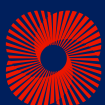


“Endgame” for Main Street Lending

Understanding how the Basel III
bank capital rules will harm
American businesses
and the U.S. economy.



U.S. Chamber of Commerce
Center for Capital Markets
Competitiveness

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Executive Summary

In July 2023, the Board of Governors of the Federal Reserve System (FRB), Federal Deposit Insurance Corporation (FDIC), and Office of the Comptroller of the Currency (OCC; or collectively, the Agencies) published a notice of proposed rulemaking (the Proposal) that would substantially revise the capital requirements applicable to large banks. The Proposal is consistent with the global trend of financial regulators prioritizing financial stability and risk mitigation by imposing stricter capital adequacy standards. But depending on the Proposal's foreseeable consequences, the Agencies may get neither financial stability nor economic growth. It is essential to evaluate the Proposal's foreseeable consequences—particularly for downstream stakeholders—which may arise from such regulatory measures. The purpose of this white paper is to comprehensively evaluate the implications and unintended consequences for main street businesses that will result from the Agencies' Basel III Endgame Proposal.

The paper begins by examining the Proposal and identifying the key changes presented for each risk type (i.e., market risk, credit risk, and operational risk). It then explores the rationale behind the heightened capital requirements prescribed in the Proposal and identifies intersections and relationships with other regulatory requirements across the financial industry. The paper continues by addressing where the Proposal diverges from international standards and could place U.S. markets at a comparative disadvantage. As Travis Hill, vice chair of the FDIC, pointed out

in his dissenting statement when the Proposal was introduced, the excessive gold plating of the Proposal (comparable with international standards) and the rejection of capital neutrality will dramatically increase capital requirements for banks with certain business models.

Drawing on empirical evidence and industry studies, this paper highlights several punitive consequences stemming from increased regulatory capital requirements. First, it discusses the potential negative effect the Proposal might have on bank lending and credit availability, particularly for small and medium-size enterprises (SMEs) and individuals, presenting specific examples of the punitive cost increases on specific types of products and services. It demonstrates how restrictive capital constraints can limit banks' ability to extend credit, thus hindering economic growth and potentially exacerbating income inequality.

Second, the paper explores the potential distortionary effects the Proposal might have on bank business models and profitability. Higher capital requirements often cause banks to alter their operations, leading to reduced risk-taking activities, which could cause capital and funding markets to shift toward less highly regulated institutions or market sectors to meet demand.

Third, the paper examines the implications of increased capital requirements on market competitiveness and the potential for unintended increases

in risk concentration. Smaller banks and institutions, such as ones classified by the FRB as Category III and IV, would likely face significant challenges in meeting the heightened standards, potentially leading to market consolidation and reduced competition.

Although the Agencies argue that regulatory capital requirements for banks are designed to enhance financial resilience and safeguard the system, the Proposal elicited a substantial negative reaction—something not common in response to interagency regulations. The vote at the FDIC board was 3-2 for publication of the proposed rule, and the vote at the FRB was 4-2. One “no” vote was that of FRB Governor Christopher Waller, who pointed out that increased capital requirements force banks to hold more capital against the services they offer to families and businesses—equivalent to imposing a tax on those services. Mr. Waller continued by highlighting that someone must bear the cost of the implied tax; one possibility is that the banks may not absorb these costs themselves and would instead pass the cost of higher capital requirements along to their customers. This transfer would raise costs for American families and businesses, which could hinder economic growth.¹

It should be noted that the Proposal is entirely discretionary; Congress did not direct the Agencies to engage in the rulemaking, and it need not be promulgated. Moreover, the results of bank stress testing in recent years reveal that banks broadly have strong capital levels that remain well above regulatory minimums even in stressed scenarios.

1. Statement by FRB Governor Christopher J. Waller

The Proposal is simply unnecessary: an unfortunate solution in search of a problem.

It is also important to note that the Proposal, along with additional proposed changes to capital requirements, is being considered following a time when inflation reached levels not seen in nearly 50 years. Although inflation has begun to slow in recent months, the ramifications of increased capital requirements could reverse that trend and further deteriorate the average American’s financial condition.

As shown throughout the paper, the Proposal will likely impose punitive consequences on a variety of stakeholders. Policymakers and regulators must carefully consider the potential unintended effects and better balance financial stability on the one hand and promote economic growth and access to credit on the other. By adopting a holistic and flexible approach, regulators can work toward achieving both objectives effectively.



Summary of Proposal's Detrimental Effect on the Economy

Table 1 identifies types of businesses and industries that would likely be affected negatively by the Proposal’s regulatory capital requirements.²

Table 1. Proposal’s Detrimental Effects on the Economy

Risk	Product/ service type	Examples of industries/businesses	Explanation
<i>Market risk</i>	Trading assets and liabilities	Commercial end users that use derivatives to hedge commercial risk, such as these: <ul style="list-style-type: none"> • Agricultural producers • Oil producers • Senior living facilities • Real estate investment trusts (REITs) • Grocery chains • Airlines 	The costs for banks to either transition their current market risk-weighted assets (RWA) processes or establish new processes to comply with the Proposal will likely be passed on to the banks’ customers/ counterparties via higher transaction costs. These increased hedging costs, in turn, could be passed on to the customers via higher prices on hedgers’ services/products, adversely affecting earnings and slowing economic growth.
	Debt issuances	<ul style="list-style-type: none"> • Municipalities • Publicly traded businesses 	For banks that apply the sensitivities-based (or standardized) approach for calculation of market RWA, the Proposal could increase the amount of capital required to trade municipal securities by 3 to 6 times current levels (or greater). ³ These higher costs could have a significantly negative effect on dealers’ ability to trade such bonds and could erode market liquidity,

2. This table is illustrative only; it is not an exhaustive list of all business types and industries potentially harmed by implementation of Basel III.
 3. SIFMA Submits Comments to the Fed Regarding the Impact on Municipal Securities from Basel Committee on Banking Supervision’s FRTB.

Risk	Product/ service type	Examples of industries/businesses	Explanation
<i>Market risk (continued)</i>			leading to higher rates for municipalities issuing new debt. The higher issuance cost could impair some municipalities' ability to fund infrastructure projects (e.g., roads, bridges, schools, hospitals).
<i>Credit Risk</i>	Real estate	<p>Businesses involved in the construction and purchasing of real estate property, such as these:</p> <ul style="list-style-type: none"> • Auto dealers • Builders (e.g., 1 to 4 mortgages, commercial, retail) • Landlords (e.g., 1 to 4 mortgages, commercial, retail) 	Affected industries will likely see increased borrowing costs to compensate for the increased RWA requirements for these types of products. These higher costs are likely to then be passed to the customers (e.g., homebuyers, tenants, subcontractors) of the borrowing entities to compensate for the greater borrowing costs.
	Corporates	Non-publicly traded companies (SMEs)	Non-publicly traded companies are disproportionately affected through higher assigned risk weights relative to publicly traded competitors, requiring banks to hold additional capital. Higher capital requirements will likely lead to increased borrowing rates for privately held businesses, reducing their earnings and/or access to credit. These costs could, in turn, be passed on to consumers and exert downward pressure on economic growth.

