The Basel III Endgame

an object lesson in why cost-benefit analysis of financial regulation should be mandatory

Deborah Lucas, MIT

Shadow Open Market Committee

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“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.”

Statement of Governor Michelle Bowman, July 27, 2023

Overview of the U.S. Basel III Endgame Proposed Rule

Summary of Structural Changes

Calculation of RWAs

- The Proposed Rule would eliminate the Advanced Approaches for determining capital requirements for credit risk (including CVA risk) and operational risk (current Subpart E), which rely on banking organizations' internal models, and replace the Advanced Approaches with a new, standardized ERB Approach based on the new standardized approach under the revised Basel Framework.
- The Proposed Rule would also replace the current U.S. market risk capital rule (Subpart F) with a new Subpart F that addresses both market risk and CVA risk.
  - For market risk capital requirements, a banking organization would be able to choose between the Standardized Measure for market risk (primarily based on parameters prescribed by the Agencies) and, with the approval of its federal banking supervisor, the Models-based Measure for market risk (which permits the use of internal models as applied at the level of a banking organization's trading desks).
- A Category I – IV banking organization would be required to calculate two main measures of total RWAs:

① Standardized Total RWAs

Standardized Approach for credit and equity risk* (Subpart D)

+

Market risk capital requirements (Subpart F)

−

Any amount of the adjusted allowance for credit losses (**AACL**)

+

Any allocated transfer of risk reserves (**ATRR**)

* Including counterparty credit risk and banking book equity and securitization exposures.

Expanded Total RWAs

The greater of:

② ERB Approach for credit and equity risk* (Subpart E)

+

Standardized Approach for operational risk

+

Market risk and CVA risk capital requirements (Subpart F)

and

③ Output Floor

(Same as ❷, except market risk capital requirement reflects 72.5% of market risk capital requirement based on the Standardized Approach for market risk)

− AACL + ATRR

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Overview of the U.S. Basel III Endgame Proposed Rule

Applicability, Impact and Key Dates

- **Applicability:**
  - Most of the changes under the Proposed Rule would apply to **Category I – IV banking organizations.**
  - The market risk component of the Proposed Rule would apply to:
    - all Category I – IV banking organizations; and
    - any other banking organization that: (1) has **average aggregate trading assets and trading liabilities of ≥ $5 billion, or representing ≥ 10% of total assets**; or (2) is required by its primary federal supervisor to calculate RWAs for market risk because of the level of its market risk.
- **Impact:** The Proposed Rule would **significantly increase capital requirements** for Category I – IV banking organizations, with the largest increase occurring for the U.S. GSIBs.
  - The Agencies estimate that their Proposed Rule would increase common equity tier 1 (CET 1) capital requirements by an aggregate of 16%* for all Category I – IV holding companies, broken down as follows:
    - 19% for Category I and II holding companies;
    - 6% for Category III and IV domestic holding companies; and
    - 14% for Category III and IV IHCs of FBOs.
  - For all DI subsidiaries of Category I – IV banking organizations, the Agencies estimate that both CET 1 capital requirements and RWAs would increase by an aggregate of 9%.
  - The Agencies also estimate that the Proposed Rule would increase total RWAs by an aggregate of 20% for all Category I – IV holding companies compared to the current standardized approach for calculating RWAs, broken down as follows:
    - 25% for Category I and II holding companies;
    - 6% for Category III and IV domestic holding companies; and
    - 25% for Category III and IV IHCs of FBOs.

* Although not clear from the Agencies' description in the preamble the Proposed Rule or accompanying documents, we assume that these percentages represent an average for the relevant categories of banking organizations.

THANK YOU!