The Cost of Implementing the Basel III Endgame Framework:

Higher Bank Capital Rules Will Hurt Small Businesses and Middle Class Borrowers the Most

Stephen Moore and David Malpass

Stephen Moore is co-founder of the Committee to Unleash
Prosperity and chief economist with FreedomWorks.
David Malpass is former president of the World Bank.

Introduction

Politicians often overreact to short term crises in ways that can make the economy worse off. The response by federal regulators to the rapid succession of bank failures last spring was certainly no exception to this rule. Despite the unique circumstances that led to the failure of SVB, Signature Bank, and First Republic Bank, it was enough for many to conjure up memories of the 2008 financial crisis. Never slow to capitalize on the fears of the populace, senate democrats have called on federal regulators to raise capital requirements for U.S. banks. In response, The Federal Reserve, with the Office of the Comptroller of the Currency and the FDIC have released their joint proposal for the U.S. implementation of the Basel III endgame regulatory framework earlier this year.

Contrary to the claims of its proponents, implementing the Basel III endgame framework would be ineffective in addressing the fundamental causes of last year's bank failures. Several well-respected government and private studies have found that American banks are NOT undercapitalized and that the banks that did fail were NOT undercapitalized. Those banks simply made a series of bad investment/lending decisions and owned too many government bonds that lost market value in an era of rising interest rates.

The FDIC and the Federal Reserve correctly want to maintain the health and safety of America's banks. They want to avoid bank runs that could do great damage to our financial system. But these new rules would only punish banks that are financially sound and shrink the available pool of loans available to homebuyers, small businesses, and lower income families. Less lending to qualified borrowers would mean less economic growth and less financial stability.

The following analysis will provide a brief review of the Basel III endgame framework, the current robust state of U.S. bank capitalization, and the detrimental implications of the framework for U.S. investment and economic growth.

What is the Basel III Endgame Framework?

The Basel III endgame framework is an international set of banking standards written by the Basel Committee on Banking Supervision (BCBS), made up of 27 member countries including the United States and the European Union. The BCBS was formed with the purpose of standardizing specific aspects of capital rules for large banks. The resulting framework of regulation has evolved over time, starting with Basel I in 1988, which introduced risk-based capital requirements using five simple risk-weight categories. Basel II, agreed upon in 2004, built upon Basel I by modifying risk-weight categories and adding regulation for other areas of perceived risk.

In the wake of the 2008 financial crisis, the BCBS set out an even more stringent framework of capital requirements and financial stress testing. Basel III was first published in 2010, with initial revisions in 2011 and additional updates in 2017. The U.S. implemented most of Basel III's first revisions between 2013 and 2015.

Finally, The Basel Committee issued its latest revisions in 2019, known as the Basel III endgame, with a specific focus on creating a one-size-fits all set of risk-based capital requirements. While the BCBS outlines the framework of regulation, member countries determine the specific points and timeline of implementation. Regulators in the European Union and United Kingdom proposed their implementation approaches soon after, and now U.S. banking regulators have presented their version of the Basel III endgame.

Based on the proposal, the anticipated increase in required capital will likely arise from four specific aspects of the framework: (1) the standalone impacts of the The Fundamental Review of the Trading Book (FRTB) implementation, (2) the overlap between the FRTB and the Stress Capital Buffer (SCB), (3) the interaction between the FRTB and the Collins Floor, and (4) additional constraints on the use of internal models.

1. Stand Alone Impacts of the FRTB Implementation

The Fundamental Review of the Trading Book is at the core of the Basel Endgame package, aimed at reforming the calculation of market risk capital requirements. It introduces a new test called the Profit and Loss Attribution test (PLAT) to complement the existing Boundary Test (BT) and ensure stricter criteria for using internal models. Under the FRTB, a bank can utilize internal models to calculate market risk capital requirements only if it passes both the BT and PLAT tests. Otherwise, the regulator-set standardized approaches must be used.

The implementation of the FRTB in this manner will lead to substantial increases in total risk-based capital requirements for most banks. By limiting the use of internal models and relying more on standardized approaches, and incorporating stricter qualitative criteria, banks will face higher capital requirements. As indicated by the Basel 2022 Quantitative Impact Study (QIS) report, the FRTB could result in a rise of over 63% in market risk capital and an increase of 7.7% in Credit Valuation Adjustment (CVA) risk capital requirements.

