BANK POLICY INSTITUTE

Basel III Endgame and the Cost of Credit for American Business

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What's the Context Here?

After the 2008-09 global financial crisis, the Basel Committee on Banking Supervision, the global standard setting body for bank regulation, agreed on a complete overhaul of bank capital standards. Those overhauled standards, known as "Basel III," largely have been implemented worldwide, including in the U.S. and Europe. Generally speaking, these standards define minimum bank capital requirements – the amount of capital banks must hold to cover potential losses – for assets such as corporate loans and home mortgages. At the end of 2017, the Basel Committee (of which the U.S. and 27 other major jurisdictions, including the EU, are members) made substantial changes to Basel III, despite its successful track record, generally with the goal of bringing assessment of credit risk more under governmental control. Currently, regulators in the EU, U.S. and other countries are preparing to revise their regulations to implement the Basel III endgame agreement. The EU issued proposed revisions at the end of 2021, and the U.S. is expected to follow sometime this year.

Why it Matters

Implementation of the Basel III endgame changes in the U.S. could overstate the credit risk of U.S. corporate and small business borrowers, resulting in higher capital requirements for U.S. banks that provide credit to these borrowers and higher borrowing costs for U.S. businesses, particularly relative to European firms. Higher loan costs will reduce credit availability for businesses in the U.S. and weaken economic growth. The effects will be felt broadly, first by the businesses seeking credit and secondarily by the communities they serve, including low- to moderate-income communities.

The European Approach

The EU has proposed to implement the Basel changes in a way that ensures that businesses will be assessed for their actual risk, and not be subjected to punitive, one-size-fits-all standardized charges that assume a worst-case scenario. Specifically, the EU proposal will:

- **Allow banks to use internal models** to determine default risk for capital purposes, as long as those models do not produce risk-weighted assets on a bank-wide basis that are lower than 72.5% of risk-weighted assets generated under the so-called Standardized Approach. (As its name implies, the Standardized Approach uses fixed risk weights for loans that have been pre-determined by regulators based on the loan type or category. For example, credit exposures to U.S. depository institutions generally receive lower standardized risk weights than credit exposures to corporate entities.)

- **Allow the use of external credit ratings (say, by Moody's or S&P) under the Standardized Approach.** In Europe, loans to businesses that are rated investment grade or above by the rating agencies enjoy more favorable treatment under the Standardized Approach – in some cases, risk weights as low as 20%.

- **Allow unrated companies to qualify as investment grade under the Standardized Approach** without requiring the company to have securities listed on a recognized exchange at least until 2031. This means that companies whose securities are not listed on a recognized exchange due to factors unrelated to credit quality may nevertheless qualify as investment grade, with exposures therefore benefitting from a 65% risk weight instead of 100%.

- **Allow for a lower risk weight for small businesses if not otherwise eligible for the 65% risk weight for "investment grade" companies.** Europe already provides a favorable capital treatment for small business lending, which lowers costs for small businesses borrowing from European banks.

The European approach eliminates all instances in which a 100% risk weight would be assigned to a firm whose actual risk justifies a lower risk weight. This lowers the cost of borrowing for these firms.

The Anticipated U.S. Approach

It is expected that the U.S. banking agencies will issue a Bael III endgame proposal in 2022 that will:

- **Disallow the use of internal models.** U.S. regulators have already signaled they intend to rely exclusively on the revised Basel standardized approaches. Thus, even though bank models are reviewed and approved by agency examiners, use of those models will be barred in favor of a single, government-devised "standardized" model for predicting credit risk.

- **Disallow the use of external ratings of corporates** to categorize loans for purposes of assigning risk weights under the revised Standardized Approach. This U.S. move is not required to be compliant with Basel III standards; rather, the Dodd-Frank Act specifically prohibits the use of external credit ratings in this context. Because the EU will allow the use of external credit ratings to reduce risk weights, similarly situated U.S. banks will have to apply 100% risk weights, consequently, forcing U.S. businesses to pay higher loan rates than their European peers.

- **Likely to disallow unrated companies to qualify as investment grade under the Standardized Approach if the entity's securities aren't listed on a recognized securities exchange.** To meet the securities listing requirement, a company's equity or debt securities must be publicly traded, which means the company is also subject to a host of SEC-related regulatory and disclosure requirements applicable to public companies. Listing standards often include factors that are unrelated to credit quality (such as governance requirements intended to protect investors) and, in practice, very few firms that borrow from banks meet the securities listing requirement. Generally, only the largest firms meet this standard.[1]

- **Likely to disallow a separate (and lower) risk weight for small businesses**, something the U.S. framework, unlike Europe, has never allowed.

How Can the U.S. Avoid Self-inflicted Wounds?

