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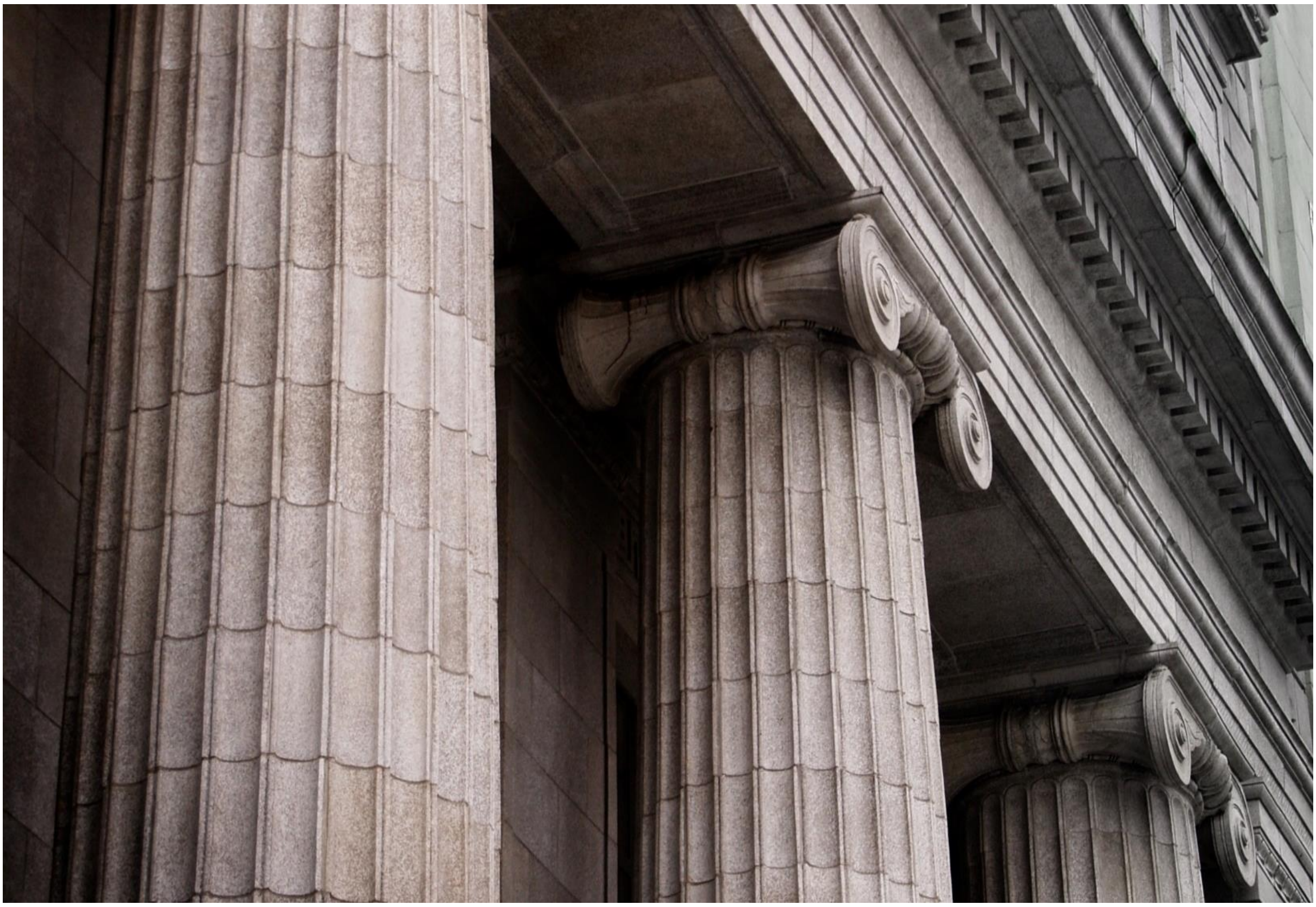
Raising the Barr-II

Impact of two NPRs

Tri-regulatory proposals will crank up cost, curb trading

Point of View | August 2023



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The tri-regulatory plan to strengthen capital rules

This Point of View is part of series covering recent proposals by the US regulators to improve capital standards.

