# Basel III Endgame: Navigating Capital Requirements and their Economic Impacts

Center Forward Basics

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## Overview

Following the financial crisis of 2008, an international standard-setting body known as the Basel Committee for Banking Supervision (BCBS) – representing central banks and bank supervisors from 28 jurisdictions – convened to modernize bank **capital requirements**. The goal was to mitigate the risk of another financial crisis and revisit a multi-decade initiative known as the Basel Accords aimed at harmonizing capital standards and improving international cooperation among global bank regulators.

Members of the BCBS agreed upon a framework known as Basel III in November 2010, and this framework was largely adopted by the global community, including the U.S., European Union, and other major jurisdictions. In 2017, BCBS revisited the framework and made significant revisions to Basel III, primarily intended to reduce unwarranted variability in capital requirements across jurisdictions, and BCBS participants agreed to enact these rules in their jurisdictions by 2025.

In July 2023, the Federal Reserve, the Federal Deposit Insurance Corporation (FDIC), and the Office of the Comptroller of the Currency (OCC) jointly released a notice of proposed rulemaking to implement the final Basel III reforms framework domestically. While some other countries call the 2017 proposal "Basell 3.5" or "Basel IV," the 2023 proposal from U.S. regulators has come to be known as "Basel III Endgame." Under the proposed timeline, covered banking organizations would have to begin their transition to the new domestic framework on July 1, 2025, with full compliance by July 1, 2028.

Industry leaders and economic experts have expressed concern that the proposal from U.S. regulators included little concrete economic analysis and impact studies, and the U.S. proposal deviates significantly from the standards agreed upon by the BCBS. Some preliminary estimates suggest that banks covered under the proposal could face a substantial 16-20% increase in required capital holdings, with estimates up to 30% for certain firms. Given (i) this significant potential impact on covered financial institutions, (ii) the apparent implication that the banking system is undercapitalized as it exists today, and (iii) the seeming absence of supporting evidence and data to that point, the proposal has sparked widespread criticism from current and former Federal Reserve Governors and lawmakers on both sides of the aisle. This Basic will examine those arguments and the potential impacts of the Basel III Endgame proposal.

## Basel Committee Background

The Basel Committee on Banking Supervision (BCBS) is a panel convened by the Bank for International Settlements (BIS) in Basel, Switzerland, and aims to

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In order to meet our challenges we need to put aside the partisan bickering that has gridlocked Washington and come together to find common sense solutions.

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## Key Terms:

- **Capital Requirements:** Standardized regulations that require banking organizations to hold a minimum amount of eligible capital in relation to their risk-based or total assets, such as debt.
- **Risk-Weighted Assets (RWAs):** Based on risk assessments, a banking organization will assign standardized or modeled "risk weights" to different categories of assets in its portfolio to determine the amount of capital it must hold on hand.
- **Credit Risk**: The probability of a financial loss resulting from a borrower's failure to repay a loan. Lenders mitigate credit risk by analyzing factors about a borrower's creditworthiness, including income,

coordinate rules among global banking regulators to protect against financial crises and promote international regulatory harmonization. The Basel Committee was established by the central bank Governors from the G10 countries in 1974 following serious disturbances in international currency and banking markets. Following its creation, BCBS released the First Basel Accords, “Basel I,” in 1988. The Committee released its second accords, “Basel II,” in 2004.

The timeline for central banks to implement Basel II recommendations was soon interrupted by the 2007-2008 financial crisis. Following the crisis, BCBS immediately began work on its third accords, “Basel III,'' which would come to supersede most of the suggestions published in Basel II. In 2010, BCBS published their recommendations for Basel III, aimed at strengthening capital requirements and introducing requirements for liquid asset holdings and funding stability to mitigate the risk of bank runs, when clients withdraw their money for fear of a pending bank failure. These standards were endorsed at the G20 Leaders’ Summit in November 2010. Since the Basel Committee’s suggestions are not legally binding, it is up to the central banks and regulatory authorities in their member countries to review the suggestions and implement them into their own regulatory regime. In 2011, the Federal Reserve endorsed the Committee’s Basel III proposal and has implemented virtually all the recommendations since then.

## 2017 Revisions to Basel III

In December 2017, BCBS released “Basel III: Finalising post-crisis reforms.” This package is often referred to as “Basel 3.5” or “Basel IV” in international jurisdictions. The Basel Committee stated the revised package of reforms was intended to improve international comparability among financial institutions and ensure banks’ capital ratios are transparent and their risk-weighting calculations are credible.