2. Overlap Between the FRTB and the Stress Capital Buffer (SCB)

The Standardized Capital Buffer (SCB) replaced the Capital Conservation Buffer (CCB) in the United States, while the CCB remains in place for other Basel Committee on Banking Supervision (BCBS) member countries. Unlike the fixed 2.5% CCB, the SCB floor is also set at 2.5%, but due to U.S. banks' gold-plating to avoid regulatory scrutiny, capital reserves are generally much higher. The 2022 stress test showed that 21 out of 34 banks subject to the SCB rule have requirements exceeding 2.5%, with some banks as high as 9.0%.

Both the FRTB and the SCB aim to measure extreme potential losses from global market shocks to a bank's trading activities. Consequently, these potential extreme losses will be counted twice for the risk-based capital requirements, as both the FRTB and SCB contribute to the required level of reserve capital. This double counting is likely to compound the capital impacts of the new regulatory framework.

3. Interaction Between the FRTB and the Collins Floor

Current U.S. capital rules offer two approaches to calculate risk-weighted assets (RWAs) - the Advanced Approaches and the Standardized Approach.

Advanced Approaches refer to a set of methodologies that allow banks to use their internal risk models to calculate risk-weighted assets. These internal models are typically more sophisticated and tailored to a bank's specific risk profile, providing a more accurate representation of the risks associated with their assets.

The Standardized Approach, on the other hand, is a simplified method for calculating RWAs, which applies predefined risk weights to various categories of assets based on the type of exposure. It is a more uniform and straightforward approach compared to the Advanced Approaches. The Standardized Approach is typically used by smaller or less complex banks that may not have the resources or expertise to develop and implement internal risk models. However, it is considered to be less risk-sensitive and may not fully capture the specific risk profile of individual banks.

The Collins Floor, an amendment of the Dodd-Frank Act, mandates that the risk-based capital requirements calculated using the Advanced Approaches must be at least 100% of the Standardized Approach. This means that any increase in market risk capital requirements resulting from the Fundamental Review of the Trading Book (FRTB) will be fully reflected in increases to the Collins Floor. In contrast, the Basel output floor, standard for EU banks, provides a 5-year phase-in period with the final floor set at a lower 72.5%.

4. Additional Constraints on the Use of Internal Models

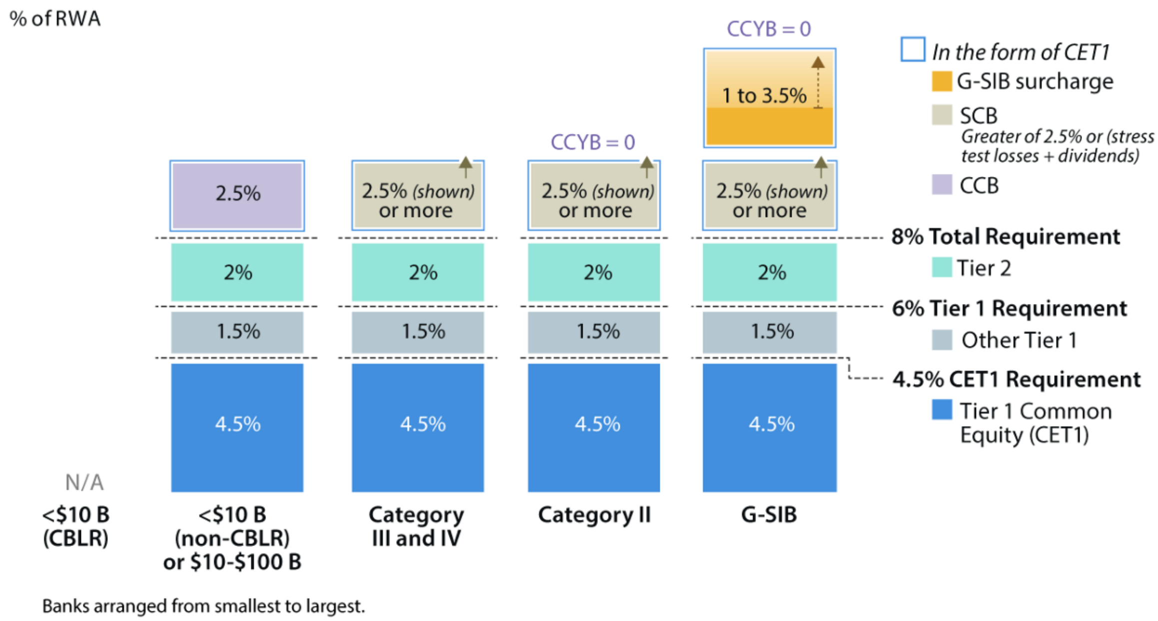
The Basel III endgame standards would likely replace the Advanced Approaches, with revised Basel standardized approaches for credit and operational risk. This shift towards standardized approaches may discourage banks from developing expertise in internal models, which are considered more effective for risk management. As a result, larger more complex banks would be forced to use simplified models that do not accurately capture their risk profile, likely resulting in unnecessarily high levels of reserve capital.