Risk	Product/ service type	Examples of industries/businesses	Explanation
<p><i>Credit Risk (continued)</i></p>	<p>Off-Balance Sheet</p>	<p>Businesses/individuals that use lines of credit for funding needs, such as these:</p> <ul style="list-style-type: none"> • Non-bank mortgage lenders • Auto dealers • Agricultural businesses • Seasonal businesses (e.g., retail) • Credit card holders 	<p>The increased risk weights applied to unfunded commitments/extensions of credit will likely lead to banks raising borrowing costs and reducing credit line availability. The increased costs to businesses will likely lead to reduced economic growth and higher consumer costs. For individuals, reduced credit availability could limit their ability to meet daily needs. Additionally, the reduced credit lines could lead to increased utilization rates on credit cards and negatively affect credit scores. Lastly, non-bank lenders that use these facilities to fund home purchases could face higher costs; this could result in making housing more expensive, which could compound current housing affordability issues.</p>

Risk	Product/ service type	Examples of industries/businesses	Explanation
Credit Risk (continued)	Derivatives	<p>Commercial end users that use derivatives to hedge commercial risk, such as these:</p> <ul style="list-style-type: none"> • Agricultural producers • Oil producers • Grocery chains • Airlines 	<p>The costs for banks to transition to the standardized approach for counterparty credit risk (SA-CCR) for calculating credit RWA, paired with the potential that the change in methodology will increase capital requirements via greater RWA, will likely be passed through to bank counterparties via higher transaction costs. The increased costs to hedge commercial risk could flow to the hedgers' customers via higher prices on products and services. This, in turn, could adversely affect earnings, reduce excess discretionary spending, and slow economic growth.</p>
	Repo-style transactions	<p>Unregulated financial institutions⁴ that use repurchase agreements and securities lending to obtain or provide funding in the market, such as these:</p> <ul style="list-style-type: none"> • Banks • Pension funds 	<p>Higher collateral requirements likely would cause unregulated financial institutions to purchase larger quantities of high-quality liquid assets (e.g., U.S. Treasury bonds). This could lead to lower returns on highly liquid collateral and lower operating returns, due to the opportunity cost of using these funds for lower yielding assets instead of more productive and higher yielding alternatives, such as investing and research and development.</p>

4. Unregulated financial institutions are those not subject to prudential regulation. Specifically, the Proposal defined as “unregulated” any financial institution that would not meet the definition of financial institution under the current U.S. capital rules but for ownership interest thresholds in part of that definition. The classification would capture non-bank financial entities that engage in lending, insurance, securities, or other financial instruments and asset management activities but that are not subject to prudential regulation.

Risk	Product/ service type	Examples of industries/businesses	Explanation
Operational risk	Commission-/fee-based financial services	Businesses and individuals who engage banks for financial services, such as these: <ul style="list-style-type: none"> • Wealth management advisory services • Fiduciary services 	<p>TBanks that concentrate on fee-based/commission-generating advisory and financial services would have increased capital requirements through operational RWA, likely resulting in these banks passing the costs to clients (via higher fees) or discontinuing product offerings. The increased fees likely would be passed on to bank clients, reducing earnings for these individuals and businesses and limiting the ability for funds to be used for more productive means.</p> <p>Additionally, banks affected by the higher capital requirements may elect to reduce services or exit the industry altogether. Reduced competition heightens the risk that these services will be more costly and limit innovation.</p>



Basel III Proposal

Basel International Standards and Implementation

The international standards related to the U.S. Basel III Endgame Proposal were introduced by the Basel Committee on Banking Supervision (BCBS) in what is known as Basel IV. Basel IV⁵ is the latest iteration of the Basel Accords, which date to the 1980s. Basel IV focuses on how the value of risk-weighted assets (“RWA is calculated when calculating a financial institution’s capital ratio.⁶ The objective of Basel IV is to address shortcomings of prior iterations, such as the lack of transparency, lack of comparability between certain

methodologies (e.g., credit and market RWA), and the perceived lack of risk sensitivity of the standardized approaches. As a result, Basel IV broadly eliminates a financial institution’s ability to use internal models when calculating risk and asset values. Instead, it transitions the industry and regulators toward a standardized framework around the calculation of RWA for credit risk, counterparty risk, credit valuation adjustment (CVA), securitizations, market risk, and operational risk.

U. S. Proposal

Overview

The 1,089-page Proposal primarily consists of modifications to calculations surrounding the definition of capital, credit RWA, market RWA, and operational RWA. Importantly, capital requirements for banking organizations greater than \$100 billion will be largely homogenized across the four Regulation YY classifications (i.e., Category I, II, III, and IV). More specifically, some rules in the Proposal heighten the current standards applied to Category III (generally, \$250 billion to \$700 billion in total assets) and IV (generally, \$100 billion to \$250 billion

in total assets) banking organizations to match the standards of Category I and II banking organizations. This is a meaningful change for regional banks and will subject them to additional regulatory costs.⁷ The Proposal also institutes minimum capital requirements, while at the same time maintaining additional capital costs and charges imposed by previous regulatory requirements—such as stress testing and resolution planning—and other capital regulations, such as the stress capital buffer and global systemically important bank (GSIB) surcharge.

5. Basel IV is the international equivalent of the Proposal (i.e., US Basel III Endgame).
6. The capital ratio is the invested capital of an institution as a percentage of its RWA.
7. The Proposal would not affect smaller, less complex banks with assets below \$100 billion.

Deductions and Adjustments to Capital

One particularly important change would require the recognition of accumulated other comprehensive income (“AOCI”) in regulatory capital—most notably, unrealized gains and losses on available-for-sale (AFS) securities. The proposed changes also would affect the criteria for

including minority interest in capital and apply more stringent requirements around capital deductions (i.e., investments in the capital of unconsolidated financial institutions, mortgage servicing assets, and certain deferred tax assets).

Market Risk⁸

The proposed changes follow the fundamental review of the trading book (FRTB) standards that have been widely discussed and distributed throughout the industry after the Great Financial Crisis. The introduction of the FRTB methodology would effectively result in double counting of risks through both the numerator and denominator of the capital calculation. Specifically, the trading and counterparty losses flow through the Stress Capital Buffer (i.e., global market shock) requirement of the numerator while also affecting the RWA calculation representing the denominator.

At a high level, the changes would include replacing the current value-at-risk–based measure with an expected shortfall (ES)–based measure. This includes replacing the fixed 10-business-day liquidity horizon with liquidity horizons reflective of the underlying risk factors to capture risk of less liquid positions, and introducing a standardized methodology for calculating market risk and improving transparency via enhanced disclosures.

