The Basel III Endgame:
An object lesson in why cost-benefit analysis of financial regulation should be mandatory.

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The “Basel III Endgame” refers to a sweeping set of proposed regulatory changes that would significantly increase bank capital requirements for large banks, raise G-SIB surcharges, and replace tailoring of regulation with more standardization. In the face of near unanimous opposition from industry, the so-called “Endgame” has now gone into extra innings. Chairman Powell, testifying before the House Financial Services Committee said, "We do hear the concerns and I do expect there will be broad material changes to the proposal. I’ll add that I’m confident that the final product will be one that has broad support at the Fed and in the broader world."

<SLIDE 1> The heart of the problem with the proposed regulations, and the broader theme of my remarks this morning, was eloquently described by our lunch speaker, Governor Bowman, in the opening sentences of the statement she published last July explaining her dissent to the proposed rule:

“The first proposal under consideration would substantially increase risk-based capital requirements for banks with more than $100 billion in assets. In my view, **there is insufficient evidence that the benefits produced by this proposal would justify the costs**. The proposed revisions under consideration have not been directed by Congress and are not compelled by a new evolution or identified weakness in the U.S. banking system. Although this proposal is intended to implement the Basel III agreement, in light of the many deviations from internationally agreed standards it is not clear that today's proposal would improve international consistency in capital requirements for large, internationally active banks.”

(The emphasis is my addition, and it is the issue I will turn back to after describing some of the key features of the proposal and some of the objections to it.)

A variety of organizations have estimated the net effect on capital requirements for different institutions. Not everyone agrees on the details, but all conclude the effects are large. I've borrowed some slides from the very detailed analysis from the law firm Davis Polk to provide a sense of what was proposed.

<SLIDE 2> The main impact of the proposed regs is on how large banks must calculate risk-weighted assets. With regard to methodology, there is a move towards standardization. The largest banks that previously were allowed to use their own models for risk assessment will be forced to use the Fed's "Enhanced Risk-based Approach" instead. Another change is that the market risk-based rule would be replaced with one that takes into account both market risk and counterparty risk, which is especially relevant to banks with broker-dealer subsidiaries.

<SLIDE 3> The bottom line for capital requirements is that they increase for large banks, with the biggest changes for the largest banks. Common tier 1 equity would increase by an estimated 19% for Category 1 and II holding companies, which include the GSIBs and banks with more than $700 billion in assets. The increases are smaller for banks between $100 billion and $700 billion (which includes the regional banks of recent concern), would be smaller at around 6%. It's worth noting that this is clearly much less than would have been needed to save the regional banks that failed last year because of exposure to interest rate risk.

I want to briefly comment on the wisdom of the methodological change that revokes the option for the largest and most complex banks to use their internal models for risk evaluation. In its place, banks would be required to use the Fed's proposed new standardized model. Federal reserve officials justify the change by pointing out that it was hard for regulators to evaluate the models, and that the models produced a wide range of risk estimates for institutions whose risks probably were not as dissimilar as the model predictions indicated.

My view is that this is ill-advised. It is imperative that, for the largest banks and bank holding companies, regulators and bank managers develop a deep and dynamic understanding of the many risks and their mitigants. Regulators lack the resources, information, and often the expertise to adequately model the complicated risk exposures of large bank holding companies. Allowing the banks

to use their own risk modeling encourages investment in those models, which in turn should allow them to better understand their own risk. The bank models also serve is a tool for educating and communicating about risk with regulators. A simpler, standardized approach means that to protect against adverse events not captured by the standard model, capital requirements on average must be higher for all large banks. To the extent that higher capital requirements imposes real costs on banks and their customers (something that is confusing to regulators and that is inadequately quantified both be regulators and by industry), an increase in average capital requirements has a social cost. Lastly but I think importantly, imposing a simpler standard model reduces the incentive for banks to control risks that they're not rewarded for curtailing.

More broadly, do the costs of the higher capital requirements justify the benefits? The unprecedented outpouring of opposition from the financial industry (along with the substance of their analyses) suggests they probably are not. In a Brookings post about the Basel lII Endgame and Fed Independence, Peter Conti-Brown puts it like this:

> "As a historian of U.S. banking, I struggle to identify a time when banks fought harder against a regulatory decision than this one. Nothing in the Clinton or Obama administrations comes close. We have to look back to the New Deal, when President Roosevelt declared in a campaign speech that bankers were "unanimous in their hatred" of his program, and even then it wasn't quite true."

