

Press Release

March 04, 2020

Statement by Vice Chair for Supervision Quarles

The stress capital buffer (SCB) rule adopted by the Board today materially simplifies the post-crisis capital framework for banks, while maintaining the strong capital requirements that are the hallmark of that framework. I support it for the following reasons:

Following the financial crisis, the Board responded by both strengthening capital requirements and by establishing rigorous stress tests. Each of these measures helped improve the resilience of banks, but they were developed in parallel, leading to unnecessary complexity and partial redundancy. The SCB takes the best elements of both frameworks, establishing administratively simpler restrictions on a firm's ability to make capital distributions depending on its projected ability to withstand stress.

Lessons learned from the financial crisis have given us the *structure* of the SCB; the financial crisis has also taught us a number of lessons that are relevant for *calibration* of the SCB. First, we should be focused on systems, rather than snapshots: we should calibrate our capital regime to be optimal over a full business cycle, and not be complacent over banks' capital ratios at any particular moment (which is one of the reasons for the creation of the stress testing framework itself). Second, we should be focused on common equity—the highest quality and most loss absorbing form of capital—than the variety of sometimes esoteric instruments that have counted as various "tiers" of capital in the past. Third, we should be focused on the incentives created by our capital framework, in addition to overall capital levels. And fourth, we should limit the degree to which required capital actions depend on the discretion of regulators rather than on clear and automatic rules.

The SCB rule adopted today draws on each of these lessons. First, we assess a firm's capital requirements based on the firm's sensitivity to severe stress throughout the business cycle, not merely at a point in time, and we must therefore evaluate the effect of the SCB rule over the full cycle rather than at any particular point in time. Second, a firm's SCB must be composed of common equity capital rather than other types of so-called tier 1 capital. Third, removing the post-stress leverage measure—keeping the leverage ratio as a key element of the overall capital framework—eliminates an incentive for banks to increase the riskiness of their portfolios.¹ And fourth, the restrictions the SCB places on capital distributions are automatic—a function of a firm's performance in the stress tests and its systemic footprint, not of regulatory discretion.

As a result, the SCB rule adopted today will lead to an *increase* in the Board's common equity capital requirements for large banking firms, as measured through the cycle, of approximately \$11 billion, including an approximately \$46 billion increase for the U.S. global systemically important banks. Banks also keep certain voluntary buffers above our required minimums, and those buffers will vary somewhat from time to time—nothing in the SCB rule adopted today gives banks an incentive to reduce those buffers, which will always remain above our now *higher* through-the-cycle requirements.

For all these reasons, the SCB will strengthen capital while enhancing the transparency, simplicity, and coherence of the regulatory capital and stress testing frameworks.

1. A leverage ratio is an important element of a comprehensive capital framework: it sets a minimum floor for required capital by disregarding risk-sensitivity measures that will always be subject to some error. Stress tests, on the other hand, can be thought of as our most granularly risk-sensitive capital requirements, and thus including a leverage ratio as *part* of them, rather than as a *backstop* to them, confuses the purposes of

the two different measures and muddles the framework. Where a leverage measure, rather than a risk-based measure, becomes the constraint on a bank's investment decisions, this inevitably creates a bias toward riskier assets, as those will generally produce a greater nominal return for any given investment if they do not carry a greater capital cost. Eliminating the post-stress leverage measure removes this incentive, but does not reduce the amount of common equity capital by one jot—and the leverage ratio itself remains a backstop in the full capital framework. [Return to text](#)

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