The Proposal creates a standardized method by which calculations would be made. It would consist of three main

components: (1) a sensitivities-based method that captures non-default market risk associated with certain risk factors, (2) a standardized default risk requirement that would capture losses on credit and equity positions in the event of issuer default, and (3) a residual risk capital requirement. This standardized approach would include three additional components that would apply in limited instances to specific positions: a fallback capital requirement, capital add-on for redesignations, and any additional requirements established by the primary supervisor.

Regulated institutions would be able to use internal models instead of the standardized method in certain instances, allowing the institutions to, among other things, enhance market risk sensitivity. But the ability to use internal models would be limited by the concept of a trading desk. Specifically, institutions would be required to validate internal models from each individual trading desk before using them as part of the regulatory calculations. If a desk fails to obtain the required validations, the standardized approach must be used. Due to the unique characteristics of an individual institution’s trading activities (i.e., asset classes/products traded,

8. For further discussion on the Proposal’s effect on market RWA, please see Section 4.4.

correlations, diversification benefits), it is difficult to quantify the model-based market RWA effect across the industry in broad terms. But the proposed model-based approach, which may offer relief through decreased RWA, subjects banks to an onerous supervisory approval process. Paired with implementation challenges, it is likely that some banks will instead elect to apply the standardized approach.

Regardless of whether regulators have

Credit Risk⁹

The Proposal would eliminate the use of internal credit risk models and introduce a new expanded risk-based (ERB) approach for calculating credit RWA. The proposed changes would also eliminate the ability of some institutions (e.g., intermediate holding companies below \$100 billion but trading assets exceeding \$5 billion, or Category IV institutions generally) to elect the current exposure methodology (CEM) for counterparty credit risk. The ERB approach would retain many of the current concepts, such as the application of risk-based treatment surrounding some forms of real estate (i.e., pre-sold construction loans, multifamily mortgages, and high-volatility commercial real estate). Compared with the current framework, the proposed changes would introduce a more risk-sensitive approach to the calculation, providing for greater segmentation of credit risk across exposure categories and allowing for the application of a broader range of risk weights. For example, the Proposal would apply loan-to-value (LTV) ratios when assigning a risk weight to a regulatory residential or commercial real estate exposure where higher LTV ratios would

approved internal model use at the trading-desk level, all institutions would be required to calculate market risk capital requirements under the standardized method. It is also important to note that the Proposal limits the RWA-reducing benefits of the model-based approach if this approach results in a materially lower RWA calculation than that of the standardized method. Specifically, the model-based RWA calculation cannot fall below 72.5% of the standardized RWA calculation.

generally increase the risk weight. The Proposal also increases RWA on certain off-balance sheet exposures by introducing a new exposure methodology that would modify the credit conversion factors applicable to commitments and redefine the criteria for defaulted exposures.

The Proposal also makes changes to the credit RWA for equity exposures (i.e., non-trading asset/liabilities), securitizations, and credit risk mitigation. For equity exposures, the Proposal would increase risk weights when applying the simple risk-weight approach. The proposed changes would also eliminate effective and ineffective hedge pair treatment, modify the conversion factor for conditional commitments, increase risk weights applicable to equity exposures to investment firms, and adjust the sensitivity of the look-through approaches for equity exposures to investment funds. The changes also include adjustments to securitization values to reflect delinquencies, level of subordination in the allocation of losses, and heightened correlation and

9. For further discussion on the Proposal's effect on credit RWA, see Section 4.5.

additional risks inherent in securitizations relative to direct credit exposures.

Changes to the application of credit risk mitigants include replacing certain methodologies (i.e., internal model methodology, simple value-at-risk, probability-of-default) with standardized approaches. The Proposal would also revise the collateral haircut approach by raising netting and diversification benefits within netting sets while also adjusting

Credit Valuation Adjustment (CVA)

The Proposal would modify the CVA capital requirements by subjecting all Category I through IV institutions to the requirement; the existing rules apply only to Category I and II institutions. Additionally, the Proposal replaces the current allowable approaches with alternative, standardized approaches. These changes are likely to affect to varying degrees all Category I through IV institutions.

The affected institutions would need to develop models that accurately calculate CVA RWA consistent with the requirements in the Proposal. The cost of developing these models would likely be significant and include developing/reconfiguring operating systems, creating and implementing models, hiring additional personnel (e.g., front line, compliance, risk, audit), expanding the scope of model risk management, and so on.

The increased costs of higher capital requirements are likely to produce unintended consequences. Banks may choose to continue offering derivative products but pass the costs to their

the market price volatility haircuts (e.g., main index/gold increased from 15% to 20%) and introducing haircut floors, or minimums. Lastly, in connection with the removal of the internal model methodology, the Proposal would revise the definition of a netting set. Specifically, the modified definition would exclude cross-product netting sets and remove the ability to recognize cross-product netting when calculating counterparty credit RWA.

counterparties, particularly commercial end users (e.g., airlines, oil producers, agricultural producers, grocery stores) that use derivatives to hedge business risks. This disincentivizes commercial end users from hedging business risk, resulting in less price stability in the overall economy and higher prices for consumers.

The increased costs could also create situations where it is more efficient and practical to no longer offer certain products. Institutions electing this option could experience customer flight to institutions that provide solutions for all banking needs across various products. This scenario could create a market environment where the banking industry gets smaller and more concentrated—increasing systemic risk and potentially decreasing market competition.

Operational Risks¹⁰

According to some estimates, the change in operational RWA requirements would represent the most significant increase in capital requirements. For example, based on the analysis released by the agencies, the new operational risk charge accounts for nearly 90% of the increase in banks' capital requirements under the Proposal.¹¹ The Proposal would require all banks subject to Category I–IV capital standards to calculate operational RWA; only Category I and II institutions must do so under the current regime. Additionally, the Proposal would replace internal models with a new standardized approach, which would be a function of the institution's business indicator component (BIC) and internal loss multiplier (ILM). The BIC would be calculated based on multiple factors, including business volume, lending and investment, fee- and commission-based activities, trading, and other activities associated with the institution's assets and liabilities. The ILM would be based on a ratio of historical operational losses to its business indicator component (subject to a floor of 1). As a result, an institution's operational risk capital requirement would increase as historical operational losses increase.

Banks with highly specialized fee-based businesses (e.g., wealth management) would likely be affected disproportionately from the Proposal, specifically driven by the services component of the BIC. Industry and regulators alike have openly discussed this effect, and both have identified weaknesses and aspects of the calculation that do not make sense. For example, the Bank for International Settlements acknowledged industry concerns in consultative documents issued in 2014¹² and 2016.¹³ These documents identified the potential issues related to the structure of the BIC, specifically noting that the methodology may disproportionately affect banks engaged predominantly in fee-based activities—by causing them to overcapitalize. The 2016 document also proposed a cap on fee-based income as a solution; the Proposal omitted this solution without any public explanation. As a result, the Proposal includes requirements that the international Basel Committee authors have publicly stated do not work and/or may be inappropriate.

