FedFin Client Report

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FedFin Assessment: What to Watch in the Regulatory-Capital Rewrite

Client Report: CAPITAL229

Executive Summary

As promised, we plan in-depth coverage of the Fed and FDIC meetings tomorrow as well as of the capital rewrites they are set to propose no matter all the warning shots from Congressional Republicans. In this report, we provide an overview of each of the rules the agencies will propose based on key issues in the Basel end-game standards they will finally advance. We do not focus on details or how the U.S. may adapt these rules except where public releases have provided advance insight. Instead, we highlight key issues to provide vital background and context of tomorrow's actions as well as key decision points on which comment and political advocacy are sure to center.

We also note areas where the U.S. is likely to diverge from Basel – e.g., with regard to the leverage ratio (LR) – and where the U.S. rules will go back to Basel III – e.g., regarding AOCI recognition. All the rules analyzed here would cover banks and BHCs with assets over $100 billion – a massive change for midsized regionals – with some revisions to the leverage ratio and SA (especially regarding mortgages and small-business loans) perhaps applicable to banks of all sizes to gain some community-bank support for this revision and thus lessen Congressional opposition. We do not expect the agencies now to turn also to the GSIB or stress-test revisions Vice Chair Barr outlined (see *Client Report* **CAPITAL228**), but will of course assess them if the package grows still bigger.

Analysis

In addition to the rules discussed below, the Basel end-game standards include new limits on the use of internal models in the advanced internal rating-based (A-IRB) approach. These are designed to eliminate what U.S. regulators long considered and Basel came to believe were regulatory-arbitrage advantages obtained when banks were able to pick the lower risk-weight assessment (RWA) based on the A-IRB or standardized approach (SA). The U.S. has come to apply the A-IRB only to the very largest U.S. banks, requiring them also to hold the higher of the SA or what in the U.S. is known as the advanced approach where models are used. Mr. Barr's talk leads us to conclude that the new standards will end use of the advanced approach and we thus do not assess Basel's rewrite of the A-IRB (see FSM Report

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CAPITAL222). The proposals we expect to see include rewrites of the:

- **Standardized Approach:** This is the framework most critical to credit risk and, in some cases, also to market risk (see below). Credit risk is derived from the probability of default (PD) and loss given default (LGD) in loans, exposures, and structured credit-risk positions, including securitizations. Because of the importance of LGD, various forms of credit risk mitigation (CRM) – e.g., guarantees, credit insurance, collateral – can reduce RWAs, creating strong business drivers for many nonbanks. As detailed in FSM Report **CAPITAL221**, Basel's SA sets RWAs along a wider spectrum, often lower for low-risk assets (e.g., certain retail loans, mortgages, C&I) and higher for higher-risk exposures. CRE, private-equity credit, and merchant-banking weightings are also increased, sometimes significantly.

- **Market Risk:** Simply put, market risk is gains or loss based on financial-market pricing. The Basel "fundamental review of the trading book" is a costly and controversial revision (see FSM Report **CAPITAL223**) with significant capital implications for large trading banks. Higher-risk trading positions, foreign exchange, and securitizations in the trading book face particularly steep RWA adjustments. When the rule was finalized, Basel estimated it raised average market-risk capital 22 percent; as always with these averages, this figure is no guide to costs for banks with large trading books for which the cost is considerably higher. Much in the rewrite is seemingly technical, but details would force significant operational changes in terms of which assets are held in the trading versus the banking book, ending some arbitrage opportunities, and the key capital input – value at risk – would be redesigned better to reflect severely-adverse market conditions rather than historical norms. It is unclear if the U.S. will end the advanced approach to market risk in concert with that to credit risk as discussed above, but Mr. Barr's comments suggest it will. This would significantly add to the cost of the new market-risk approach for the very largest banks.

- **Operational Risk:** This is risk due to natural disasters, fraud, systems failures, and similar events. Basel's final standards (see FSM Report **OPSRISK20**) totally changed the global approach and will surely lead to elimination in the U.S. of the one aspect of the prior standards adopted here, the advanced measurement approach (AMA). In its place, the new requirements could impose a risk-blind approach to operational risk that reduces rewards for risk mitigation and in many respects is based on retrospective risk determinations, not forward-looking ones based on expectations in fast-changing areas such as cyber-risk. Banks with large asset-management, custody, and fee-based activities are likely to face significant capital increases, undermining competitiveness with the nonbank firms that play particularly important roles in these sectors.

- **Leverage Ratio:** The LR is largely risk-blind – i.e., a flat capital charge based on asset valuations or certain exposures. Given Mr. Barr's discussion of the leverage ratio (LR) and FDIC Chair Gruenberg's strong focus on it, the U.S. is unlikely to follow much in Basel's LR rewrite (see FSM Report **LEVERAGE11**). However, refinements are possible, especially with regard to certain cleared derivatives (see FSM Report **LEVERAGE19**) and – less probable – expansion of the exemption for central-bank deposits (i.e., reserves) now afforded custody banks to all banks. This would facilitate the Fed's "ample reserve" and systemic resilience, but may still be farther than the FDIC is willing to go.

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