Prepare For Stricter Capital Rules: The Basel Endgame Is Nigh

By **Jonathan Gould, Joshua Sterling and Nathan Brownback** (April 7, 2023)

Jonathan Gould

Joshua Sterling

Nathan Brownback

U.S. implementation of the Basel III "endgame" revisions to U.S. capital requirements — in whatever form the rules are ultimately finalized — is sure to have a significant impact on how banks structure their businesses and balance sheets to meet new and amended capital requirements.

In congressional testimony on March 28, Michael Barr, the Federal Reserve Board's vice chair for supervision, in response to a question, said, "I think it's important for us to strengthen capital and liquidity rules. We're working on strengthening them as part of our [Basel III] reforms and our holistic reform of capital, and I think we need to move forward with that."

The bottom line? New capital requirements will be proposed soon, likely this year. And especially in light of the recent bank failures in the U.S. and abroad, they are likely to strengthen, not merely rationalize or standardize, bank capital requirements.

If and when finalized, these capital rules are likely to require banks to make significant efforts to comply and to impose real changes on how financial institutions make decisions.

In particular, adoption of Fundamental Review of the Trading Book requirements is likely to require banks to take significant compliance steps. At this early stage, before a proposal from the U.S. regulators, banks should begin to consider how recent concerns about interest rate risk management may affect regulatory thinking, how the FRTB might function, and what their potential responses to a rulemaking would be.

As former regulators who adopted and supervised the implementation of capital requirements for financial institutions, we can attest that the task ahead will be quite daunting — certainly for the supervisory agencies, but even more so for the banks themselves.

As we explain below, while this additional regulation is inevitable, that does not mean it will be a net plus for the financial system in which banks serve the broader economy.

Background: What Is Regulatory Capital?

Regulatory capital is one of the most important tools of prudential regulators. It is a measure of a bank's ability to absorb unexpected losses from credit, market, operational and other risks.

Banks are required to hold capital, such as common equity, in excess of certain numeric thresholds expressed as a percentage of the bank's total assets.

Banks must meet capital thresholds based on total assets, like leverage requirements, as well as based on risk-weighted assets. In the latter case, asset classes are assigned certain risk weights to reflect the relative risk associated with the exposure.

Risk weights can range dramatically, from 0% for certain sovereign exposures like the U.S. government, to 1,250% for certain securitization exposures. They can be assigned by regulators or calculated by complex mathematical models.

Recent Dislocation in the Banking Industry: Market Risk in Focus

The recent failures of Silicon Valley Bank and other financial institutions has raised questions about the adequacy of some banks' market risk management framework and the banking agencies' regulatory and supervisory approach to it, including its regulatory capital treatment.

One of the underlying issues that contributed to the failure of SVB was a decline in the value of its investment portfolio, which consisted in large part of long-term fixed rate bonds such as U.S. Treasury bonds. As interest rates rose, the market value of the portfolio declined, and SVB was forced to realize those losses as it sold assets at less than par value to meet deposit withdrawals.

SVB did not need to hold regulatory capital against many of the assets held in its investment portfolio, because they were direct and unconditional guarantees of the U.S. government and subject to a zero risk weight. Although these exposures had no credit risk, their market value was nevertheless subject to market risk as the Federal Reserve tightened interest rates.

The rapid collapse of SVB is already raising questions about how market risks, such as changing interest rates, affect bank financial statements and regulatory capital. This is on top of concerns that emerged among banks, corporations, funds and regulators in March 2020 regarding the potentially procyclical nature of other regulatory requirements — notably the supplemental leverage ratio, which substantially disrupted the market for Treasury securities by causing large banks to withdraw from their customary dealing role in that market.

Since Treasury securities are the grease on the gears for trillions of dollars of financial transactions worldwide, the problem of procyclical rules in that context did not go unnoticed, either on Wall Street or on Main Street.

What Is the Basel III Endgame?

The Basel III endgame is the international effort of regulators to amend certain aspects of large banks' capital rules. These efforts are spearheaded by the Basel Committee on Banking Supervision at the Bank for International Settlements in Basel, Switzerland.

These regulatory amendments have proceeded in stages. Basel I, agreed to in 1988, spawned the risk-based capital requirement approach and used five risk-weight categories. Basel II, agreed to in 2004, built on Basel I by altering the applicable risk-weight categories and considering additional areas of risk.

However, the 2008 financial crisis resulted in the United States never adopting a full slate of rules stemming from Basel II. It also set the stage for future revisions to regulatory capital requirements.

First published in 2010, Basel III was first revised in 2011, with additional revisions in 2017. The U.S. implemented most of Basel III's first revisions between 2013 and 2015.

Building on Basel II, and with the 2008 financial crisis in mind, the Basel Committee again issued revisions to its risk-based capital standards in 2019. These revised standards, known as the Basel III endgame, seek to increase transparency and further standardize risk-based capital requirements.

In response, national regulators in the European Union and United Kingdom have proposed their versions of how to implement the Basel III endgame. U.S. banking regulators, however, have not made such a proposal.

With U.S. banking regulators expected to propose a rule in the coming months that will govern how the U.S. will put the Basel III endgame into practice, it is likely that they will take into account the recent bank failures.