Current State of Bank Capitalization

The intense political pressure on federal regulators to implement the Basel III endgame might lead one to believe that U.S. bank capitalization rates have fallen to dangerously low levels. In reality the opposite is true. Far from the fragile position it was in prior to the 2008 financial crisis, the banking sector is already exceptionally well capitalized, with nearly $3 trillion in high quality liquid assets (4.5 times 2008 levels).

A recent report from the Congressional Research Service shows that even under the current regulatory framework the largest banks or globally systemically significant banks (G-SIB) are required to hold 14% in risk-weighted capital reserves. This is a significant increase from the 8% capital requirement from the original Basel I framework and the 10.7% average effective rate of the Basel II requirements.

Figure 2. Adequate Risk-Weighted Prompt Corrective Action Requirements and Buffers



Source: CRS based on bank regulatory capital rules.

In addition to the 14% in capital reserves that G-SIBs are required to hold, many banks build in an additional margin of safety to avoid risk and costly regulatory scrutiny, a practice called "gold-plating." A Price Waterhouse Cooper (PWC) meta-analysis finds that gold-plating amongst U.S. banks has raised the actual average G-SIB capital level to 15.5%. PWC further provides review of the academic literature on capital reserve levels. It shows that the optimal level of reserve capital, that provides the most security from systemic financial risk with the least detriment to economic growth, is 15.5%, precisely what banks currently hold. This means that any additional capital requirements would only serve to limit the funds that banks can lend, choking credit and crippling economic growth.

The latest June 2023 Federal stress testing of the top 23 U.S. banks further solidifies the secure capital position of the U.S. banking industry. Under even the sharpest global financial shocks, including simulations of unemployment surging to 10%, a 40% decline in commercial real estate values and a 38% drop in housing prices, the top banks could sustain $540 billion dollars in losses and continue to provide loans for households and businesses. Consistent results like this highlight that there is little to no further security to be found in further raising capital requirements.

The Congressional Research Service (CRS) estimates that the proposed regulatory changes would on average increase aggregate Tier 1 capital by 16% and up to 19% for large G-SIBs. They claim that all but five Category I and II holding companies already meet the proposed requirements and that these institutions will only have to raise their capital levels between 16 and 105 basis points relative to their risk weighted assets to comply. Despite this seemingly low impact intervention, there is good cause to believe that the CRS is wildly underestimating the full impact of the proposed regulations.

The BCBS estimates that the FRTB component alone of the Basel III endgame framework will raise market risk capital requirements from their current levels by 56.5%. Applying this to their estimated effective rate of 14.8% that G-SIBs currently hold, this would imply a 8.36 percentage point jump in capital requirements, bringing the total level of required risk-weighted capital to a staggering 23.16%. If we apply the 56.5% increase to PWC's estimated effective rate of 15.5% this would imply a 24.26% level of required capital under the new regulations. And this doesn't even account for the more than 900,000 "annual burden bours" that the CRS estimates it will take for U.S. banks to stay in compliance with the new regulations.

