Basel III Endgame: Why a Comprehensive Quantitative Impact Analysis and Reproposal are Essential

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The quantitative impact study is a crucial component of the Basel III Endgame proposal, as it assesses the potential impact of the proposed rules on banks' capital requirements and thereby has implications for the cost of credit for households and businesses, and ultimately economic growth.

Considering the proposal's potentially significant impact on both the banking industry and the economy, one would have expected the rulemaking to follow a logical—and legally required—sequencing: first, a QIS to gather relevant data to form the basis for a rule proposal, followed by a rule proposal providing the required data and analyses to support proposed changes and only proceeding to a final rule after considering public comment on both the proposal and the data used to support it. These required procedural hurdles were ignored in this process, as the agencies first released a proposal with no supporting data and only sought to gather appropriate QIS data after the fact. Now, nearly four months after the close of the comment period, the QIS data has yet to be released for public comment, and was of course not available to inform public comment on the original proposal.

Given these procedural missteps, to proceed now, the agencies must release the QIS analysis followed by a reproposal.[1]

The QIS data serves only as a rough starting point for estimating the total impact of the Basel proposal. The current QIS rightly focuses on how the proposal would affect bank capital levels, but that's only part of the story. Arguably the much more meaningful part of the story is how those capital changes would flow through to, and affect, the bank's customers, other end users and the real economy, a question the

[1] Alternatively, the agencies could include the results of the QIS analysis in the reproposal. This approach would have the advantage of allowing the agencies to incorporate modifications they may have agreed upon based on the findings of the QIS and comments from end users and the industry.

current QIS does not attempt to answer. Thus, it's impossible to assess the relative benefits and costs of the proposal without expanding the QIS to capture these critical downstream effects.

Setting the QIS aside, several other major aspects of the proposal lack a grounding in any empirical evidence or thorough analysis (at least none that has been made publicly available). These include:

- The elimination of banks' internal models for calculating capital requirements for credit risk is not appropriately justified. This change would be a significant driver of increased capital requirements for U.S. banks, as other jurisdictions still allow the use of internal models for credit risk, subject to a 72.5 percent floor based on the standardized approach. The U.S. proposal, however, sets this floor at 100 percent of the standardized approach, effectively overcapitalizing the credit risk capital charge.

- For the standardized approach, the agencies have deviated from Basel by increasing capital requirements for mortgage and consumer loans without proper justification. The punitive capital treatment of bank lending to non-publicly-traded businesses, and small and medium-sized businesses, also lacks appropriate reasoning.

- There is no consideration of how to address the material overlap between the Fed's annual supervisory stress tests, which set the stress capital buffer of each bank, and the capital requirements included in the Basel proposal. As a result, banks face duplicative charges for the same risks, particularly for operational and market risks.

Given these serious data and analytical shortcomings, the only viable path forward is to repropose and provide a comprehensive justification for the proposed changes, including a thorough assessment of its expected economic impact and a complete analysis of its relative benefits and costs.

This post outlines the analyses the Federal Reserve should conduct to justify—as a legal matter under the basic procedural and substantive standards that govern all federal agency rulemaking under the Administrative Procedure Act—the proposed increases to banks' capital requirements. Conducting this kind of analysis would align with the approach taken by regulators in other jurisdictions, such as the U.K., as well as the APA's basic legal requirements.

Why a Reproposal is Needed

To correct the procedural missteps and adhere to the logical sequencing required to come into compliance with the APA, the agencies would—at minimum—need to:

- First, release a QIS analysis that assesses the potential impact of the proposed rules both on banks' capital requirements and on customers and other end users, along with a robust cost-benefit analysis.

- Second, repropose the rule, incorporating any necessary modifications based on the QIS results and public feedback received after its release. Any reproposal should include a comprehensive justification for the proposed changes and address the shortcomings of the original proposal, including those noted above.

The potential issue with this sequencing, however, is that additional information may be required if the agencies purport to make changes in a reproposal not contemplated in the original proposed rule and thus not assessed in the current QIS. In other words, if the banking agencies decide to substantially

modify certain elements of the Basel rule, as we think they should, the agencies would need to conduct a new QIS, since the current QIS is based on the original proposal.

Thus, even though the Federal Reserve has committed to releasing the QIS results for notice and public comment before finalizing the Basel rule,[2] to then proceed directly to a final rule without a reproposal—and a new QIS based on that reproposal—would deprive the public of the opportunity to comment on any material changes included in the final rule, potentially exposing the agencies to litigation risk. Simply enabling stakeholders to evaluate the economic implications of the original proposal would be incomplete.

A reproposal that includes an accurate and reliable assessment of the impact of the proposed changes, including a comprehensive QIS, is the only viable path to satisfying the requirements of the APA.[3] Only after taking into account the results of that impact assessment—and making that data and analysis available for public comment—will the agencies be in a position to repropose the rules based on sufficient evidence for all aspects of the proposal.

Recommendations on Expanding the QIS's Scope

The QIS results would provide a rough starting point for estimating the total impact of the Basel proposal on banks' capital requirements. However, this would just be the initial step. The next crucial phase is to comprehensively justify the proposal by assessing its potential impact on bank behavior (as well as the consequences for bank customers, other end users and the economy) and conducting a thorough cost-benefit analysis.

To achieve this, the agencies need to undertake a more in-depth analysis to quantify the costs and benefits of the Basel proposal, similar to the approach adopted by the Bank of England. The BoE's methodology involves three key steps: first, modeling how banks are likely to respond to the proposed regulatory changes; second, assessing how these changes in bank behavior might affect the cost of financial services provided by banks; and third, evaluating how these behavioral shifts could influence the probability of a future banking crisis.