10. For further discussion of the effect of the change in operational RWA on IPOs, see Section 4.6.

11. About Excessive Calibration of Capital Requirements for Operational Risk.

12. Operational Risk: Revisions to the Simpler Approaches.

13. Standardised Measurement Approach for Operational Risk.

Differences between U.S. Proposal and Basel Framework

Overview

The BCBS sets standards for the prudential regulation and supervision of banks. Although the goal is to align regulatory banking standards across international jurisdictions, the BCBS standards constitute minimum requirements that are expected to be implemented consistently;

however, a variety of considerations across jurisdictions and implementation approaches ensure that there may be differences. That is the case here, as there are any number of important differences between the Proposal and the international standards (Basel Framework).

Market Risk

Standardized Measure

Differences between the Proposal and the Basel Framework regarding the standardized measure for market risk are generally limited. The Basel Framework contains some relief for covered institutions by requiring only a monthly calculation, compared with a weekly calculation under the Proposal, while also providing institutions with a simplified standardized approach—something the Proposal does not include.

The standardized measure for market risk consists of three core and three add-on components. Under both frameworks, a credit risk spread and default risk measure aim to capture the credit quality of the covered positions. These measures in the Basel Framework are tied to ratings assigned by credit agencies. The Dodd-Frank Act, however, prohibits the use of ratings from credit agencies and would instead tie the credit quality of the covered positions to the existing

definition for Investment Grade and propose new definitions for Speculative Grade and Sub-Speculative Grade.

The Proposal also applies a less granular approach to the risk weight of certain commodities (i.e., electricity and gaseous combustibles). Where the Basel Framework looks at these two commodities individually and applies different risk weights, the Proposal applies the same risk weight to reflect the correlation between the price of the two commodities.

One other difference involves the add-on for redesignating an instrument from being a credit risk exposure to a market risk covered position. The Proposal takes the approach of disincentivizing this behavior by requiring an add-on in such occurrences, whereas the Basel Framework does not require an add-on but would require supervisory approval prior to any redesignation.

Internal Models Approach (IMA)

The IMA has several key differences between the U.S. and the international standards, with the Proposal appearing to provide less stringent requirements. The Proposal allows an institution to make its own determination on using models, while the Basel Standards allow this approach only if an arbitrary threshold is met (i.e., 10% of market risk capital requirements based on positions that qualify for internal models).

As previously noted, the fundamental change to the IMA is the requirement for models to be approved at the trading-desk level. Proposal gives institutions the choice of whether to use the standardized approach or the IMA depending on which results in a lower capital requirement. Further, the U.S. approach does not require regulatory preapproval of trading-desk models if the institution chooses the IMA. Conversely, the Basel Framework requires institutions to get approval to treat a trading desk as model-eligible or model-ineligible, and the ineligibility status cannot cite a lower market risk capital requirement for the reason.

The Proposal offers more flexibility in the ES measure. Specifically, if an institution has sufficient data for all

Credit Risk: ERB

Internal Models

The common theme of standardization in the Proposal extends to all risk types, including credit risk. The Proposal eliminates the option for firms to use models such as the internal ratings–

required risk factors, the Proposal allows the use of the direct approach. The Basel Framework does not provide this option and exclusively requires institutions to apply the indirect approach, which would include three separate calculations rather than the one calculation required in the direct approach. The stressed ES measure also slightly differs: the Proposal is less granular by segmenting positions by risk factor. This is broader than the Basel Framework’s approach, which is based on the “bucket level.”

Overall Market Risk Measure

Another example of the Proposal providing relief relative to the Basel Framework is the application of the Standard Approach as a ceiling for the capital requirement for the core components. The purpose is to prevent overcounting of capital requirements due to the lack of credit risk mitigation benefits for hedging activities performed across model-eligible and model-ineligible desks. For example, if the IMA yields a greater capital requirement on the core components compared with the Standard Approach, the institution is allowed to use the lesser of the two. It is important to note, however, that the market RWA calculated through the model-based approach is not allowed to be lower than 72.5% of the standardized calculation.

based approach for general credit risk and the Internal Model Method for counterparty credit risk. This elimination is aimed at standardizing the calculation for comparability and transparency across U.S. institutions.

Sovereign and Supranational Exposures

The Dodd-Frank Act prohibits the use of external ratings, so the Proposal ties risk weights to the country risk weights prescribed by the Organisation for Economic Co-operation and Development (OECD). The Basel Framework, by default, provides for the use of external credit ratings for risk weights on sovereign exposures but also leaves room to use OECD classifications.

The Proposal also distinguishes between conditional and unconditional sovereign exposures. For example, an unconditional guaranteed exposure (e.g., U.S. Treasury) would garner a 0% risk weight and a conditional guaranteed exposure (e.g., Government-Sponsored Enterprises exposure) would garner a 20% risk weight. Although the Proposal differentiates between the two, the Basel Framework follows the external credit ratings, or OECD approach, without consideration of an explicit or implicit type of guarantee.

Real Estate Exposures

The Proposal identifies specific real estate exposure subtypes, including statutory multifamily mortgages, presold construction loans, and high-volatility commercial real estate; the Basel Framework does not. Additionally, for acquisition, development, and construction exposures the Proposal applies a 100% risk weight; the Basel Framework applies a default 150% risk weight, which may be reduced to 100% if certain conditions are met.

Both the Proposal and the Basel Framework

introduce the concept of tying residential and commercial real estate (CRE) risk weights to the LTV and the dependency on cash flows from the underlying real estate. But the Proposal applies a higher risk weight for all residential real estate exposures. For example, residential real estate not dependent on cash flows ranges from 40% to 90% across the LTV buckets, compared with a range of 20% to 70% under the Basel Framework.

Retail Exposures

Generally, the rules define retail exposure as any exposure to a natural person or an exposure to an SME, such as a credit card, auto loan, or student loan. The Proposal risk weights are 10 percentage points higher than those of the Basel Framework.

Corporate Exposures

The Proposal generally aligns with the Basel Framework; however, the Proposal does not provide the same carve-outs as does the Basel Framework for certain exposures that would reduce the risk weight. Specifically, the Basel Framework includes a separate subtype for certain SMEs and preferential risk weight to project finance exposures in the operational phase that are deemed high quality.

Defaulted Exposures

Both the Proposal and the Basel Framework place a risk weight of 150% on defaulted exposures. The main difference is that the Basel Framework also provides the ability to reduce the risk weight to 100% if certain conditions/provisions are satisfied; the Proposal does not.