What is perhaps the most glaring oversight of the implementation of the Basel III "endgame" standards is that they fail to address the true causes of the recent bank failures. The proposed rules require financial institutions to hold excess capital to account for operational risks, loan default risk, and trading risks but they utterly neglect the risk posed by rapid increases in market interest rates or inadequate liquidity, the primary causes of the recent bank failures. A recent ABA article even states that, "No reasonable amount of capital would have prevented SVB's failure." So even if the proposed standards had been in effect, SVB, Signature Bank, and First Republic Bank, would have faced the same inevitable fate.

Implications for U.S. Investment and Economic Growth

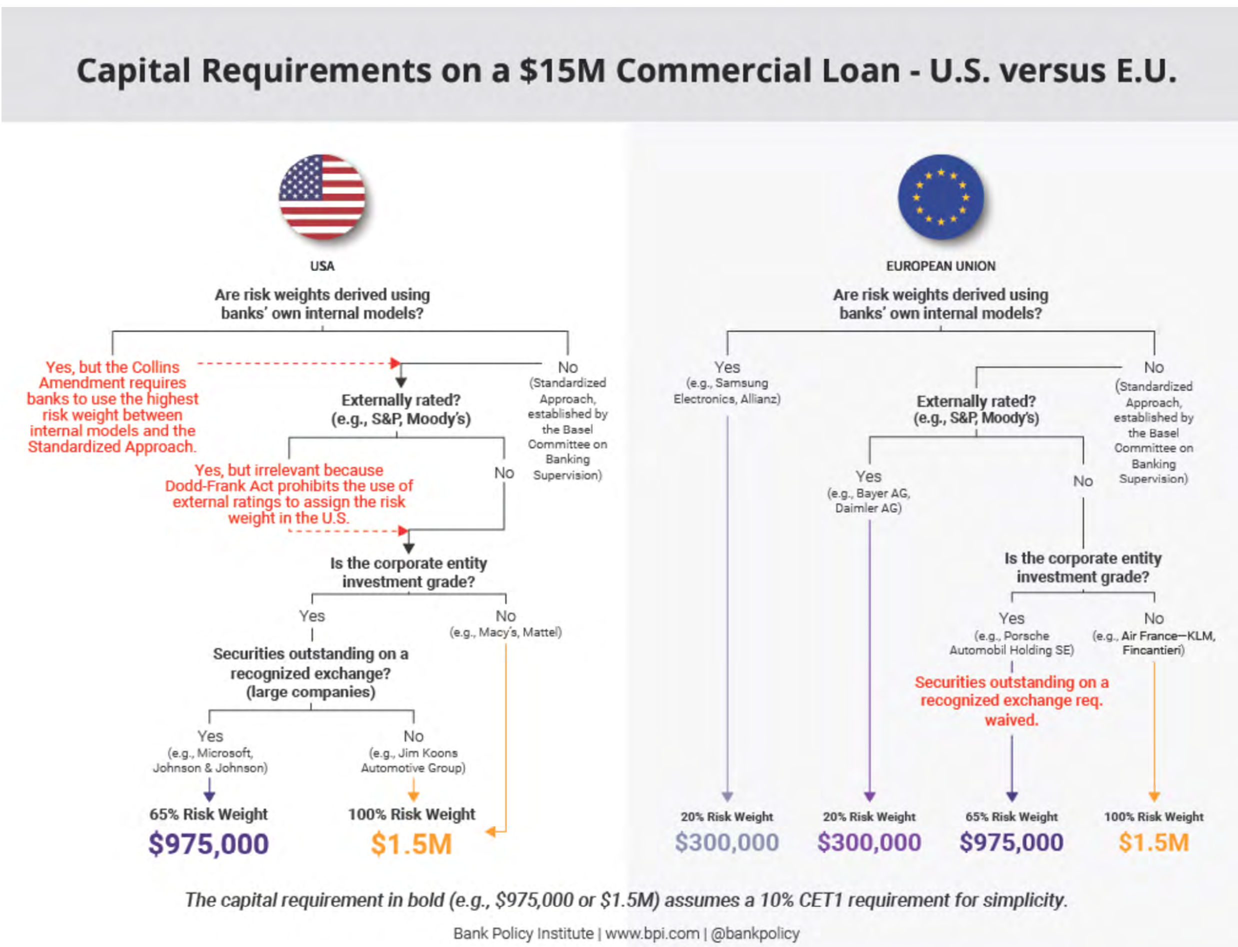
The unprecedented increase in effective capital requirements from the Basel III endgame framework will have a negative impact on U.S. investment. It is a truism that the more that banks are required to hold in capital reserves the less they have to lend to U.S. households and businesses.

