BANK POLICY INSTITUTE

# Looking for a Needle in the Capital Stacks

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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 affect U.S. economic growth.

### How it works now:

The largest U.S. banks must comply with two “stacks” of risk-based capital requirements, as determined by Basel. This dual-stack approach, and the U.S. “gold-plating” of Basel capital standards that were fully implemented in 2018, 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.

### Looking for a needle:

A stack is a mix of capital minimums and so-called 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. And if they don’t, banks are subject to restrictions on capital distributions to shareholders and may need to reduce lending.

### 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; double-count certain risks already addressed in the Fed’s stress tests; and could complicate determining compliance with the capital “floors” contained in the Dodd-Frank Act’s Collins Amendment if the proposal is extended beyond the largest banks. (The Collins Amendment is one example of U.S. gold-plating – an element of the framework that makes capital higher than what it would otherwise be.)

2. The U.S. could alternatively **retain a two-stack approach** but 1. replace the advanced approaches stack with one based on the full set of standardized approaches in the Basel finalization package and 2. maintain the existing U.S. standardized approach. 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 promote consistency in stress testing practices by leaving the U.S. stress capital buffer regime untouched. 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, which would increase borrowing costs for U.S. businesses and households and reduce market liquidity in financial markets.

## 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, which was enshrined in law by Congress in the bipartisan Economic Growth, Regulatory Relief, and Consumer Protection Act (S.2155).

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