Securitizations

The Proposal would replace the existing simplified supervisory formula approach for calculating risk weights applicable to a securitization exposure with the similar, but new, securitization standardized approach. Conversely, the Basel Framework includes the securitization standardized approach and alternatives, such as an internal ratings-based approach and an

external ratings-based approach. Under the Basel Framework, these alternative approaches offer institutions the ability to apply preferential risk weights to traditional securitizations (i.e., simple, transparent, and comparable exposures) and cap the capital requirements at the amount of capital the institution would have been required to hold against the underlying exposures if it had not securitized them.

Operational Risk

The Proposal is generally consistent with the Basel Framework's operational RWA calculation; there is, however, one notable difference: the Proposal floors the ILM at 1.0, while the Basel Framework does not prescribe a minimum—which would allow banking organizations with losses that are small relative to business volume to hold less capital by allowing this multiplier to go below 1.0. This incentivizes firms to implement strong operational risk management programs, whereas the Proposal would not recognize any incremental benefits to a banking organization for reducing its operational risk relative to its BIC. This key difference represents one of the significant factors that disproportionately

affects banks covered under the Proposal relative to banks in other jurisdictions.

Lastly, as noted earlier, the methodology for operational RWA introduced in the Proposal contradicts the international Basel Committee's own conclusions, which acknowledge the BIC component was designed to capture the operational risk profile of a universal bank and has notable flaws. For example, this approach disproportionately affects banks predominantly engaged in fee-based activities, resulting in overcapitalization of banks with high fee revenues/expenses and capital requirements that are too conservative relative to the operational risk these banks face.

Other U.S. Rules and Proposals

Overview

In today's complex financial landscape, regulations play a crucial role in maintaining stability, protecting consumers, providing transparency across

markets, and preventing systemic risks. But it would be a mistake to view banking regulations, such as Basel III Endgame, in isolation. It is essential to assess the

regulatory environment holistically across the entire financial industry, considering the relationship of new (and proposed) regulations issued across different regulatory bodies. The Agencies failed to recognize this interconnectedness and the Proposal's consequences for the broader financial ecosystem given the current regulatory environment. For example, the Proposal sets the foundation for minimum capital requirements but does not consider other existing regulations (e.g., resolution planning, stress testing) that already add to banks' overall capital requirements.

What is more, it is not enough to look at regulations singularly; this would fail to capture the intricate web of relationships and dependencies that exist within the financial regulatory system. The actions and decisions of one regulatory body can have far-reaching consequences that reverberate throughout the industry. Therefore, it is crucial to understand the interconnectedness of regulations and their collective effect on the stability, efficiency, and competitiveness of the financial sector overall.

The following sections aim to highlight changes, including recently issued or proposed regulations from U.S. supervisory authorities (e.g., SEC, Commodity Futures Trading Commission [CFTC]), that could result in unintended consequences when combined with Basel III Endgame.

Global Systemically Important Bank (GSIB) Surcharge

On August 14, 2015, the FRB adopted a final rule that established risk-based capital surcharges for the largest, most

interconnected U.S.-based bank holding companies. This GSIB surcharge is an added capital buffer that U.S. GSIBs are required to hold, over and above their minimum risk-based capital requirements and other capital buffers. Under the BCBS methodology (i.e., Method 1), banks are identified as GSIBs based on their "systemic indicator" scores across five categories (i.e., size, interconnectedness, substitutability, complexity, and cross-jurisdictional activity). The score of each indicator is quantified by dividing each bank's indicator score by the aggregate amount of that indicator across all banks in the sample. Each indicator score is then given an equal weight, which is then aggregated to arrive at the overall score. Banks (both foreign and U.S.) with a score of 130 or greater would be identified as a GSIB, with the surcharge equal to 1% and increased in 0.5% increments for each 100-point increase in the score.

The FRB developed its own methodology (i.e., Method 2) to determine the GSIB surcharge. U.S.-based banks are required to calculate their score under both methods, and the surcharge is based on the higher of the two results. Based on 2022 scores published by the Office of Financial Research,¹⁴ all U.S. GSIBs have Method 2 surcharges greater than their Method 1 surcharge and are therefore bound by Method 2, which departs in several important ways from Method 1.

On September 1, 2023, the FRB issued an NPRM to make certain technical changes to the GSIB surcharge. The most significant modification would include changes to the measurement of some systemic indicators, including revising the

14. Bank Systemic Risk Monitor.

systemic indicators for cross-jurisdictional claims and cross-jurisdictional liabilities to include derivative exposures. The most significantly affected group would be foreign banks, resulting in seven Foreign Banking Organizations (FBOs) and two intermediate holding companies of Foreign Banking Organizations moving to Category II from Category III or IV.

The proposed changes would result in an increased capture of certain client-cleared derivative transactions within the interconnectedness and complexity indicators. More reportable transactions may lead to higher surcharges for GSIBs. Given the significant role of GSIBs in clearing activities, the higher surcharges could lead to increased costs or decreased availability for commercial end users. For example, according to data published by the CFTC, the number of firms that provide clearing for exchange-traded futures and options has fallen by 50% during the past 20 years. Most firms that currently offer clearing solutions for commodity products are banks. The combination of the GSIB proposal and Basel III Proposal has the potential to harm the market more broadly by further reducing the number of providers willing to offer clearing services to commercial end users. In the end, a further reduction in these instrumental market participants that provide clearing services is likely to limit available options for commercial end users and, in turn, results in higher costs for end users. Paired with the Proposal, this change is another example of regulatory authorities piling on unnecessary regulations that will increase costs and likely create unintended consequences for markets and the economy more broadly.

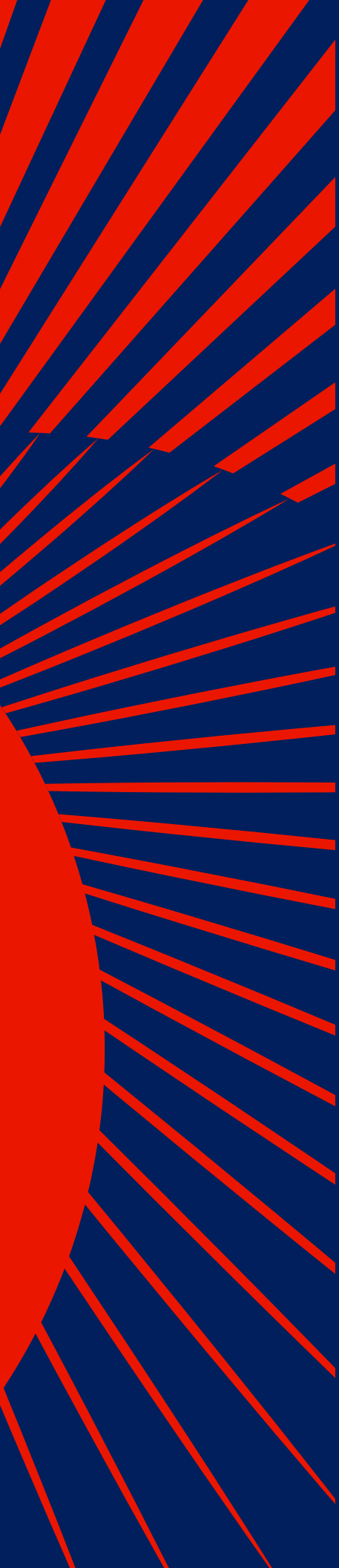
Long-Term Debt Proposal

On August 29, 2023, the Agencies published a proposal that would require large banking organizations (banking organizations with total assets above \$100 billion) to issue minimum levels of long-term unsecured debt (LTD). The Agencies argued that this requirement would increase capital buffers and optionality for resolution making the banking system more resilient and minimizing potential bank runs and failures.