Foremost, the U.S. could delay or eliminate the securities listing requirement so that creditworthy but smaller borrowers can avoid a punitive capital treatment. Although this would technically represent a deviation from the Basel III endgame standard, consider that (1) the EU is already planning a 10-year delay of the same requirement in its own rulebook, (2) the statutory prohibition on using external ratings already puts the U.S. at a major disadvantage under the Basel III endgame standards, and (3) the U.S. agencies already "gold-plate" so many other facets of the Basel standards (meaning they often impose requirements that are much higher than the standards articulated under Basel agreements). For example, the largest 33 banks in the U.S. are subject to a stress capital buffer, which is determined from the supervisory stress test results, and is about 1 percentage point higher than Basel's capital conservation buffer of 2.5 percent on average.

Additionally, the U.S. agencies believe that letting banks decide whether a corporate entity meets the qualitative standards of an investment grade rating will increase the variability in risk weighted assets across banks. Recent research shows that eliminating the securities listing requirement does not increase materially variability in risk-weighted assets.

Conclusion

If U.S. regulators interpret Basel III endgame in an extreme way, domestic banks will face capital requirements that outweigh those of their foreign rivals and overstate businesses' actual default risk. Instead, U.S. regulators could adopt a version of Basel III endgame similar to the EU approach that recognizes the true creditworthiness of business loans that banks must hold capital on. This outcome would reduce the cost of credit for U.S. businesses of all sizes, including small businesses, and allow them to compete fairly with global peers.

A Deeper Dive

For more on how American businesses could face more expensive access to credit, see our explainer video here.

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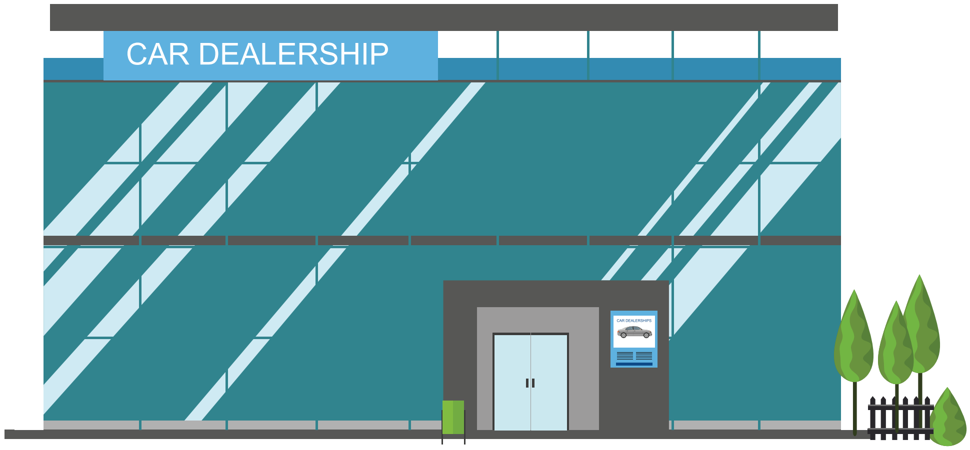
[1] A recent study using Federal Reserve data shows that banks subject to the stress tests lend to 155,589 unique U.S. corporations of which 153,000 are private. Therefore, the large majority of U.S. corporations do not meet the securities listing requirement. See Caglio, Cecilia; Mathew Darst; and Sebnem Kalemli-Ozcan; "Risk-Taking and Monetary Policy Transmission: Evidence from Loans to SMEs and Large Firms", National Bureau of Economic Research, WP #28685, April 2021," available at: https://conference.nber.org/conf_papers/f159755.pdf#page=14.



Loan Amount: $15,000,000

($15M is the average corporate loan amount according to Federal Reserve data)

Standardized Approach	Investment Grade	Unrated Company	Securities Listing Req.
✓	✓	✗	✗

Capital Requirement

USA

$1.5M

(100% Risk Weight)

EUROPEAN UNION

$975,000

(65% Risk Weight)

For corporates borrowing from U.S. banks, this means:

3.5 percentage point

assumes a 10% capital requirement
(10% * 100%) - (10% * 65%)

increase in capital requirements for the lending bank, which translates into...

45.5 bps*

higher rate on the loan to the U.S. business, which means...

$68,250

($15M [Loan Amount] x 45.5 bps)

in higher yearly interest expense for the U.S. business.

** The Basel Committee on Banking Supervision (2010) estimates that each 1 percentage point increase in the capital ratio raises loans spreads by 13 basis points.*

Loan Amount: $15,000,000

($15M is the average corporate loan amount according to Federal Reserve data)

AA External Rating

Does Not Meet Securities Listing Req.

Capital Requirement

USA

$1.5M

(100% Risk Weight)

EUROPEAN UNION

$300,000

(20% Risk Weight)

For corporates borrowing from U.S. banks, this means:

8 percentage point

assumes a 10% capital requirement
(10% * 100%) - (10% * 20%)

increase in capital requirements for the lending bank, which translates into...

104 bps*

higher rate on the loan to the U.S. business, which means...

$156,000

($15M [Loan Amount] x 104 bps)

in higher yearly interest expense for the U.S. business.

** The Basel Committee on Banking Supervision (2010) estimates that each 1 percentage point increase in the capital ratio raises loans spreads by 13 basis points.*