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The Trillion-Dollar Omission in Vice Chair Barr's Cost Analysis

Francisco Covas | Oct. 12, 2023

In a speech on Oct. 9, the Federal Reserve Board's Vice Chair of Supervision downplayed concerns about the potential effects of proposed capital increases on lending activity. Michael S. Barr stated that the "estimated increase in capital required for lending activities on average" would be only 3 basis points, or 0.03 percent, and he said that estimate accounts for both credit risk and operational risk charges. However, as we show in this post, Vice Chair Barr's estimate fails to account for $1 trillion in risk-weighted assets that the proposal creates to estimate operational risks closely associated with lending activities. Correcting for that error would nearly quadruple the effect of the proposal on bank funding costs for lending activities.

The Vice Chair's estimate originates from an analysis conducted by the banking agencies that was referenced in the agencies' proposed capital rule.[1] That analysis estimates the economic impact that the proposal would have on *lending activities* by considering its effects on credit risk-weighted assets and the component of operational risk related to interest income (notably it excludes the component of operational risk related to non-interest, or fee, income). This amounts to an increase of $380 billion in risk-weighted assets, corresponding to a 3.5 percent hike in risk weighted assets or a 30-basis-point rise in the required risk-based capital ratio. In his speech, Vice Chair Barr explained the 3-basis-points effect on funding by assuming a cost of equity about 10 percent higher than the cost of debt.

The proposal makes a similar calculation to determine the economic impact on *trading activities*. It estimates an increase of $880 billion in risk-weighted assets related to trading activities, encompassing market risk, derivatives counterparty risk and the component of operational risk related to trading activities. Given that the projected increase in the market risk component stands at $420 billion and the new charge for derivatives counterparty risk is $288 billion, the assumed operational risk charge pertaining to trading activities amounts to $172 billion (calculated as $880 billion – $420 billion – $288 billion).

The sum of the two operational risk charges (lending and trading activities) therefore amounts to $952 billion. But this figure is considerably less than the estimated $1,950 billion in risk-weighted assets for operational risk reported in the Basel proposal. **As a result, Vice Chair Barr's speech and the agencies' economic impact analysis both exclude $1 trillion in risk-weighted assets for operational risk unallocated to either lending or trading activities.** That is a very material amount of risk-weighted assets to go missing.

The sources of those calculations are shown in Table 1. The estimates either come directly from the Basel proposal or are arithmetically derived from those figures.

[1] A discussion of this analysis starts on page 64167 of the Federal Register version of the proposed capital rule available here.

Table 1: Risk-weighted Assets by Risk Stripe

	Current Stdz. RWA ($ Billions)	B3E NPR RWA ($ Billions)	B3E NPR vs. Stdz ($ Billions)	B3E NPR vs. Stdz. (%)	Inc. in Capital Req'd (% Total RWA)
Credit Risk	10,900	10,500	(400)	-3.7%	
Market Risk	560	980	420	75.0%	
Operational Risk		1,950	1,950	—	
CVA Risk		288	288	—	
Total*	**11,600**	**13,800**	**2,200**	**19.0%**	
Memo: Lending and Trading Activity Details Impacts					
Lending Activity Including Related Op. Risk	**10,900**	**11,280**	**380**	**3.5%**	**0.30%**
Credit Risk	10,900	10,500	(400)		
Operational Risk		780	780		
Trading Activity Including CVA and Related Op. Risk	**560**	**1,440**	**880**	**157.1%**	**0.67%**
Market Risk	560	980	420		
CVA Risk		288	288		
Operational Risk		172	172		
Other (Not Included in Lending or Trading Activity Impacts)		**998**	**998**		
Operational Risk		998	998		

*Totals do not sum up due to rounding.

**Numbers in blue are provided directly in the NPR; other numbers are derived arithmetically.

The operational risk services component includes non-interest income, and much of this revenue is linked to lending activities. Examples include income from the issuance and usage of credit cards; earnings from the sale and servicing of mortgage loans; fees from syndicated lending; and revenue from operating leases on auto loans, to name just a few. Other fees and commissions correlate with various services that banks offer on behalf of their lending clients, such as custody and fiduciary activities or the underwriting of equity or market debt.

For instance, in a recent post, we used FR Y-9C data to estimate that banks typically selling mortgages they originate to government-sponsored enterprises could see their capital requirement for mortgages more than double from the operational risk add-on.

Similarly, banks that originate credit-card loans and receive both interchange and credit-card fees might easily exceed a 100-percent risk weight solely from the associated operational risk charge. For other banks, the credit-card fees would translate to at least a 20-percent add-on for operational risk, solely from the fee income portion of their credit-card business.[2]

Assuming that the entire services component for operational risk—equivalent to another $1 trillion in risk-weighted assets—is closely associated with lending activities, this would lead to an estimated increase in funding costs for lending activities of 11 basis points on average. This is nearly quadruple the estimate cited in this week's speech by Vice Chair Barr. We must acknowledge that not all fee income is associated with lending activities for all banks. However, regardless of the proper allocation between the two categories, there is no basis for failing to allocate $1 trillion of risk-weighted assets to one or the other.

Another important concern is that the banking agencies' analysis and Vice Chair Barr's speech put too much emphasis on averages. Banks frequently use a risk-adjusted performance measure to evaluate the profitability of individual business units.[3] These units are reviewed at a much more granular level than merely considering total credit or market risk RWA, as presented in the agencies' analysis of economic costs of the Basel proposal. Banks will typically calculate return on capital for particular business units and decide whether to expand or reduce financing based on capital-adjusted profitability. As a result, the rise in funding costs would disproportionately affect activities projected to face steeper increases in capital requirements. Among these are mortgage loans to low- and moderate-income borrowers, credit-card borrowers and below-investment-grade nonfinancial borrowers, which include most small businesses.

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[2] This result will be explained in a forthcoming blog post.
[3] See John Hull, "Risk Management and Financial Institutions," Wiley Finance, Chapter 26 (2018).