The LTD requirement, if implemented, could place significant market, earnings, and operational burdens on regional banks. The essential application of Total Loss Absorbing Capital standards, previously required only for Category I GSIBs, toward Categories II, III, and IV banking organizations means many regional banks would be forced to access unsecured bank debt markets that they have not previously entered, at least not materially. This proposal also requires the debt issued by the bank to remain held by the consolidating parent, which creates issues with stress testing, because the liquidity (i.e., issuance proceeds) is trapped with the parent (or holding company).

The unsecured regional bank debt markets may lack the liquidity and depth needed to respond—something particularly problematic due to the \$400,000 minimum issuance criteria. These factors could impair the markets' ability to absorb a significant level of new entrants without materially raising the cost to regional banks in an environment where intermediate debt costs are already near their highest levels in 20 years.¹⁵

15. Proposed Capital Rules and Impact to Clearing.



Key Components and Effects

The LTD proposal does not seem to accurately consider market factors. For example, it indicates that the net interest margin effect would be “moderate” at just three basis points, which seems unreasonably low.

But the analysis does not fully consider the additional earnings effect related to the market spread widening from the estimated \$70 billion shortfall (or as high as \$250 billion) in what Category II, III, and IV entities would need to issue in order to comply.¹⁶ According to the LTD proposal, of that \$70 billion new LTD shortfall, \$50 billion would be needed at Category IV firms—meaning that affected firms would need to issue debt into a considerably less liquid market than that of debt markets at Category I and II banks. This effect is compounded by the fact that the debt

markets already view Category III and IV banks unfavorably. This added regulatory requirement will pile on the effect from the NPRM and offers limited value.

16. Excluding Category I firms, the market currently has only \$70 billion outstanding.

Overview

The Proposal includes the estimated monetary effect of the proposed changes, shown in Table 2.

Table 2. Estimated RWA Effect¹⁷

Risk category	Aggregate RWA (\$ billions) for Category I and II holding companies			Aggregate RWA (\$ billions) for Category III and IV holding companies	
	Current standardized	Current advanced	Proposal estimate	Current standardized	Proposal estimate
Credit risk	6,900	4,300	6,700	4,000	3,800
Market risk	430	430	760	130	220
Operational risk	0	1,700	1,400	0	550
CVA risk	0	240	260	0	28
Total	7,400	6,700	9,200	4,200	4,600

The Proposal recognizes that these estimates come with several caveats. First, the estimates heavily rely on organizations' Basel III Quantitative Impact Study submissions, conducted prior to the NPRM. For market risk, the estimates rely on assumptions about whether institutions will pursue the internal models versus the standardized approach and their success in obtaining approval for modeling. Second, for organizations that do not participate in Basel III monitoring exercises, the

estimates are primarily based on regulatory filings, which the Proposal recognizes as a limitation for precise estimates due to insufficient granularity in the filings. Third, the estimates are based on organizations' balance sheets as of year-end 2021 and do not account for changes in banking structure, organizational behavior, or market conditions since that point.

17. Sourced from the Proposal.

The Proposal was likely accelerated in response to the banking turmoil in March 2023, so it is unclear whether the Agencies would have used these estimates in normal circumstances. The limitations that the Agencies identified are substantial—not to mention the additional limitations left unacknowledged. The apparent failure to grapple more fully with the limitations in the estimates is even more concerning given how the proposed changes would dramatically affect the primary products and services banks offer.

Further, the Proposal admits that the estimates are based on data through December 31, 2021. The age of these data should have prompted the Agencies to reevaluate the Proposal, considering the dramatic changes to the market environment in the intervening period. For instance, the as-of date was before the FRB began its rate hiking cycle (in which the Fed Funds rate increased 550 bps)—before concerns of an impending recession and commercial real estate challenges, and before numerous other headwinds for the industry and economy at large. Ignoring these developments reflects poorly on the Agencies and should have been considered prior to issuing the Proposal.

The Proposal also fails to address several material limitations. One major assumption the Proposal makes is the effect of the changes from an expense standpoint, particularly overhead. The Proposal fails to acknowledge, particularly for Category III and IV organizations, the cost of not only upgrading systems but also implementing new ones. Nor does it account for or even recognize additional costs in personnel across all lines of defense, including operations.

The Proposal even seems to have failed to estimate adequately the effects on Category I and II institutions, even though the Agencies regularly receive from these institutions a substantial amount of information that could have been used to better estimate the effects of the Proposal. Instead, the Proposal failed to such a degree that JP Morgan CEO Jamie Dimon criticized it by noting that the Agencies “had 10 years to do this, and it’s shocking to me that we are sitting here after 10 years, and we are talking about what it’s going to do for small business.”¹⁸ The limitations and unsupported assumptions cannot be overstated, and the following sections attempt to quantify and qualify the effects in much more detail.

Costs of Capital

The binding constraint for a bank is its balance sheet. Banks are limited in their activities based on the composition of their balance sheets. Overall, banks are constrained based on two primary factors: internal risk appetite and regulatory requirements. The primary focus of the

remainder of this paper is to discuss how regulatory requirements, primarily related to capital, will affect how banks can support the needs of their business customers.

The capital regulations prescribe the amount of capital banks are required to

18. Annual Oversight of Wall Street Firms.

maintain as a cushion to protect against potential losses and ensure stability and solvency. In simple terms, capital is like a safety net that banks must maintain to cover unexpected losses or economic downturns. There are several reasons why capital is costly to banks. Holding capital creates opportunity cost because capital held to meet regulatory requirements could have been used or invested elsewhere to meet the needs of customers, grow the domestic economy, and support main street businesses. By holding additional capital, banks are tying up funds that could have been used for economically worthwhile purposes, thereby impairing economic growth.

Regulations on capital can incentivize or disincentivize certain behavior, which in turn can have dramatic consequences for an individual bank's activities. For instance, banks operate in a market-

driven and competitive environment. When regulatory authorities promulgate wholesale regulatory changes, banks reorient their operations to maximize return, in line with their fiduciary responsibility to shareholders, while operating within the new regulatory framework. This can lead to a change in the mix of products and services the bank offers, which can result in higher costs or lower service levels for the public.

