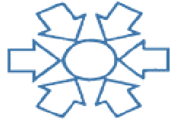

FedFin Client Report

Monday, June 19, 2017

FedFin Assessment: Treasury Capital Reforms and Their Strategic Impact

Client Report: **CAPITAL216**

Executive Summary

In this report, we build on our analysis of the overall Treasury report (see Client Report **REFORM136**) and its approach to global regulation (see Client Report **REFORM138**) with an in-depth look at the capital regime Treasury recommends. This differs considerably from the leverage-based approach in H.R. 10 (see FSM Report **REFORM137**), arguing instead for a balance of leverage, risk-based, and stress-test capital standards that also reflects other rules (most notably those related to liquidity and stress-testing) and accounting standards. The scale of Treasury's recommendations has led some analysts to conclude that as much as $2 trillion in new lending would result. This is not unreasonable if banks devote the capital improvement to lending. However, capital increases would also enhance the ability of large banks to accept cash deposits and retain large balances of high-quality liquid assets and build TLAC buffers without the added risks we highlighted in our assessment of the U.S. approach to this rule (see FSM Report **TLAC6**). In concert with Treasury recommendations for foreign banking organizations (see forthcoming FedFin report), non-U.S. banks could also play a far larger role in U.S. lending and capital markets. Proposed changes to the operational risk-based capital rules would also make it less costly for all banks active in the U.S. to engage in asset management and other fee-based activities.

Despite a strong statement in favor of both risk-based and leverage capital standards (along with recommendations for various changes too each detailed below), the Treasury paper also contemplates an off-ramp akin to that in H.R. 10 relying solely on a leverage ratio (LR). It does not explain how these views are compatible, perhaps reflecting the early stage of Congressional action on sweeping financial reform.

Federal Financial Analytics, Inc.
1140 Nineteenth Street, N.W., Washington, D.C. 20036
Phone (202) 589-0880 Fax: (202) 589-0423
E-mail: info@fedfin.com www.fedfin.com

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Analysis

Based on analysis of research linking higher capital requirements to problematic credit availability, key Treasury recommendations include:

- addressing what Treasury argues are duplicative capital calculations due to the requirement (unique to the U.S.) that banks hold the higher of the standardized or advanced risk-based capital approaches. Treasury's recommendations here are not specific but appear to recommend general reliance only on the standardized approach except for selected asset classes (e.g., derivatives and securities lending). A new FedFin paper lays out a marginal cost-benefit analysis of the U.S. advanced approach;
- considering whether implementing FASB's current expected-credit loss (CECL) accounting methodology makes banks safer. Treasury again does not provide specific recommendations dealing for example with the question of how capital should be adjusted in response to this change, an issue U.S. regulators have discussed but not resolved (see FSM Report **ALLL**);
- walking away from Basel's fundamental review of the trading book (see FSM Report **CAPITAL211**) due to its add-on cost to the already costly post-crisis framework for market risk;
- avoiding reliance solely on a leverage or risk-based ratio;
- revising the LR to remove central-bank reserves, Treasury obligations, and initial margin. A 2016 FedFin paper reviews these issues;
- increasing tailoring to govern capital, liquidity, and stress-test standards. These recommendations are addressed in more detail in FedFin's overall assessment of the Treasury report. Treasury's stress-test recommendations are essentially incorporated into H.R. 10;
- considering exempting community banks (i.e., those with less than $10 billion) from the U.S. Basel III rules, with Treasury particularly concerned with the risk weights assigned to MSRs and high-volatility commercial real estate. The Collins Amendment (see FSM Report **CAPITAL177**) should also be removed for these banks;
- eliminating a counter-cyclical capital buffer (see FSM Report **CAPITAL213**) in favor of applying counter-cyclical capital charges only through stress-testing; and
- changing operational risk-based capital much as H.R. 10 would do.

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Phone (202) 589-0880 Fax: (202) 589-0423
E-mail: info@fedfin.com www.fedfin.com

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