The first one was published on July 18, 2023.

On July 27, 2023, the Federal Deposit Insurance Corporation (FDIC), the Federal Reserve, and the Office of the Comptroller of the Currency (OCC) released interagency proposals to increase capital requirements for large banks in the United States (US) via two separate Notices of Proposed Rulemaking (NPRs):

I. the Basel III Endgame proposal[1] and

II. the Global Systemically Important Banks (G-SIB) surcharge proposal[2].

The first one seeks to modify capital requirements for large banks to better reflect underlying risks and to increase the standardization of capital computation methodology. This is to implement the final components of the Basel III agreement, also known as the Basel III Endgame.

The second one seeks to change the surcharge applicable on systemically important banks by revising the treatment of cross-jurisdictional exposure, among other changes.

Estimated impact and transition provisions

The proposals are expected to increase Common Equity Tier 1 capital requirements of large banks by about 16%. They contain transition mechanisms that allow banks enough time to adapt to the changes, while minimizing potentially negative consequences. Large banks are expected to begin transitioning from July 1, 2025, with full compliance by July 1, 2028.

In the first year, banks would be required to recognize 80% of the expanded risk-weighted assets (RWAs), increasing to 85% in the second year, 90% in the third year and 100% from the fourth year.

The banking industry can send their feedback by November 30, 2023.

[1] Basel III Notice of Proposed Rulemaking (federalreserve.gov)

[2] Federal Register notice: Regulatory Capital Rule: Risk-Based Capital Surcharges for Global Systemically Important Bank Holding Companies; Systemic Risk Report (FR Y 15) (federalreserve.gov)

Applicability

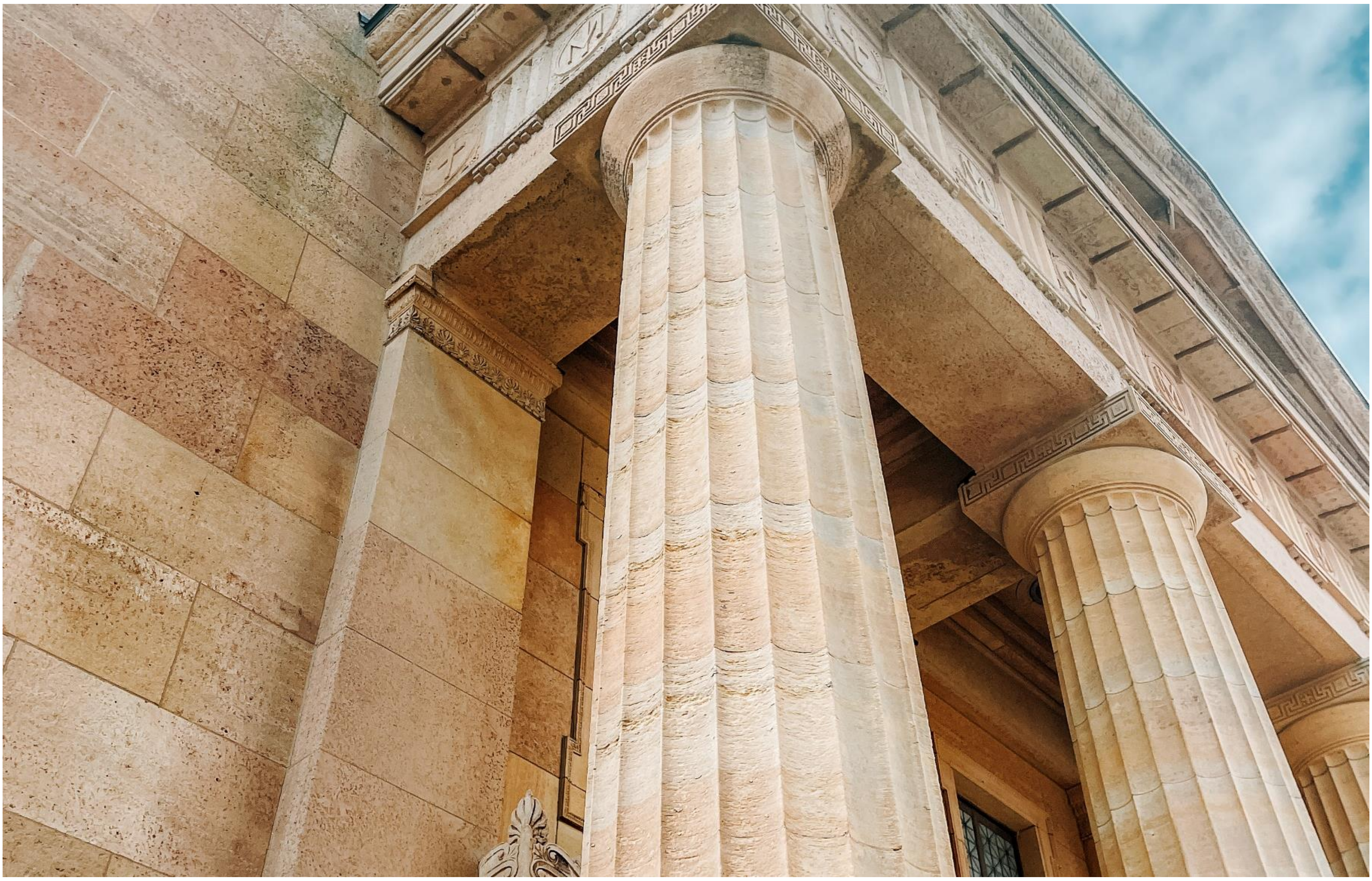
The range of institutions covered by the NPRs has been expanded. The Basel III Endgame proposal is primarily intended for banks with total assets of $100 billion or more. For those with less — but with 'significant trading activity' — the proposals' market risk rules would apply. The threshold for 'significant trading activity' is aggregate trading assets and liabilities of $5 billion or more, or 10% or more of total assets.

