What is 'Basel III endgame' and why are U.S. banks worked up about it?

The rules, applying to banks with over $100 bn in assets, would overhaul the way the biggest banks manage their capital, with knock-on implications for lending. trading activities; banks say additional capital is unnecessary and will hurt the economy and have aggressively lobbied against the project

EXPLAINER

Reuters

The U.S. Federal Reserve said last month it will make significant changes to a sweeping proposal for stricter bank capital requirements known as the "Basel III endgame" in a win for Wall Street banks that have waged an unprecedented campaign to water down the rule. What is Basel and why is it so contentious?

The rules, which would apply to banks with over $100 billion in assets, would overhaul the way the biggest banks manage their capital, with knock-on implications for lending and trading activities.

Banks say additional capital is unnecessary and will hurt the economy, and have aggressively lobbied against the project.

'Basel III endgame'

The Basel Committee on Banking Supervision is a panel convened by the Bank for International Settlements (BIS) in Basel, Switzerland, which aims to ensure regulators globally apply similar minimum capital standards so that banks can survive loan losses during tough times.

The committee's "Basel III" standard was agreed after the 2007-09 global financial crisis. It includes numerous capital, leverage and liquidity requirements. Regulators across the world have worked for years to implement many of those standards, and the so-called "endgame," agreed in 2017, is the final iteration. The "endgame" proposal, unveiled in July, refines Basel's approach to setting capital based on the riskiness of banks' activities.

Sweeping overhaul: The U.S. proposal would overhaul how banks gauge their risk. REUTERS

The U.S. proposal would overhaul how banks gauge their risk, and in turn, how much capital they should set aside as a cushion against potential losses. The main areas of focus are credit risk, market risk and operational risk.

On credit risk, regulators are seeking to end banks' ability to use their own internal risk models when determining how much capital should be held against lending activities, like mortgages or corporate loans.

Federal Reserve Vice Chair for Supervision Michael Barr said those internal models can often underestimate risk, as banks are incentivised to keep their capital costs low. Instead, regulators would prefer uniform modelling standards across large banks. Similarly, the proposal would establish new requirements for how banks gauge the risk posed by swings in the markets and potential losses from trading. Regulators say these market risks are currently being understated.

When assessing these risks, banks will be permitted to continue using internal models approved by regulators, although Mr. Barr has said standardised models may be required for particularly complex risks. Banks will also have to model trading risks at the level of the individual trading desk, as opposed to at an aggregate level.

All told, the changes would result in higher capital needs for banks with large trading operations.

Gauging operational risk is a key new area of the Basel Endgame. This refers to the potential losses banks could face from unexpected sources, such as failed internal policies, management mistakes, litigation costs or external events. Similar to credit risk, regulators are looking to replace existing internal models with a standardised approach, which would take into account a bank's various activities and historical operational losses when calculating capital levels.

Banks warned this approach could lead to significantly higher costs for some banks that rely heavily on non-interest fee income, such as credit card and investment banking fees. These fees are included in a formula used to help calculate operational risk, and banks warn it could lead to disproportionately higher capital requirements for some firms if not capped.

'Well capitalised'

While the rules have been years in the making, banks had hoped U.S. regulators would offer relief elsewhere by making tweaks to existing capital requirements to help offset the new hikes. They argue banks are well-capitalised, having withstood the COVID-19 pandemic and regularly clearing the Fed's annual stress tests, and any capital hikes are unjustified. Banks have also complained that regulators have not provided sufficient data to justify the new increases, and have even threatened to sue.

Mr. Barr said that most banks already have enough capital to meet the requirements, and those that need to raise funds could do so by retaining earnings for less than two years while still paying dividends. And regulators have also pointed to the failure of three lenders in 2023 as evidence they need to be vigilant.

Following months of criticism and pressure from the industry, U.S. regulators are expected to meaningfully reduce the impact of the proposal in a broad rewrite. Reuters reported in March the agencies are expected to significantly lower the overall capital impact of the new rules. Fed Chair Jerome Powell confirmed that trajectory when he told Congress last month he expects "broad, material" changes to the plan.

The Fed and other regulators are currently digesting hundreds of public comments submitted on the proposal, most of which have been critical. Regulators are also expected to conduct additional data analysis around the proposal.

No timeline has been set for completing the rule-writing project, and an open question is whether regulators opt to re-propose the rule following the rewrite. Such a step could ease industry complaints by giving them a chance to offer more feedback, but would significantly delay the effort and potentially imperil it, as regulatory leadership could change following the November presidential election.