Increased capital requirements also could require banks to go to the market and raise capital through issuance of stock or debt. These activities have an associated financing cost, such as underwriting fees, interest payments on debt, and dividends paid to shareholders. These increased expenses reduce operating profit and can lead to reduced bank lending capacity or restriction of other activities on which the economy relies.

Deductions and Adjustments to Capital

One of the most widely discussed topics over the past year, stemming from the banking issues in March 2023, is the unrealized losses that banks have accumulated within Available for Sale ("AFS") and held-to-maturity (HTM) portfolios. The current rules allow Category III and IV institutions to neutralize any gains or losses within the AFS portfolio through the "opt-out" election, where unrealized gains are subtracted and unrealized losses are added back to the Common Equity Tier 1 ("CET1") capital calculation. The Proposal removes this option, resulting in the capital calculation reflecting unrealized gains and losses.

The elimination of the "opt-out" election is likely to have unintended consequences and downstream effects to market participants more broadly. For instance, the current macroeconomic environment is tenuous at this point, with volatility in most markets and uncertainty in the interest rate and overall economic outlook. This uncertainty, paired with the Proposal's removal of the option to neutralize unrealized gains and losses, may make banks even more cautious about duration risk. This could create a negative feedback loop where longer-term treasuries become less desirable, decreasing demand (in an increasing

supply environment due to U.S. deficit spending) and ultimately resulting in higher rates on the long end and more volatility. Heightened volatility in bond yields creates increased volatility in other market sectors and higher long-end rates would result in higher costs for borrowers across all industries, including the U.S. government.

Additionally, this change may prompt banks to classify more securities as HTM to avoid the effect that unrealized gains and losses would have on capital. Unlike AFS, HTM securities are much less liquid because accounting rules limit the ability to liquidate these assets (or change the classification). An unintended consequence of eliminating the “opt-out” election is reduced market liquidity, which is counterproductive to capital markets.

Market Risk

The Proposal highlights the estimated effect on market risk capital requirements for Category I to II and Category III to IV institutions at \$330 billion and \$90 billion, respectively. However, the Agencies arrived at these estimates from a transaction perspective, estimating the increased capital requirements based on data sourced from FR Y-9C forms. Thus, the Agencies’ estimation makes a significant assumption that all affected institutions already have a framework and resources in place that will make the transition for complying with the new requirements relatively benign. In his statement following the release of the Proposal, FRB Governor Christopher Waller highlighted the lack of support for the estimated 70% increase in large banks’ market risk capital requirements that could result from the Proposal. Mr. Waller

also noted his worry that the Proposal could discourage banks from engaging in certain market making activities, which could impede market functioning.¹⁹

The Agencies failed to acknowledge or capture the effect of the overhead costs to banks (e.g., personnel, systems, technology solutions). The Proposal is likely to result in significant overhead costs for banks to comply with the market risk capital requirements. It is difficult to estimate these costs that the Agencies failed to acknowledge broadly for the industry because each institution would be faced with unique challenges based on its individual characteristics. That said, the following sections attempt to point out key areas where challenges are likely.

19. Statement by Governor Christopher J. Waller.

Market Risk Models

Applicability

The Proposal would extend coverage of market risk capital requirements, regardless of trading activity, and establish a new trading activity threshold.²⁰ As a result, banks that have never met the current rules trading thresholds and primarily use trading positions to hedge risks associated with lending would suddenly be subject to an entirely new set of regulations.

The market risk capital requirements are expansive and complex. Requiring non-complex institutions that primarily serve small businesses and provide much-needed lending products to the economy would likely have significant adverse consequences, including imposing material compliance costs on these institutions. They would need to develop, implement, and validate technology solutions (e.g., market risk models) based on the Proposal's standardized approach. They would need to build out model risk management functions for validation and ongoing monitoring requirements for market risk models. In aggregate, these efforts would dramatically increase costs—both for the initial fixed costs for the technology and system solutions and for ongoing variable costs associated with maintaining the systems and expanding full-time personnel.

Models

The proposed changes to the market risk capital requirements may be some

of the most complex components of the Proposal. The effect of the changes will be institution specific, which makes it challenging to quantify. But some of the changes will affect several institutions in similar ways. For example, as discussed earlier, institutions are exempt from specific requirements if their trading assets are below a certain threshold.²¹ The elimination of this threshold would result in a significant increase in regulatory burden for institutions that are currently below the threshold but would now have to come into compliance. This would include increased costs for, among other things, overhead, infrastructure, and risk management. But the effect is not limited to just these smaller institutions: larger institutions that currently are subject to the regulations too would be affected materially in many of the same ways. The Agencies appear to have failed to consider this in their estimate surrounding the market risk capital requirements.

A substantial portion of this increased cost would be for the development of data infrastructure. Developing and maintaining robust data infrastructure are crucial, as institutions need to collect, store, and process vast amounts of data to develop and implement accurate models. Internal models often require sophisticated technology and software tools for data analysis, modeling, and simulation. These tools are expensive to acquire and maintain, particularly if they need to be customized or integrated with existing systems. Efforts include investing in

20. The Proposal does provide supervisory authorities with discretion of excluding an institution that would otherwise be required to comply and including an institution that would otherwise not be required to comply, based on the Proposal criteria. But regulators already have that discretion under the current rules.

21. \$1 billion of trading assets plus trading liabilities or 10% of the firms' total consolidated assets.

data storage, data management systems, cybersecurity, and data integration capabilities, all of which can be costly.

In addition to the systems themselves, institutions would need to bring on personnel to ensure they have the necessary expertise and skill sets to meet the new regulatory requirements. Building and managing internal models require a team of highly skilled professionals, including data scientists, statisticians, risk analysts, and software developers. More skilled personnel would be needed in the second and third lines of defense (quality control and internal audit) for validation and ongoing monitoring requirements. Hiring and retaining such talent can be expensive, and this expense is likely to be compounded by the brief time given to comply.

Affiliates

One aspect of the Proposal that has received insufficient attention is the effect on institutions with affiliates that engage in significant trading activity (already subject to Subpart F)²²—specifically, the apparent failure of the Agencies to coordinate the CFTC prior to promulgating the Proposal.

In October 2021, the CFTC issued a final rule that subjected registered swap dealers (SDs) to capital requirements. The rules allow SDs to elect between two different methods; one is the bank-based approach that is tied directly to the current bank capital rules.²³ As a result, to take advantage of continuity across legal entities, SD subsidiaries of bank holding companies generally elect the bank-

based approach. These SDs are required to comply with all aspects of the bank capital rules, which include the market risk capital requirements that require approval from the National Futures Association.

