

## Bank Capital Regulation and the Off-Ramp

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The financial crisis of 2007-2009 taught us that failures of large financial institutions can impose costs on the entire system. In an effort to reduce the likelihood of another systemic crisis, the Dodd-Frank Act of 2010 imposed regulatory constraints on large banks, requiring banks to participate in annual stress tests and to satisfy certain capital and liquidity ratios.

The CHOICE Act argues in favor of an exemption, or opt-out option (referred to as the “Dodd-Frank Off-Ramp for Strongly-Capitalized, Well-Managed Banking Organizations”), for banks that have a leverage ratio of at least 10%. The logic behind the proposal is that banks with sufficient capital pose no systemic risk and therefore do not require regulation.

In our view, any implementation of the off-ramp requires regulators to take into the account banks’ responses to using a simple leverage ratio for the off-ramp. The history of bank regulation has shown that a single target may not be sufficient in containing risk. Regulators therefore need to make sure that banks have sufficient capital not only during regular times but also during crises. In practice, this requires regulators to measure capital during a crisis, using credible stress tests. It also requires that regulators monitor bank risk using proper measures of leverage, off-balance sheet exposure, and bank risk exposure. We conclude that while stress tests may impose significant costs on banks, they are necessary for the largest, most complex and most interconnected banks in order to limit systemic risk.