Community banks have been excluded from this exercise.

These proposals were highlighted recently by both, Michael S Barr, Vice Chair for Supervision of the Board of Governors of the Federal Reserve System, and Martin J Gruenberg, FDIC Chairman.

On July 10, 2023, Barr delivered a speech at the Bipartisan Policy Center, Washington DC. Titled 'Holistic Capital Review'. He emphasized the need to strengthen capital standards to create a more resilient financial system[3].

Though the holistic review of capital standards was initiated by the Fed in 2022, Barr's speech came in the context of the recent crisis that saw three US banks fail in quick succession between March and May 2023[4].



[3] Speech by Vice Chair for Supervision Barr on bank capital - Federal Reserve Board
[4] FDIC: Bank Failures in Brief

Key takeaways

The Basel III Endgame underscores adequate capitalization as the bedrock of banking, and assumes good supervision or management cannot, by itself, ensure safety.

Following are some of the key takeaways from the NPRs:

1. **Market risk capital requirement:** The proposed calculation of market risk capital broadly reflects the Fundamental Review of the Trading Book (FRTB) guidelines by the Basel Committee on Banking Supervision. While the trading book/banking book boundary is defined based on FRTB, the new proposal replaces the existing framework with a standardized approach and an internal models-based approach.

   Modelling of risk has to be at an individual trading desk level for each asset class instead of the firm level. Banks would be allowed to use internal models for specific desks subject to stringent governance, controls and individual trading desk approval. Banks will have to enhance their governance function to define the trading desk, document market risk activities and secure trading desk approval.

   In contrast to FRTB, regulators are allowed to increase market risk capital requirements on an as-needed basis for a specific bank. This is accomplished through add-ons on top of baseline capital requirements that the regulators may apply at their discretion for both standardized and internal model-based computations.

   The proposal sets an ‘output floor’ at 72.5% of the expanded standardized approach for internal models to limit capital reductions. The objective is to prevent unjustified reductions in the capital requirement.

   The potential increase in market risk capital because of this proposal will likely lead to a reduction in aggregate and specific trading activities.

2. **Credit risk capital requirement:** The NPR has proposed to end the reliance on the use of internal credit risk models in favor of the existing standardized approach and 'expanded' standardized approach to compute risk-based capital that banks need to hold. This is a more stringent version of the Endgame Standard as it requires banks to compute risk-based capital ratios under both the existing standardized approach and the expanded standardized approach (with higher risk weightings), and use the higher risk-weighted asset amount (i.e., less favorable/lower ratio).

