FedFin Client Report

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FedFin Assessment: What the Agencies Think the Rules Will do and Why Much of That is Wrong

Client Report: CAPITAL234

Executive Summary

With this report, we conclude our assessment of the regulatory-capital proposal with analysis of what the sum total of the credit (see FSM Report **CAPITAL231**), operational (see FSM Report **OPSRISK22**), and market (see FSM Report **CAPITAL233**) rules could do in the real world of banks, nonbanks, foreign banks, and complex market interconnections. Our first assessment of the proposal's framework (see FSM Report **CAPITAL230**) provided the agencies' quantitative-impact statement (QIS). Here, we evaluate the QIS, expand on the agencies' qualitative conclusions, and add our own assessment of what might actually happen in the face of these sometimes-contradictory capital incentives.

Although the agencies initially committed to making the "end-game" rules "capital neutral," the QIS admits that this would not in fact occur, but nonetheless asserts that overall implications are nominal, transition periods more than suffice, and banks will not change the way they do business despite significant increases in regulatory-capital requirements. As noted below, we conclude that the wide variation of empirical results, data used to arrive at them, contradictions in key findings, and flaws in many of the studies cited in support of key policy conclusions lead us to question the substantive findings as well as the overarching rationale that any heightened cost is warranted by offsetting financial stability. As we note here and in our prior analyses, some aspects of the rule could actually increase systemic and macroeconomic risk.

Analysis

What the Agencies Say

The agencies readily admit that the QIS is complicated by problematic data, founded also in large part on assumptions about how banks would behave. Findings and assumptions are based on year-end 2021 data without accounting for subsequent industry or market changes. Regardless, key conclusions in the NPR include:

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- As previously noted, the agencies believe that there would be an aggregate twenty percent capital hike in risk-weighted assets, with this largest at category 1 and 2 BHCs and intermediate holding companies.
- The benefits of heightened financial stability and macroeconomic resilience are said to outweigh the possible costs of banks or troubling market effects. This is also found to be the case with regard to the offsetting benefit of the slight reduction in lending the agencies think possible as a result of the average capital requirements at affected banks.
- Only small reallocations in loan portfolios are said to be likely, with the agencies also noting that stronger banks mean that lending is more likely to continue under stress.
- Banks forced to internalize the effects of their activities are likely to pose less risk.
- U.S. banks are now at the lower end of what the agencies consider "optimal" capital requirements, although a footnote references papers that suggest optimal capital standards could also be below current U.S. requirements, let alone those in the proposal.
- Perhaps attempting to buttress the "neutrality" promise noted above, the QIS notes that current minimum ratios would not change, but affected banks would nonetheless need to hold approximately sixteen percent more CET1.
- There is wide variation in actual impact on individual entities. Based on 2021 data, five category I and II holding companies need to raise CET1 between sixteen and 105 basis points.
- The QIS dismisses any adverse impact by noting that the largest BHCs on average earn 180 bps of capital each year (2015-2021); how this number relates to the five deficient BHCs and what each might need to do is not made clear, nor are the size of these companies and any macroeconomic or financial implications that might result if any of the nation's very largest BHCs sharply altered its business model to optimize capital to quickly become capital-compliant.
- Large holding companies would see market-risk related RWAs rise by $880 billion or as much as 67 percent, varying widely by institution. Interestingly, the agencies say here that higher capital could over time lead to a larger role for bank broker-dealers and market-makers, enhancing financial stability. However, the analysis also finds that the incentives to engage in certain market-related activities could also drop, impairing market liquidity.
- AOCI recognition dominates capital effects for category III banks. Additional capital reductions most affect category III IHCs. AOCI recognition increases for category III domestic BHCs risk-based capital by 4.6 percent and leverage ratios by 3.8 percent. Both changes affect IHCs with regard to risk-based capital by 1.3 percent and a 9.7 percent leverage hike. Implications for category IV BHCs and IHCs are less severe.
- Adjustments to AOCI risk management could offset these results but increase market-correlation risk.

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- Changes in the NPR would make risk-based capital the binding TLAC standard for all category I BHCs. These companies would thus have a "modest" TLAC shortfall. Similar effects are likely at some IHCs. GSIB-surcharge changes are also likely (we will assess these in a forthcoming analysis).

What We Think

First, several observations in the impact section of the NPR are puzzling. For example, the analysis asserts that – other than with regard to market risk – the proposal does not change the current standardized approach. This is in one sense correct – the current SA is kept as is. However, the credit-risk proposal creates an "expanded" SA for credit risk and banks must hold the higher of current or expanded RWAs, which we take as a substantive hike in current SAs for purposes of calculating the new output floor governing a bank's final capital requirements. Indeed, the agencies' impact analysis elsewhere reflects this, noting as we have that the expanded SA will usually prove binding. Still, the key conclusion stands as a major result.

We also observe that:

- The QIS acknowledges that no effort has been made to identify the impact of higher RWAs on the final capital requirements totaled for affected banks under the stress capital buffer despite acknowledging that this would likely result in an overall increase in the SCB floor and thus still higher minimum capital requirements.
- The conclusion that tougher weightings increase the odds of lending under stress does not reflect that stress testing is premised also on continuing financial intermediation in severely adverse scenarios.
- As noted, the agencies expect minimal portfolio reallocation. Portfolio reallocation said perhaps to slightly affect retail and CRE exposures while benefiting corporate, residential real estate and securitization. However, this analysis follows only the ups and downs of the RWAs and therefore does not assess which markets could absorb higher funding costs or the extent to which banks will realign portfolio cross-subsidies. Due to the rule's sum-total calculation of total capitalization under the output floor, current standardized charges could be binding and thus nullify expected benefits.
- The conclusion of possible asset-class benefits is further muddied by a second-order analysis finding that smaller banks could be adversely affected if large banks increase offerings in certain sectors, noting that big banks under the "higher-of" standard ignored and in fact might not realize the asset-class benefits identified a bit earlier in the proposal's impact analysis, noting also that some risk weights (e.g., for mortgages) are purposefully set high enough to ensure big/small-bank competitive equity. Thus we conclude that, when big banks allocate capital, the classes the agencies suggest might benefit in fact will not do so and the total effect on portfolio allocation could be considerably larger than anticipated marginal effects.

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- The opposing conclusions drawn for the sharp spike in market risk-based capital suggest that the agencies have an uncertain grasp of actual impact in key sectors.
- Many of the studies cited for empirical and projected results do not apply to the proposal because they are outdated (e.g., 2010 and 2015 analyses of capital effects on credit availability), apply to banks in the EU or other nations with significant structural differences from the U.S., or are models-based founded on assumptions that, as we have noted in study assessments over the years, are often based on academic or theoretical assumptions, not observed market results.

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