Basel Endgame: Background and Key Issues

In July 2023, the U.S. federal banking regulators (Federal Reserve, FDIC and OCC) issued a proposed rulemaking (which they call "Basel Endgame") that would significantly increase capital requirements for large U.S. banks. The proposal estimates an increase in these requirements by **16% on average,** amounting to about **$160 billion more** of the most loss-absorbing type of regulatory capital. That increase will limit banks' ability to offer customers mortgages, car loans, credit cards, small-business loans and other products at competitive rates and create a permanent drag on the American economy.

The increase in capital requirements is totally unjustified.

The banking industry is extraordinarily well-capitalized by every credible measure and has just withstood several real-life stresses quite well (e.g., COVID), while continuing to lend to businesses and families.

The increase in capital requirements will have serious negative consequences for the economy.

A recent review of the academic literature by the Basel Committee on Banking Supervision found that a 1-percentage-point increase in capital requirements reduces annual GDP by up to 16 basis points, equating to a **loss of about $42 billion in U.S. output per year**. The banks subject to this proposal account for nearly 80 percent of banking sector assets and capital requirements are set to rise by about 2 percentage points (i.e., from 12 percent to 14 percent), so **the proposed rule would permanently reduce annual U.S. GDP by more than $67 billion each year.**

The increase in capital requirements actually undermines the overall stability of the financial system instead of strengthening it.

Raising bank capital requirements does not eliminate risk; it merely shifts the risk away from banks and into the shadow banking system, where prudential standards for managing risks are largely absent. Nonbanks don't rely on taking deposits, which makes their funding much less stable than banks, so they tend to reduce lending much more than banks do during recessions. This instability exacerbates economic downturns and sometimes invites federal intervention in markets.

Key Issues

- **Large banks are already well-capitalized and highly resilient to economic downturns.**
  - Levels of high-quality capital at these banks have **increased nearly 3.5x** since the financial crisis and annual Fed stress tests that simulate economic downturns continue to show that large banks are highly resilient. For instance, the 2022 hypothetical worst-case scenario tests projects net aggregate losses to the banks amounting to $300 billion, which is dwarfed by these banks' total loss-absorbency capacity of $2.8 trillion (over 9x the amount of hypothetical losses).
  - In fact, the intent of the original "Basel Endgame" agreement in 2017, which the agencies are purporting to implement, was to not increase capital levels overall. At the time, one of the key architects of the Endgame said:
    - "The focus of the exercise was not to increase capital. As a matter of fact, the GHOS [the governors of the central banks and heads of supervision at the agencies represented at Basel] almost a year ago endorsed this review by the Basel Committee, provided it wouldn't create a significant capital increase in the aggregate of the banking system."

- **The proposal lacks a robust cost-benefit analysis to justify the large increases in capital requirements.**
  - Regulators failed to adequately consider the costs of raising capital requirements, both overall and with respect to specific products and services, including how costs will increase for consumers and businesses and how more activity will be pushed into the non-regulated sector. In fact, they indicated that they plan to continue conducting important analysis to inform the final parameters of the rule *during* the public comment period, thereby *precluding* any opportunity for public review of and comment on key information and analysis.

- **The process by which this proposal was developed lacked transparency and meaningful public input.**
  - The proposed rule is based on a deal struck among U.S. and global regulators without Congressional mandate or the protections of the Administrative Procedure Act, and the deliberations and decision-making process at Basel were never made public.

- **The proposal is inconsistent with the Basel Agreement's goal of harmonizing capital requirements.**
  - U.S. regulators have proposed this rule in many ways that are stricter than both the original Basel agreement as well as other jurisdictions' plans to implement the agreement. This will result in U.S. consumers and businesses facing unnecessarily high costs for loans and other financial products, especially compared to their international counterparts.

- **The proposal represents a *de facto* repeal of the Economic Growth, Regulatory Relief, and Consumer Protection Act (also known as "S. 2155") as passed by Congress.**
  - Congress in 2018 recognized that not every bank poses the same level of risk, and therefore banks should not all be held to the same rules developed after the financial crisis. However, the new proposal reverses Congressional intent by taking a capital standard developed for the most complex and globally active financial institutions and applying it in a "one-size-fits-all" fashion to U.S. regional and midsize banks.
  - The Basel standard was not developed with U.S. regional and midsize banks in mind, and applying it to them, perhaps unsurprisingly, leads to strange and perverse outcomes—which the proposal either fails to appreciate or entirely ignores.

Conclusion

Ultimately, Congress must urge the Federal Reserve and other banking regulators to withdraw this problematic proposal and consider the costs that significantly raising capital requirements will have on American families and businesses before re-proposing a more sensible and rational rulemaking.