One of the core elements of the 2017 proposal revised and expanded the current use of “standardized approaches” to calculating a firm’s **risk-weighted assets (RWAs)**. Among other things, the expanded risk-based approach would revise and generally increase the riskiness assigned to certain types of assets and introduce a new method of assigning **credit risk** and **operational risk**. The standardized approach proposes to limit banks’ ability to use their own internal risk models to determine the riskiness of their lending activity and the capital required for such services, including mortgages, credit card lending, and business loans. The proposal does allow for the use of internal models in a limited number of categories, including **market risk**. The new rules are intended to improve transparency and sensitivity to market dynamics, and some supporters of the proposal suggest the internal models banks currently use underestimate risk to keep operating costs low. Critics of the proposal, however, note standardized approaches are blunt tools that cannot fully consider a firm’s individual portfolio and business model.

The 2017 BCBS proposal also introduced increased minimum capital requirements from the 2010 proposal. The 2017 reforms have also introduced a new non-risk-based **leverage ratio** to serve as a backstop to the risk-based

credit history, and current debt.

- **Operational Risk:** The uncertainties and hazards a company faces from day-to-day activity in a given field or industry. This results from a breakdown of internal procedures, as opposed to external forces.
- **Market Risk:** Also called “Systemic Risk”, it is the possibility an individual or institution will experience loss due to factors affecting investment performance and financial markets in their entirety.
- **Leverage Ratio:** A set of ratios that highlight a business's financial leverage in terms of its assets, liabilities, and equity. They show how much of an organization's capital comes from debt — a solid indication of whether a business can make good on its financial obligations.
- **Common Equity Tier 1 Capital (CET1)**: Part of a bank’s core capital to fund business activities, it is the highest quality of regulatory capital that can immediately absorb losses when they occur. CET1 includes shareholders’ common equity and retained earnings.
- **Globally Systemic Important Banks (G-SIBs):** A bank whose systemic risk profile has been evaluated to be of such magnitude that the individual bank’s failure would trigger a wider financial crisis and potentially threaten the global economy. The Basel Committee developed a framework for categorizing G-SIBs based on size, interconnectedness, and complexity, among other factors. Because of their impact on the global economy, G-SIBs are often subjected to stricter regulations including higher capital requirements and stringent stress tests.
- **Lending Spread:** The difference between the interest rate a financial institution earns on loans it makes and the interest rate it pays on the deposits or funds it borrows to finance those loans. In simpler terms, it represents the profit margin a bank or lender earns from lending money after accounting for the cost of obtaining funds.

capital requirements. Increased capital requirements can serve as a buffer when banks are faced with financial stress, but they also make regular lending practices more expensive. Under the new requirements, qualifying banks must hold a **Common Equity Tier 1 (CET1) Capital** buffer of 50% of their overall risk-weighted capital. Currently, most banks with $100 billion or more in assets are required to hold a minimum CET1 ratio of at least 8%.

After the final package of Basel III reforms was finalized and agreed upon in 2017, the initial timeline mandated member states implement the new rules by January 2022. Following delays during the COVID-19 pandemic, most member states are on track to implement their versions of the new rules by July 2025. Individual member states and their central banks will have the authority to establish the timeline and infrastructure to implement these new standards domestically. Although the Basel standards are not legally binding treaties or laws, the provisions agreed to in the final Basel III package constitute minimum standards. Central banks like the U.S. Federal Reserve may elect to depart from the final BCBS reforms to reflect jurisdictional-specific considerations or establish a different timeline for full compliance. While jurisdictional implementation is generally expected to be consistent with the agreed-upon international standards, central banks may also adopt more stringent standards, a practice often referred to as "gold plating."

- **Capital Markets:** The venues where funds are exchanged between buyers, capital suppliers or investors, and sellers, entities seeking capital or investment. Buyers and sellers can trade various financial instruments including securities and equities. The most common capital markets are the stock market and the bond market.
- **Tax Equity:** A mechanism whereby an entity qualifies for a given tax credit from the government, but does not have the tax burden to fully capitalize on that incentive, so they sell the full credit to a non-qualifying entity with a larger tax burden.

