Calibrating Bank Capital Requirements

Six Key Things Regulators Can Do to Make Basel Finalization More Balanced

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In this third installment of our series on the Basel Finalization agreement, we explore potential modifications to enhance the sensitivity to risk and reduce the procyclical impact of capital requirements, so as to prevent worsening of economic downturns. These modifications also aim to avoid raising borrowing costs for businesses and households, maintain market liquidity and promote economic growth. Previous posts in the series provide context on the background and evolution of Basel, as well as an overview of the expected scope and structure of U.S. implementation of the Basel Finalization standards.

The context:

Capital requirements in the U.S. have significantly increased since the 2007-09 global financial crisis, sometimes not aligning with actual bank risk levels. What is the reason for this?

- Post-crisis reforms greatly enhanced the quality and quantity of bank capital.
- Furthermore, the U.S. has "gold-plated" several standards, making its capital regime more rigorous than if international Basel standards were applied without modification.
- Recently, capital requirements for large banks have risen further due to factors unrelated to bank risk.
    - Higher Global Systemically Important Bank (GSIB) surcharges for the largest globally active banks, primarily driven by economic growth and inflation.
    - Higher stress capital buffers for large banks, partially due to balance sheet expansion from fiscal and monetary stimulus during the pandemic.

Big potential rise: U.S. implementation of Basel Finalization revisions could raise capital requirements by as much as 20 percent for the largest U.S. banks which would raise borrowing costs for businesses and households. It could also significantly affect U.S. capital markets which play a crucial role in funding the credit needs of corporations and households.

- **Operational risk:** The rise in capital requirements is mainly due to the inclusion of **operational risk** into the standardized approach for calculating risk-weighted assets, a first for the U.S. capital framework. Additionally, the standardized approach for operational risk imposes higher capital charges on banks that rely more on noninterest income compared to net interest income, such as those with a significant portion of income from capital markets activities.
- **Market risk:** The Basel Committee's Fundamental Review of the Trading Book (FRTB) will have a major impact on banks' capital requirements for market risk and their risk management practices. It will tighten restrictions on banks' use of internal models for measuring market risk and aim to better capture tail risk in stressed conditions. However, since U.S. regulators already have a separate capital requirement for this same tail risk through the stress tests' "global market shock" component, it would effectively double-count these market risks.

Banking regulators have two broad options for mitigating unnecessary capital increases while maintaining the risk sensitivity of the U.S. framework: (1) adjustments to risk-weighted assets and (2) adjustments to capital buffers.

Three key adjustments to risk-weighted assets:

1. **Credit Risk: Remove the Securities Listing Requirement for corporate exposures.** In the U.S., where external credit ratings cannot be used to determine capital requirements, a company borrowing from a bank can only qualify for the lower "investment-grade" risk weight (65 percent) if the firm or its parent company has securities listed on an exchange. However, this standard is only met by the largest firms in the U.S. and having listed securities is not a reliable indicator of credit quality. This requirement does not accurately reflect the credit risk associated with a corporate loan, so U.S. regulators may consider removing it to prevent unnecessary borrowing cost increases for many creditworthy American businesses, including most small business borrowers.

2. **Operational Risk: Set the Internal Loss Multiplier to 1 and Adjust the Services Component.** The Basel standardized approach for operational risk overestimates the capital required for operational risk losses, especially for banks with higher fee revenue and expenses. U.S. regulators can mitigate this overestimation by using the option in the Basel Finalization package to set banks' internal loss multiplier to 1 and capping the impact of income from services on the overall operational risk charge.

3. **Credit Risk: Remove the Minimum Haircut Floors for Securities Financing Transactions.** The Basel Finalization revisions impose minimum economic haircuts on collateral for SFTs with non-bank counterparties, like pension funds and mutual funds, to reduce bank financing in this area. The U.S. should follow the example of other jurisdictions and not implement this aspect of the Basel Finalization revisions to prevent transactions with end-users, such as reverse repurchase agreements, from becoming uneconomical.

Three key adjustments to capital buffers:

4. **Address Double-Counting of Market Risk and Operational Risk in the Basel Finalization Package and the Supervisory Stress Tests.** The stress test global market shock (GMS) and the Fundamental Review of the Trading Book both aim to capture similar tail market risk. The losses from the global market shock make up a significant portion of banks' stressed capital buffer requirement, so implementing FRTB in the U.S. without modification would result in U.S. banks over-capitalizing for that risk. The same issue applies to operational risk, which is already accounted for in the stress tests.

5. **Modify the U.S.-Specific GSIB Methodology.** The U.S. GSIB surcharges are higher compared to unmodified Basel standards because they are calculated based on the higher of the two methods, "Method 1" (international standard) and "Method 2" (U.S.-specific). Regulators could reduce these surcharges by adjusting scores to account for economic growth and inflation (as required by the final rule), narrowing the GSIB surcharge bands, or resetting the weight of the short-term wholesale funding component to 20 percent.

6. **Address the Effects of Reserve Balances and U.S. Treasuries on Risk-Based Requirements.** The Federal Reserve's quantitative easing policy led to an increase in banks' size due to the accumulation of risk-free assets such as reserve balances, resulting in higher risk-based capital requirements through higher GSIB scores and stress capital buffers. To alleviate this issue, the Federal Reserve could consider excluding the impact of bank size on pre-provision net revenue projections in the stress tests.

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