, and (c) total trading assets and liabilities of 5 percent or less of total consolidated assets, they can maintain a minimum leverage ratio of without computing risk-based capital ratios. The current community bank leverage ratio is 9% of total consolidated assets.

Finally, an area of serious current concern is the treatment of certain securities whose market values are currently below their book values and are either "available for sale" or accounted for as "held to maturity." Though the largest banks periodically recognize market value changes (both gains and losses) in their "available-for-sale" securities in "accumulated other comprehensive income," smaller banks have the option to elect not to recognize such value changes – both "available-for-sale" and "held-to-maturity" securities are carried at cost. Partly in response to the spring 2023 bank failures, in which losses on securities were realized when they were sold to meet heavy deposit withdrawal demands, regulators have proposed to expand the range of banks required to recognize market-value gains and losses on "available-for-sale" securities periodically through AOCI, whether they sell securities or not.

Why It Matters

Regulatory capital provides the primary bank cushion to absorb losses of all kinds, protecting bank customers and allowing banks to provide ongoing services. Yet required capital also acts as a constraint on credit growth and bank innovation and sometimes hinders adjustment to changing business conditions. It is critically important that banks' capital levels be correctly calibrated to provide an adequate cushion against risk and losses while also allowing banks to remain competitive sources of credit for their communities. Recent increases in interest rates have magnified this potential effect. If capital levels are excessive, banks are likely to have to seek higher yields to support their higher all-in cost of funds. Besides threatening customers with higher costs, making banks less competitive will eventually drive more credit out of the regulated, transparent banking sector into the opaque, unregulated areas of the financial system. Moreover, in addition to constraining lending, capital requirements affect the composition and volume of bank liabilities, which may limit banks' flexibility in providing deposit services to customers. These changes threaten to make the financial system less stable rather than promoting the stability for which regulatory agencies aim.

Recommended Action Items

In conversations with Congressional offices and regulators, make clear that appropriate regulatory capital requirements depend on a careful balance and calibration of risk coverage and competitive all-in funding costs, as well as being flexible enough to allow reasonable deposit services for bank customers. Current regulatory capital proposals already threaten a segment of ABA members with these pressures, and they may represent trends (such as in the accounting for securities gains and losses) that would eventually affect more banks.

Also, make clear to regulators that, if they expand the required recognition of gains and losses on "available-for-sale" securities to a wider range of banks, they need to provide an appropriate transition period of at least five years. They should also avoid a linear phase-in of the change and instead adopt one that is back-weighted and more reflective of the securities' cash flows.

American Bankers Association