## Proposal From U.S. Regulators - "Basel III Endgame"

The Federal Reserve, along with the FDIC and OCC released their proposal to implement the final Basel III reforms in the United States in July 2023, a proposal often referred to as "Basel III Endgame." Citing the turmoil in the spring of 2023 and the collapses of Silicon Valley Bank and First Republic Bank, the U.S. agencies' proposal seeks to apply a broader and more conservative regime of capital requirements than the Basel Committee suggested.

Because of substantial changes to risk-weighting methods for covered firms, banks with assets exceeding $100 billion could face a substantial increase in required capital holding requirements under the proposal. Estimates for domestic non-**GSIBs** are generally 16-20%, while the U.S. GSIBs estimate the proposal will increase their capital requirements by roughly 30%. These increases can vary substantially by firm depending on their business model but are largely driven by the expanded standardized approaches for risk-weighting.

In their proposal, the Federal Reserve and other agencies expressed their belief that most banks could adjust to any needed additional capital under the proposed requirements without much difficulty. However, some economists and advocates insist these new rules will impose a significant cost on lenders and have widely criticized the agencies for failing to include any meaningful data or analysis to demonstrate that the expected benefits of such an increase justify the significant cost. Other critics including industry leaders, consumer groups, regulators, and policymakers in both major parties argue the cost imposed by the changes is largely unjustified. They voiced serious concerns that the rules could increase the cost and decrease the availability of credit and other financial services and that certain provisions may lead to unintended consequences that could harm American businesses and households, jeopardizing U.S. economic growth at an especially sensitive time.

The regulating agencies accepted public comments on the proposal until January 16th, 2024. Comments overwhelmingly opposed the proposal in its current form and recommended either substantial revisions or that the agencies rescind the proposal and re-propose new rules supported by available data. The agencies must now consider the public comments and work towards developing a final set of rules. Under the proposed timeline, covered financial services organizations will need

to begin transitioning to the new framework in its final form by July 1st, 2025, with full compliance by July 15th, 2028.

## Potential Impacts

The real impacts to banks varies based on the institution's size and business model, as well as the makeup and complexity of their lending portfolios and other operations. In any case, the proposal's revised and expanded approach to calculating capital requirements is likely to make banks' core lending practices more expensive. To offset these increased costs, banks will have to find new revenue sources. The most direct way to do this is to increase their **lending spreads** – the interest rates they charge on loans – effectively passing those costs to customers. The increased costs of lending could disproportionately fall on businesses and consumers deemed riskier under the new standardized measures, including small and early-growth businesses, low-medium income (LMI) households, and communities of color. If some lending activities become less economically viable under the revised capital rules, banks may withdraw from that sector or service entirely.

In the mortgage market, Basel III Endgame is drawing criticism for being overly punitive towards mortgages in banks' portfolios, particularly those with high loan-to-value ratios, which would disproportionately impact low- and moderate-income and minority borrowers. Expert economists see the revised approach to risk-weighting for mortgage lending as excessive, especially given the proposal's departure toward a more stringent standard than the 2017 BCBS standards. Some industry experts stress the success of the 2010 Dodd-Frank reforms in making mortgage lending more secure and argue that banks should have the flexibility to offset the risk of mortgage lending with less risky debt elsewhere in their portfolio, a maneuver that is significantly restricted under the newly proposed standardized risk assessments. The new costs can increase mortgage rates and reduce capital access for buyers. Since mortgages and home ownership play a crucial role in wealth creation and economic mobility, these new costs could have serious impacts for first-time home buyers and low-income households.

Small businesses are heavily reliant on capital access during early growth stages and are already weighed as one of the riskier loans banks offer. Under the proposed implementation of Basel III Endgame, banks would have to hold more capital and absorb higher costs to service these loans, particularly for the substantial proportion of small businesses that do not have publicly traded securities. If small business loans become less profitable, banks will likely issue fewer new loans and credit lines, potentially hindering small business growth and new entries to the market. Even businesses that take loans from regional or community banks under $100 billion in assets are not be insulated from these effects. Because smaller banks often share some of their credit risk and debt burdens with larger lenders, impacts on the largest banks can trickle down through the whole system.

