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How Different Basel Capital Paths Stack Up

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U.S. banking regulators will be releasing a proposal to implement changes to the Basel capital standards in the coming months. One key question is how they will shape the structure of the U.S. capital framework and which banks would be subject to those changes. These key determinants of U.S. capital requirements will drive how much American businesses and households pay for loans, and impact U.S. economic growth.

How it works now: The largest U.S. banks must comply with two "stacks" of risk-based capital requirements. The dual-stack approach, and the U.S. gold-plating of Basel capital standards, results in higher capital requirements compared to what the Basel framework would require alone.

Changes? As the U.S. implements Basel Finalization, policymakers could choose to retain a two-stack approach to large-bank capital requirements, potentially with changes, or they could opt for a single-stack system.

Stacks and risk weights: A stack is a mix of capital minimums and buffer requirements relative to risk-weighted assets that a bank must maintain to avoid negative consequences, such as limitations on share buybacks and dividends. The capital framework assigns to banks "risk weights" or multipliers for assets on their balance sheet based on the assets' perceived risk levels—calculations that are critical to determining how much capital a bank must maintain. The two current stacks are the standardized approach and the advanced approaches.

- **Advanced approaches:** Reliant on banks' internal data and models or tools to quantify risk and set risk weights.
- **Standardized approach:** Regulates capital requirements based on regulatory risk weights for consistency and comparability across banks. Includes a bank-specific capital requirement calculated from annual stress test results.

The largest banks must calculate their capital ratios using both an advanced approaches RWA and a standardized approach RWA. They then use the lower capital ratio of the two calculations to determine whether they comply with applicable risk-based capital standards.

Possible paths:

1. The U.S. could **adopt a one-stack approach** by striking the advanced approaches stack and modifying the standardized approach stack to resemble Basel's version more closely. While simple, this approach would raise capital requirements up to 2 percentage points for the banks in question; double-count certain risks already addressed in the Fed's stress tests; and could complicate determining compliance with the "floors" contained in the Dodd-Frank Act's Collins Amendment if the proposal is extended beyond the largest banks.
2. The U.S. could alternatively **retain a two-stack approach** but replace the advanced approaches stack with one based on the full set of standardized approaches in the Basel finalization package and maintain the existing U.S. standardized approach, with Fundamental Review of the Trading Book replacing the current market risk requirement. This would mitigate the substantial increase in capital requirements associated with the one-stack approach; each stack would cleanly align with either Basel or U.S.-specific calculations; and would leave the U.S. stress capital buffer regime untouched, promoting consistency in stress testing practices. This option would further avoid disrupting banks that don't currently follow a two-stack approach, such as certain smaller and regional banks. However, it would also have disadvantages – some of the largest banks would still face higher capital requirements and/or reduce capital markets activities.

Scope: For the largest U.S. banks, the key question is *how* Basel Finalization will apply. For slightly smaller banks, the question is *whether* it will apply. A key question for regulators: Apply the Basel Finalization changes only to banks in the largest two categories, or expand it to slightly smaller ones (generally, banks with $250-$700 billion in assets)? Applying Basel Finalization Revisions only to banks in Category I and II would limit changes to banks' capital planning processes and would continue to prioritize the importance of regulatory tailoring.

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