There was also opposition to the proposal from two Fed Governors (Waller along with Bowman) and from two FDIC commissioners.

As a quick aside, my colleagues on the SOMC often lament the lack of dissent at the Fed with regard to monetary policy. It's encouraging that at least in the regulatory arena there is willingness to publicly take opposing views.

I haven't seen enough evidence to have a personal view on whether overall the benefits of the increases in capital requirements are likely to exceed the costs. But much more importantly, the Fed also appears not to know the answer because it did essentially no cost-benefit analysis, or at least none it was willing to make public.

One can only speculate on the timing of the rollout and why so little analysis appears to have been done. Perhaps there was a rush to get out a strong regulatory response to the regional bank problems to deflect criticism. If that was the strategy, it backfired because the proposed measures were generic and clearly didn't address the problems with the regional banks that Charlie Calomiris spoke about earlier—It was disappointing though not surprising that the tightened market risk calculation still fails to explicitly take into account interest rate risk, and that measurement problems arising from held to maturity accounting were ignored. The idea that these rules were by way of simply finishing the implementation of Basel III was also unconvincing. As Governor Bowman and many others have noted, the proposed rules do not conform to Basel III, and part of the controversy is that they are more stringent in some respects.

The gist of many of the objections is that new capital requirements were layered onto the existing rules without consideration of whether they were duplicative of existing protections for specific risks. The Fed did not provide evidence (for example, based on additional stress tests results) that the existing levels of capital were inadequate. A concrete example, and one that drew the ire of the derivatives industry, is the additional counterparty risk adjustments levied on the broker-dealer operations of bank holding companies. The proposed amount of additional capital required for derivative counterparties is insensitive to whether the risk is already largely covered by margin requirements or other collateral. It is also substantial. The industry argues that this will increase the cost of intermediation and cause some to exit the business entirely. Beyond increasing customer costs and discouraging hedging, it will work against other regulatory goals, such as promoting central clearing or maintaining liquidity in the non-bank financial marketplace.

The Fed's freedom to promulgate regulations without a supporting cost-benefit analysis arises from its classification as an independent agency. Cost-benefit analysis is required for all federal agencies by Executive Order 12866. The order was issued in 1993 and has remained in effect since that time. It requires that an analysis be undertaken, and recommends that regulations with the greatest benefit relative to cost be selected. However, it allows for exceptions based on other factors. It is interesting that the SEC, which is also an independent agency, voluntarily adopted fairly extensive use of cost-benefit analysis a number of years

ago after losing several important court cases where evidence that costs exceeded benefits was used to strike down its regulations. The FDIC is also independent, but its Inspector General published a report critical of the inadequacy of its cost-benefit analyses. The CRS notes there is growing pressure in Congress to extend the requirement to the independent agencies.

Does Fed independence require an exemption from the mandate to perform cost-benefit analyses of its regulatory policies? I would argue not. The privilege of independence is justified by the need for monetary policy to be insulated from short-term political pressures, and specifically, to give the Fed the latitude to take the politically unpopular action of raising interest rates when the macroeconomic situation calls for it.

It is much harder to make the case that the Fed's regulatory responsibilities require more insulation from political pressures than other federal agencies. Regulation intrinsically involves political decisions, in this case, the tolerance for risk in the banking system and the tradeoffs involved are not something that can be resolved based on expert judgment alone. Arguably, cost-benefit analysis would strengthen the credibility of the Fed's regulatory decisions, and thereby help to protect its independence.

Cost benefit analysis is certainly not a panacea—countless ill-advised regulations are adopted by agencies currently subject to the rule. However, the act of attempting to quantify costs and benefits is illuminating. Even where precise measurement is impossible, a formal analysis can provide a much clearer idea of order-of-magnitude effects. The very act of enumerating costs and benefits and trying to quantify them can lead to voluntary curtailment or restructuring of bad policies before they reach the public eye. These important advantages are recognized in the bipartisan support for the rule.

A final observation: A trademark position of my colleagues at the SOMC is to favor rules over discretion. Routinizing serious cost-benefit analysis on the regulatory side is in the spirit of rules that provide discipline and transparency to Federal Reserve policy-making.