   The expanded standardized approach increases the credit conversion factor (CCF) for unconditionally cancelable commitments from 0% to 10%. This may increase the capital burden on banks issuing consumer credit cards, which previously qualified for a 0% risk weight on unconditionally cancelable credit limits.

   The aim is a more transparent and uniform measurement of credit risk across the banking sector. Internal credit risk models could still be used for internal stress testing, capital planning and risk management.

3. **Credit value adjustment (CVA) risk capital requirement:** The NPR has proposed to replace the current exposure methodology (CEM) by a standardized approach to counterparty credit risk (SA-CCR).

   Counterparty credit risk, and specifically the CVA measures, have been simplified to include two main components, in line with the Basel III guidelines:

   - A basic CVA approach, which captures only the credit spread component of CVA risk. This is similar to the current simple CVA approach in the US
   - A new standardized measure for CVA (SA-CVA), which includes the new standardized approach as well as the basic CVA approach requirement

The new CVA approach includes prescribed treatment for risk classes, risk factors and associated correlations. While netting of sensitivities and hedges for underlying positions are permitted, diversification benefits are not recognized between risk classes when calculating the aggregate CVA charge.

This proposal would require banks to beef up governance and control for identification and documentation of counterparty credit risk. An increase in cost associated with CVA would likely lead to reduction in the volume of OTC derivative transactions.

4. **Operational risk capital requirement:** The proposal would replace internal models for operational risk with a standardized approach adjusted upwards as per the bank's historical loss experience. It also introduces new operational risk capital charges based on fee or commission-based income from underwriting, advisory, loan servicing, brokerage and other fee-generating practices. Banks that have a higher proportion of revenue originating from fee/commission-based businesses will be impacted more from this proposal.

Implications of the proposed enhancements to capital standards

The goal of the NPRs is to strengthen the financial system's resilience and decrease the risk of contagion. If implemented as is, it will lead to better transparency around bank capital ratios, but also spawn some headwinds.

In terms of cost, the proposals would raise the capital requirements for banks and may shift some of the lending to non-banks. They would also reduce profitability (as equity is more expensive than debt, and banks would be force to hold more equity and less debt on their balance sheets).

Creditors might pass on some of the costs to borrowers by increasing their lending spreads, fees and charges to offset the higher cost of lending and trading. This would make borrowing more expensive i.e., would make credit more scarce and costly for borrowers.

The proposals are also worrisome for some of the largest banks that had invested the most in the development and implementation of internal models to compute credit and operational risk.

The proposals would also force banks to reconsider individual lines of business and product offerings to increase profitability and minimize the capital drag.

Impact on Category III and IV banks: The proposals would have the greatest impact on banks in Category III ($250 billion to $700 billion total assets) and IV ($100 billion to $250 billion total assets) as the requirements are aligned with the largest banks. Therefore, Category III and IV banks will have to consider the implementation impact of the proposals on their unique product offerings.

We expect pushback on the proposals, and are already seeing some.

Travis Hill, FDIC Vice Chairman, voted against the proposals and raised concerns about dramatically increasing capital requirements for banks with certain business models[5].

Jonathan McKernan, FDIC Director, also dissented by highlighting the lack of rationale in Basel III standards to increase the level of capital[6]. These are some of the evidences on lack of consensus on the proposals.

Rob Nichols, President and CEO of American Bankers Association, stated in a press release recent stress tests had already indicated US banks were well capitalized and forcing them to hold more capital would cost the economy[7].

While the proposals are quite sweeping in nature, they would not be implemented anytime soon as regulators would take comments and banks will get a timeline for transition.

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[5] FDIC: Speeches, Statements & Testimonies - 07/27/2023 - Statement by Travis Hill, Vice Chairman, FDIC, on the Proposal to Revise the Regulatory Capital Requirements for Large Banks

[6] FDIC: Speeches, Statements & Testimonies - 7/27/2023 - Statement by Jonathan McKernan, Member, FDIC Board of Directors, on the Proposed Amendments to the Capital Framework

[7] Statement on Basel Endgame Proposal | American Bankers Association (aba.com)

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