As we highlighted in a prior blog post, a critical aspect of this analysis is allocating the projected increase (or decrease in some cases) in risk-weighted assets across the different lines of business operated by banks. Our suggestion was for the agencies to leverage the FR Y-14 regulatory reports, which contain granular data on various business lines. Instead of broadly categorizing the impact into lending and trading, as done in the proposal, the agencies should break down the changes in RWA into more specific lines of business, such as mortgages, retail loans, small business lending, commercial lending, investment banking, merchant banking/private equity, sales and trading, investment management, investment services, Treasury services and insurance services. This granular approach would provide a more comprehensive analysis of the proposal's potential impact and facilitate a more straightforward allocation of RWA changes across different business activities.

[2] On Jan. 12, Vice Chair for Supervision Michael Barr announced the Federal Reserve's intention to publish its analysis of the quantitative impact study results and to invite public comment on this analysis.

[3] As we previously noted in our Jan. 12, 2024 comment letter on the Basel III proposal, the proposal fails to meet the basic procedural and substantive requirements of the APA in several significant ways. Not only does the proposal repeatedly and significantly fail to obtain and consider appropriate data and evidence that would provide a sufficient evidentiary basis for its policy choices, but it also ignores evidence that is available, and is predicated on an economic analysis of the proposal's effects that is deficient and inconsistent with the evidence. Further, the proposal fails to explain the methodology and assumptions that underlie it, and improperly fails to disclose underlying data and analysis from the public.

Another crucial element to consider is that the impacts of the Basel proposal on various business lines cannot be evaluated in isolation. Banks typically compare the expected returns across different lines of business against the respective capital requirements to determine whether to expand or scale back their involvement in a particular area. A common metric used for this purpose is the risk-adjusted return on capital, which calculates the ratio of expected profitability for each business line to its corresponding capital requirement. The higher the required capital for a specific business unit, the lower its risk-adjusted return. Consequently, business lines with lower risk-adjusted returns tend to contract, while those with higher returns are likely to expand. Therefore, assessing the proposal's impact on bank responses necessitates a holistic approach that accounts for changes in capital requirements across all business lines, as these shifts can significantly influence banks' strategic decisions and resource allocations.

Furthermore, as noted in our prior blogs and comment letters, the agencies omitted approximately $1 trillion (roughly half of the total) increase in RWA from their analysis of the proposal's economic impact. This oversight underscores the need for a more comprehensive and rigorous assessment of the potential consequences.

Analyzing the Costs and Benefits of the Basel Proposal

The next step of the analysis would be to analyze the welfare costs and benefits to U.S. households and businesses using a quantitative general equilibrium model. The advantage of quantitative macroeconomic models is that all decisions made by households, firms, banks and nonbanks are fully endogenous and have a direct impact on the cost of bank debt and equity, as well as the economy's growth rate. Moreover, the calibration of these models is subject to a high degree of rigor. This rigor leaves little room for altering the assumptions without first demonstrating that the new calibration matches key features of the data, both in terms of macroeconomic indicators and the level and volatility of important asset price variables, such as credit spreads. Additionally, these models often include heterogeneous banks and match the distribution of U.S. bank capital levels.

Given the characteristics of the U.S. economy, it is crucial for the quantitative model to include both a banking and nonbank financial sector to allow for a meaningful interaction between the two. This is important because the main trade-off associated with higher capital requirements for banks is that, while it makes banks safer, it may also result in more credit intermediation being done by nonbank financial institutions. Nonbank financial institutions, however, are much less regulated than banks and some are funded by runnable liabilities, which makes them more vulnerable to runs during periods of economic stress.

If such runs on nonbank financial institutions were to occur, it is more likely that economic shocks would be amplified rather than dampened by the financial sector, resulting in higher volatility and the economy being less resilient to economic shocks. This amplification effect could potentially offset the benefits of having a safer banking sector due to higher capital requirements.

Therefore, the quantitative model needs to accurately capture the potential migration of credit intermediation activities from banks to nonbanks, as well as the relative vulnerabilities of each sector, to provide a comprehensive assessment of the overall impact on financial stability and economic welfare. The model should also account for potential feedback loops and second-order effects, such as changes in lending standards, asset prices and investor confidence, which could further amplify or mitigate the effects of the proposed capital requirements.

By incorporating these dynamics, the quantitative general equilibrium model can provide a more holistic analysis of the costs and benefits associated with the proposed capital requirements, taking into account the complex interplay between the banking sector, nonbank financial institutions and the broader economy.

Final Thoughts

In conclusion, the QIS is a vital component of the Basel III Endgame proposal, as it assesses the potential impact of the proposed rules on banks' capital requirements and, consequently, the cost of credit and effect on economic growth. The banking agencies must release the QIS analysis and repropose the rule to allow for public feedback and a comprehensive assessment before finalizing it.

However, the QIS data alone is insufficient for estimating the total impact of the proposal on banks' capital requirements. The agencies need to assess the impact on end users and conduct a cost-benefit analysis, addressing the shortcomings in the current proposal, such as the lack of justification for eliminating banks' internal models for credit risk, increased capital requirements for certain loans and overlap with the stress tests.

A reproposal that includes an accurate and reliable assessment of the impact on bank capital requirements is the only viable path to satisfying the Administrative Procedure Act's requirements. The agencies should undertake a more in-depth analysis to quantify the costs and benefits of the proposal, similar to the Bank of England's approach. This analysis should involve modeling banks' responses to the regulatory changes, assessing the impact on the cost of financial services and evaluating the influence on the probability of a future banking crisis. The analysis should also consider the potential migration of credit intermediation activities from banks to nonbanks and the relative vulnerabilities of each sector.

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