U.S. bank regulators were already under pressure to propose additional or higher standards than the ones recommended by the Basel Committee.

Regulators also have a habit of "gold-plating" Basel standards, sometimes as a result of idiosyncratic U.S. legal requirements. For example, the Collins amendment to the Dodd-Frank Act imposed floors on regulatory capital such that banking agencies were prohibited by statute from reducing leverage and risk-based capital levels below the levels in effect by regulation as of 2010.

New U.S.-specific capital requirements, if any, may well complicate U.S. implementation of the Basel III endgame's capital standards.

The package of standards and proposals that make up the Basel III endgame includes a number of changes to bank capital rules. Notably, one of those changes, known as the Fundamental Review of the Trading Book, or FRTB, addresses market risk capital rules. U.S. regulators have not yet implemented this portion of Basel III, but they will have an opportunity to do so with the expected rulemaking.

What Are the Components of the FRTB?

The FRTB addresses perceived deficiencies in the current approach to market risk capital rules in four key ways.

First, the FRTB is designed to address the lack of a clearly defined boundary between a bank's trading book and its banking book.

Regulators were concerned that banks were reclassifying exposures to take advantage of arbitrage opportunities between the differing regulatory capital treatments applicable to exposures in these different books. To address this perceived risk, the FRTB lists the instruments that must be included in a bank's banking book and those that must be included in its trading book.

As an initial matter, it is not certain what risk-reducing effect such a bifurcation will have, or how easily it can be administered. Regulators should bear in mind the costs of imposing risk-reducing standards along with any benefits they perceive; specifically, that less risk-taking means less opportunity for return and likely less risk transfer and mitigation for bank counterparties.

Second, regulators are focused on addressing weaknesses associated with the existing value-at-risk approach to modeling risk.

The 2008 crisis exposed certain limitations of this modeling approach, particularly its inability to model tail risk. The FRTB introduces the expected shortfall approach, which may perform better in periods of extreme conditions and high market volatility.

Of course, it may be worse, instead.

It is a truism that all models are wrong, but some are useful. Hopefully regulators bear in mind what is, at best, the heuristic value of risk models when they focus on this aspect of the FRTB.

Third, the FRTB requires banks to consider the relative liquidity of their trading book positions and the trade-offs between liquidation speed and price.

Some of the assumptions about the market liquidity of particular exposures proved wrong in 2008, when banks found that they could either fail to liquidate exposures within the time they expected or do so only at fire sale prices.

While considering liquidation speed and price together should be helpful, ultimately no regulatory provision can solve on its own the sustained breaks in normal market operations for even the most liquid assets.

In March 2020, we experienced from our respective agencies what a Treasury market seizure looked like. Regulators should be none too confident that determinations of liquidation speed and pricing will work as forecasted.

Fourth, the FRTB focuses on a perceived lack of transparency and comparability between the types of internal models banks were using to assess market risk impact and, consequently, determine what level of capital they are required to hold against such risk.

The solution is a so-called standardized approach to modeling risk, which the Basel Committee believes will promote more consistent determination as to capital requirements, even at the expense of risk sensitivity. In turn, a more consistent determination as to capital requirements lends itself to more accurate and informative comparisons across institutions.

Bearing in mind the admonition above that all models are wrong in some way, regulators should be mindful that standardized risk models may all be wrong in the same way, missing risks that might otherwise be detected by permitting a range of models to be employed across banks.

What Will Be Some of the Key Impacts of FRTB on Banks?

The FRTB will have far-reaching consequences for banks. The aggregate effect of the FRTB will be higher capital levels for many banks. Higher capital levels will be driven by several factors.

Under this regime, a bank's prudential regulator will have to approve the bank's internal risk models before the bank can rely on them. Banks will also be subject to back-testing and profit and loss attribution requirements when using their own models, which will provide regulators with clear opportunities for second-guessing.

If the bank does not get the regulator's blessing, it will have to use the standardized

approach to risk modeling, which in other capital contexts raises costs for many institutions. This can have the effect of lowering liquidity for the bank and its trading counterparties, causing risk to be stuck on certain balance sheets when it otherwise could be dispersed and better managed elsewhere.

The FRTB will also impose penalties in the form of capital add-ons for risk factors that fail specified modellability tests. Under the Basel Committee's formulation, a risk is modellable when there are continuously available prices for a sufficiently large set of representative transactions. The capital penalties for nonmodellable risks are therefore more likely to have a particular effect on more illiquid markets where there is simply less observable data for prices and other factors.

Once more, banks must prepare to manage greater complexity by regulatory fiat while trying to fulfill the essential tasks of deposit taking, lending, trading, market making and custodying that are vital to the broader economy. That will be no mean feat.

With the endgame coming — or at least beginning! — later this year, banks should proactively consider their responses, be alert for any U.S. gold-plating to address recent bank failures and, in the longer run, determine how to ensure compliance with the final regulations.

Jonathan Gould is a partner at Jones Day. He previously served as senior deputy comptroller and chief counsel of the Office of the Comptroller of the Currency.

Joshua Sterling is a partner at the firm and former director of the market participants division at the Commodity Futures Trading Commission.

Nathan Brownback is of counsel at the firm.

Jones Day associate Tim Villari contributed to this article.