Federal Financial Analytics, Inc.

MEMORANDUM

TO: Federal Financial Analytics Clients

FROM: Karen Petrou

DATE: February 6, 2023

Many rules determine the terms of combat in key financial markets, but none is as fundamental as bank-capital standards because every decision a bank makes first factors capital costs or benefits. These are axiomatic because, even if every other business assumption a company makes is good, a financial product or service will still prove unprofitable if capital requirements are high enough to doom returns sufficient for insatiable investors. Said by some only to be a tidy Basel III clean-up, the Basel IV "end-game" capital rules set to come in the next month or so are actually a substantive recalibration of which businesses make banks how much money compared to all the competitors empowered over the years by the happy – if highly risky – absence of like-kind requirements. It's thus no wonder that it's already game-on for the future of the end-game regulations.

As we've noted in recent client updates, Rep. Andy Barr (R-KY) now chairs the HFSC subcommittee with power over both financial-institution regulation and monetary policy. Although one of his first bills in this Congress deals only with loosening capital rules for de novo banks (H.R. 758), he has made it very clear that he fears that the new big-bank capital construct will prove unduly costly and anti-competitive. Senate Banking Ranking Member Tim Scott (R-SC) said the same thing in more guarded tones when he released his priorities, making it clear that the GOP has its eyes on the new capital rules.

No coincidence, conservative critics are also gunning for the end-game rules, arguing that the U.S. should just say no rather than advance a global capital construct established by a regulatory cabal including many countries that are no friend of the United States. A similar campaign against global insurance-capital standards forced Treasury and the Fed to back down; Basel end-game critics are clearly hoping this playbook yields a similar victory when it comes to banks.

Will it? No, but that's not to say the Fed, OCC, and FDIC will finalize a capital rule just the way they like it.

2023's Basel debate already echoes that of a decade ago. In 2013, the banking agencies had a hard time agreeing among themselves about what the Basel III rules should look like in the U.S. and similar, if less heated, battles have been waging over Basel IV behind the agencies' tightly-closed doors. As a result, the end-game proposal will itself be a compromise on which key points of potential change will be evident to the experienced eye by dint of the kinds of questions on which the regulators seek comment. Careful reading will quickly identify points of vulnerability and effective advocacy by industry advocates will get to work.

However, 2023 is also different in two important ways. First, banks in 2013 bitterly complained that higher capital costs would hinder their post-crisis recovery and long-term profitability. Congress was, though, in no mood to concede on big-bank capital given the harsh costs of the 2008 crisis. In 2023, the great financial crisis is long gone and the mood on Capitol Hill has, at least among Republicans, grown far more venomous about global edicts.

Second, the agencies have now made a major mistake. As we noted last year, Fed Vice Chairman Barr is absolutely right that the U.S. capital standards need a major rewrite to ensure that they all make sense as a whole. Enacting sweeping changes to the credit, market, and operational rules without having this "holistic" framework in place ensures that the capital construct will only be still less coherent or consistent.

Piecemeal rewrites in the absence of a transparent, clear set of capital principles will do little for long-term bank resilience and much for near-term regulatory arbitrage strengthening the competitive hand of the nonbank financial intermediaries regulators have also targeted as a top-priority concern. In the absence of a consistent capital construct, big banks may get more resilient, but the financial system will prove still more prone to 2020-style meltdown.

In short, the combination of inter-agency disputes, political pressure, and substantive incoherence ensures a fragile rulemaking process. At the end, we'll get Basel end-game rules, but the game won't be over because there will still be too many players on the field and those outside the scope of sensible capital regulation will be scoring most of the goals.