The proposal would also require banks to hold credit for unused credit lines. For example, if a consumer has a credit card limit of $5,000, but only uses $1,000 each month, the bank will still be required to hold a certain amount of capital for the $4,000 in unused funds, and that cost will likely force banks to restrict credit line increases for credit cards and home equity lines of credit. This approach has been criticized as being especially non-risk-sensitive since the size of credit lines offered generally reflects a bank's assessment of credit risk. The size of credit lines is typically inverse to credit risk, meaning the lowest-risk borrowers generally have the largest credit lines and the lowest utilization percentages. If banks reduce credit lines under these new incentives, borrowers will have less credit available, and assuming the same spending, also have a higher utilization percentage. Higher utilization can negatively impact a borrower's credit score, meaning this approach could potentially reduce both the credit currently available to consumers, as well as their future access to credit.

Reducing incentives for large institutions to operate and participate in public **capital markets** will likely lead them to scale back their activity, and that divestment will trickle down to hurt consumers and retail investors. College funds and retirement savings will see reduced returns as pension plans and investment managers face higher financing costs and potentially reduced market liquidity. Furthermore, commodities businesses and other companies like airlines and insurance carriers use capital markets to lock in their costs and keep their prices lower. Increasing the cost of these activities could make products like plane tickets, utility bills, insurance premiums, and groceries more expensive.

Even some rather niche rules proposed by the U.S. regulators could have wide-ranging economic consequences. Financing for renewable energy development and infrastructure projects will likely come under strain due to a new rule on **tax equity** risk weighting. Tax equity is used by smaller companies that do not have the tax burden to fully capitalize on tax credits or incentives offered by the government and will sell tax credits to larger banks to help finance new builds. The U.S. proposal includes a 400% risk weight for non-public tax equity holdings, making this lending drastically more expensive. Tax equity has been regulated and used in this space for decades and has no clear tie to the causes of the 2008 crisis that Basel III is intended to address. This change comes at an especially bad time for the renewable energy industry, following massive investments from the Inflation Reduction Act. The increased risk weighting will reduce the practical impact of government dollars spent on these programs and likely delay the timeline of renewable energy deployment.

## What is happening now?

National banking trade associations, large lenders, and advocates from across different sectors of industry have all expressed alarm at the U.S. proposal, raising concerns about the lack of economic data and analysis underpinning the suggested changes and warning this approach will have unintended consequences on economic growth and consumers. Although some critics suggest a more aggressive approach is warranted given the 2023 collapse of Silicon Valley Bank (SVB) and subsequent collapses of regional banks, an analysis from the Brookings Institute in agreement with other experts found that the U.S. proposal does not directly address the factors that lead to the SVB collapse. Postmortem analyses depict the SVB collapse as a more traditional bank run spurred by a rapid increase in market interest rates and inadequate liquidity risk management, and not an indication of a system-wide problem. The vast majority of U.S. banks survived the stress of the COVID-19 pandemic without collapse and no major institution has failed the Fed's stress tests in years, suggesting that U.S. banks are well-capitalized.

Some regulators have also voiced doubts, including Federal Reserve Chair Powell, Federal Reserve Governors Christopher Waller and Michelle Bowman, and former Vice Chair of the Federal Reserve Randal Quarles, who cautioned that full the implementation of Endgame could result in significant capital increases of up to 20% for large banks. Adding to the apprehension, 222 Members of Congress from both major parties have expressed concerns about the U.S. proposal in its current form.

This collective apprehension underscores the widespread unease across sectors with the repercussions of Basel III Endgame. According to one report, 97% of entities that submitted comment letters opposed the Basel III Endgame proposal. However, some legislators, regulators in the Biden Administration, and Federal Reserve Governors appointed by President Biden remain publicly determined that increased capital requirements are necessary and appropriate to enhance the overall resiliency of the U.S. financial system. Following the close of the comment period, it was reported on March 6th, 2024, that the agencies are considering rewriting their proposal for Basel III implementation given this widespread concern.

## Links to Other Resources

- Bank for International Settlements (BIS) – History of the Basel Committee
- Bank Policy Institute – A Better Way to Assess the Economic Impact of the Basel Proposal
- Brookings Institute - What is Bank Capital? What is Basel III Endgame?
- Corporate Finance Institute – Basel III The global regulatory framework for banks
- Federal Reserve – Agencies request comment on proposed rules to strengthen capital requirements for large banks
- KPMG – Capital Requirements: Proposed "Basel III Endgame" & GSIB Capital Surcharges
- Latham & Watkins – Comments on the Basel III Endgame Proposal
- PwC – Basel III Endgame The next generation of risk-weighted assets
- Reuters - US regulators expected to significantly reduce Basel capital burden