



Striking the Basel Balance

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U.S. bank regulators will soon propose rules implementing the 2017 revisions to the international Basel capital accord. The implications will be significant — for U.S. banks, their customers and the U.S. economy. It's important to get it right.

After the 2008-2009 global financial crisis, the Basel Committee on Banking Supervision, the global bank regulatory standard-setter, agreed on a complete overhaul of bank capital standards, known as Basel III. Capital requirements set out the amount of capital banks must maintain to cover potential losses on assets such as mortgages and business loans. Among other things, Basel III defines what are deemed the “minimum capital requirements” from a regulatory perspective. Over the last decade, the U.S., the U.K., the European Union, and other jurisdictions have implemented most of these standards. The Basel capital framework, designed initially in 1988, is intended to keep bank capital requirements consistent across the global economy to protect financial stability and to avoid regulatory arbitrage across national boundaries. Basel standards have evolved over the years, becoming more risk-sensitive and, particularly after the global financial crisis, more stringent.

In 2010, Dodd-Frank took separate actions to tighten capital standards, including requirements that conflicted with the Basel standards or layered additional capital requirements on top of them. For example, Dodd-Frank's Collins Amendment set a “floor” on U.S. capital requirements. Another Dodd-Frank Act provision banned U.S. regulators from incorporating external credit ratings (e.g., Moody's) into capital rules. In addition, and more significantly, U.S. regulators have “gold-plated” U.S. capital requirements — their phrase for making them much stricter than global standards, such as higher surcharges for the largest globally active banks and a stress capital buffer for large banks that is set based on stress test results released in June of each year.

In 2017, the Basel Committee made substantial changes to Basel III despite the existing standard's successful track record since the Global Financial Crisis. One goal of these revisions was to restrict the use of bank models in assessing credit risk, even if those models were reviewed and approved by regulators and back-tested. The EU issued proposed revisions at the end of 2021, the U.K. at the end of 2022, and the U.S. is expected to follow in the next few months.

Now, as U.S. regulators are preparing to implement the final round of Basel changes and the Federal Reserve is reviewing other aspects of the gold-plated U.S. capital framework, it's an ideal time to examine where bank capital requirements are, where they're going, and why. A new series of BPI analyses, beginning with today's post, explores those questions.

How capital works: Capital is not an asset or a liability, it is the amount by which a firm's assets (including loans) exceed its liabilities (including deposits). The mix of funding sources on a bank's balance sheet is a crucial consideration for regulators, who want to minimize the chance and impact of a bank failure. Banks prefer to use deposits for funding because they are cheaper and more stable than other forms of financing, with capital being the most expensive source of funds. Capital requirements require banks to fund a certain percentage of their assets with shareholder equity instead of deposits. Prioritizing equity financing over deposits and other debt financing is part of how capital requirements safeguard against losses in worst-case scenarios. In a failure, equity would absorb any losses first, so capital requirements protect depositors and the federal deposit insurance fund.

- **Different forms:** Capital requirements can be “risk-based” (varied based on the relative risk level of a certain asset) or based on more simplistic leverage requirements, which do not differentiate based on the risk of banks' assets. The disadvantage of leverage requirements is that they provide a misleading

picture of a bank's true risk and can discourage banks from holding lower-risk assets because they yield a lower rate of return and require the same amount of capital as riskier assets.

- **Trade-offs:** Capital requirements make the banking system safer, but come at a meaningful cost. Increases in capital requirements reduce economic growth by making it costlier for banks to lend and support certain capital markets activities (e.g., holding inventories of securities for market making purposes). There is a constant tension between economic growth and capital requirements, and every calibration of capital rules needs to evaluate these trade-offs by conducting a robust cost-benefit analysis. There's also a financial stability trade-off -- excessively high capital requirements push financial intermediation into the less regulated nonbank sector, which is riskier. So the notion that higher capital requirements always guarantee a safer financial system isn't necessarily true. And there's a trade-off between complexity and simplicity; complex requirements can be challenging to implement but overly simple requirements can lead to unintended consequences.

Basel's evolution: Today's post breaks down how the Basel capital adequacy framework has evolved over the years. Basel I in 1988 began as an effort to make bank capital requirements more consistent among global economies. Basel II in 2004 made capital requirements more risk-sensitive. Basel III in 2011, in response to the global financial crisis, further increased the level and stringency of capital requirements. Also, Basel III established common equity as the predominant component of bank capital, as it is most effective at absorbing losses.

- **Buffers and GSIBs:** Basel III imposed new capital "buffers" on top of regulatory "bare" minimums and also created the category of Global Systemically Important Banks (GSIBs), the largest globally active banks, which face special additional capital surcharges and, per a directive from the Financial Stability Board, a requirement to issue a large quantum of bail-in-able long-term debt.

Key U.S. challenges: The 2017 Basel package aims to increase the risk sensitivity of its standardized evaluation of credit risk while restricting the use of more granular internal models. In addition, it introduces additional capital charges for operational risk and credit valuation adjustment risk, as well as significant upward revisions to market risk capital requirements. On net, these changes will likely result in significantly higher capital requirements for the largest banks. Other challenges for U.S. banks:

- **Internal models:** Regulators have tried to reduce perceived variability in credit risk weights that may arise from differences among banks' internal models. The finalization package meaningfully restricts banks' ability to use their own models to calculate risk-weighted assets. The U.S. will likely go beyond the requirements of the Basel finalization package and remove banks' ability to use internal models to estimate capital requirements for credit risk.
- **Trading book:** The Fundamental Review of the Trading Book (FRTB) standard will significantly raise market risk capital requirements for the largest U.S. banks, which are already elevated as a result of the global market shock included in the annual stress tests. This further increase could significantly curtail banks' ability to intermediate in capital markets and reduce market liquidity during stress conditions.

Bottom line: The effects of Basel finalization on banks, their customers, and the economy hinge on how the U.S. handles the structure and scope of Basel capital standards, whether it offsets any increased requirements and how it compares to the way other jurisdictions roll out the Basel changes. U.S. economic growth depends on getting these decisions right.

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