It is also important to remember the foundational significance of U.S. capital markets. As of the end of 2022, the U.S. capital markets funded almost 75% of all economic activity in the country. They provide the oxygen for the global economy. The U.S. capital markets are the largest globally, representing 41% of the $118 trillion global equity market capitalization (approximately $48 trillion) and 39% of the $123 trillion total outstanding securities worldwide (around $48 trillion). Any regulatory shock to the U.S. capital market will have significant economic repercussions both domestically and globally.

How will this affect U.S. investment? A recent study from the Securities Industry and Financial Markets Association (SIFMA) finds that for every one percentage point increase in additional risk weighted capital required, aggregate available assets decreased by $16.26 billion. If we apply this to the BCBS's own estimate of an 8.36 percentage point increase in effective risk-weighted capital, this means that implementing the increased capital requirements as laid out in the Basel III endgame framework, would result in a loss of more than $136 billion in available capital for lending each year that it is implemented. This study only takes into account the direct impact of the FRTB component of the proposed regulatory framework. The other potentially confounding factors previously mentioned in this analysis suggest that $136 billion a year is a low-end estimate of what the true cost will likely be.

A paper from the European Systemic Risk Board, evaluating the impact of the Basel II capital requirements finds that for every percentage point increase in required capital, bank lending fell 8% and firm borrowing fell 4% due to higher interest rates and stringent credit limits. A similar study from the European Central Bank also found that a one percentage point increase in bank capital requirements was associated with a short-run decline of 0.15-0.35% in GDP. This may sound inconsequential, but a loss of 0.35% of U.S. 2022 GDP would be $918.38 billion. A [study](#) from the Federal Reserve Bank of Philadelphia estimates that the decrease in GDP may be as high as 0.6%, or equivalently, $1.5 trillion for each percentage point increase in capital requirements.

It is also worth noting that the heavy regulations ALREADY imposed on American banks put our lending institutions at a competitive disadvantage vis a vis foreign banks. The existing regulatory standards that apply to U.S. G-SIBs, the addition of the Basel III endgame framework will make U.S. banks less competitive compared to banks in the EU. An [analysis](#) from the Bank Policy Institute shows that due to the differences in existing regulation, a U.S. business that takes out a $15 million loan (the average corporate loan amount according to Federal Reserve data) will pay an interest rate that is 45.5 basis points higher than a business taking out an equivalent loan in the EU. This equates to an additional $68,250 in annual interest paid by the U.S. business. The chart below outlines some of the key regulatory differences that make the implementation of the Basel III endgame framework more harmful to the U.S. than the EU.



Conclusion

Maintaining the financial soundness of the American banking system is critical to maintaining a healthy and prosperous U.S economy – as well as the global economy. This study finds that the Basel requirements would NOT add to the safety of the banking system, but would have a negative economic impact on banks, businesses, and American families by unnecessarily constricting lending.

In summary, based on the best available evidence, we conclude that the proposed new regulatory network of higher capital requirments for banks could:

1. Increase capital requirements for banks by as much as 25%.

2. Reduce GDP growth in the short term by between .3 and .6% of GDP per year. This is the equivalent of a roughly $50 billion annual tax on the U.S. Economy.

3. Reduce the available pool of capital by $100 to $150 billion a year.

4. Reduce the international competitiveness of U.S. Banks versus foreign banks.

5. Small businesses and lower income families are most likely to be crowded out of capital and lending markets as a result of these new rules.

While recent bank failures have understandably sparked public concern, the knee-jerk response of advocating for higher capital requirements for all larger banks is misguided. Capital adequacy is not the sole determinant of a bank's stability, and it would be bad policy to burden all institutions with regulations that are as unnecessary as they are costly. The Basel III endgame framework threatens the stability and continued growth in the U.S. banking industry and the overall economy.

COMMITTEE
TO UNLEASH PROSPERITY