These SDs have spent the past two years implementing processes, developing models, and obtaining regulatory approval at the legal-entity level to comply with the CFTC requirements. The Proposal would essentially reverse many of the changes implemented over the past two years because the revised methodology (particularly for market risk) in the Proposal deviates from the CFTC's current requirements. This is important because these SDs are consolidated into the institutions covered under the Proposal. As a result, the changes in the Proposal could affect not only individual institutions but the U.S. (and global) capital markets more broadly. For instance, this could make certain affiliate businesses unviable and force them to shut down. This could lead to various unintended consequences—including concentration of a few organizations, which increases systemic risk. This could also lead to reduced liquidity in markets that materializes in increased volatility, creating an exogenous shock. This consequence reflects additional costs and is another effect that the Agencies do not appear to have considered or acknowledged in the Proposal.

22. Specifically, institutions with SD/security-based SD subsidiaries that are subject to CFTC capital requirements; 17 C.F.R. Part 23.
23. 12 C.F.R. Part 217.

Effect on Businesses

As discussed in the preceding paragraphs, the Proposal significantly modifies the requirements for the calculation of market RWA. The changes to the market RWA calculation could increase capital requirements for banks, leading to unintended consequences for

businesses and the broader economy. The following sections aim to give examples of the detrimental effect of the Proposal; however, the examples reflect only a small subset of businesses and industries that would likely be affected.

Debt Issuance

The potential for increased capital requirements through market RWA could also affect funding costs for public companies. Issuing debt is a way companies can raise funds for operations, including expansion and/or research and development that can provide innovative solutions and grow the broader economy. The effect of increased capital requirements for banks, due to the changes to the market RWA calculation, could impair market functionality through less liquidity and wider bid-ask spreads—and ultimately increase interest costs for companies, which could negatively affect profit margins for the issuing companies.

Assume Company A operates a discount retail store that offers services/products

in underserved locations. Company A issues a short-dated commercial paper to fund its business operations. Bank A has large holdings of commercial paper in its investment portfolio. The changes to the market RWA calculation result in higher capital requirements related to these assets for Bank A. As a result, Bank A determines it is more capital efficient to use these funds for other purposes. The result for Company A (and this market collectively) is less demand and is likely to require Company A to increase the yield it offers. The increased costs for Company A reduce its profit margin and could affect its ability to expand into additional localities and provide much-needed services/products for underserved populations.

Agricultural Industry

Derivative markets are critical for hedging price risks in the agricultural supply chain. Agricultural producers (e.g., farmers and ranchers) use derivatives to ensure they can cover their costs of production, while companies that process agricultural products into food and other products use derivatives to protect their profit margins from a steep increase in input costs. The business of offering derivatives

for hedging is already an expensive business, and the changes to the market risk capital requirements could make this business even more expensive.

Take for example Food Producer A, who processes grain into food products and sells to grocery chains. Food Producer A uses derivatives to manage market volatility, such as weather or geopolitical

risk. To compensate for the increased capital requirements related to market RWA, Bank A increases its costs associated with its derivative products. Food Producer A determines that it is no longer beneficial or cost effective to use derivatives, assuming the risk and reflecting an unhedged position. Unexpectedly, Russia invades Ukraine, and the cost of grain increases significantly. Being unhedged,

Food Producer A now must pay much more for the grain that is needed to produce the final product. Food Producer A's costs go up, resulting in higher prices for the grocery chain customer, who then also passes these costs to its customers. The result is increased costs throughout the supply chain, ultimately affecting the individual consumer and impairing future economic growth.

Real Estate Investment Trusts (REITs)

REITs are companies that own and operate, or finance, income-generating real estate. REITs cover a wide range of industries including but not limited to office and apartment buildings, warehouses, shopping centers, hotels, and health care facilities (e.g., nursing homes and hospitals). REITs, like most businesses, use debt

to fund their operations and can employ derivatives to hedge risks, such as interest rate derivatives. The ability to hedge interest rate volatility allows the business to better forecast and project costs and expenses—in turn providing a more stable pricing environment for its customers.

Credit Risk

Changes to how credit RWA is calculated will also have broad implications throughout the banking industry.²⁴

Primary Residence

Assume Bank A is underwriting a \$500,000 mortgage loan for the purchase of a primary residence with an LTV of 95%. Under the Proposal, Bank A would be required to apply a risk weight of 70%, resulting in credit RWA totaling \$350,000. Under the current rules, this loan would garner a 50% risk weight, or \$250,000, representing a difference of \$100,000 or an increase in credit RWA of 40%.

This change would affect individual consumers the most—particularly consumers who cannot afford a large down payment. The costs resulting from the increased capital requirements for primary residence mortgage loans likely would result in additional borrowing costs and/or higher interest rates for borrowers. Further, the higher costs could reduce the number of individuals who qualify for mortgage

24. The examples discussed in the following sections solely highlight the potential effect to credit RWA. Additionally, all those examples would also affect the operational RWA calculation because these activities would generate some level of fee income that would be considered in the operational RWA calculation.

loans, resulting in decreased overall demand. This scenario could affect home builders and subcontractors (e.g., plumbers,

electricians, other trades) through reduced revenue, impairing small businesses and reducing overall economic growth.

Rental/Investment Properties

Assume Bank A is underwriting a \$500,000 owner-occupied residential real estate loan (i.e., non-multifamily) where the primary source of repayment is the cash flows received from rents. If the loan has an 85% LTV, then Bank A would be required to apply a risk weight of 80%, resulting in credit RWA totaling \$400,000. Under the current rules, this loan would garner a 50% risk weight, or \$250,000 credit RWA, representing an increase in credit RWA of 60% based on the Proposal.

The increased capital requirements would likely result in banks passing the

additional costs to borrowers via higher interest rates for individuals or businesses that rent one to four residential real estate properties, such as short-term (e.g., AirBnB) and long-term rentals. The increased interest rates would lower the profitability of these properties, requiring the owners (or landlords) to raise rental prices to compensate. The effect of higher rental prices would be borne by the individual tenant, decreasing excess discretionary income and ultimately creating a drag on economic growth. This scenario would also increase the unaffordability in housing more broadly.

Commercial Real Estate (CRE)

Assume Bank A is underwriting a \$100 million CRE property (i.e., office building) for which the primary source of repayment is the cash flows received from tenants' rents and leases. If the loan has an 85% LTV, then Bank A would be required to risk weight the exposure at 110%, since under the Proposal any CRE loan above 80% LTV receives 110% risk weight. As a result, the loan would have a credit RWA of \$110 million. Under the current rules, this loan would garner a 100% risk weight, or \$100 million credit RWA, representing an increase of 10% based on the Proposal.

This example highlights that banks are incentivized to underwrite at an LTV of 80% or below; if unable (e.g., due to competition), then there is no difference in risk weight for an LTV of 81% to 99%.

Ironically, this scenario could lead to more risk taking, because, in theory, banks could compete for business by requiring smaller and smaller down payments without a corresponding increase in credit RWA.

As a result of the increased capital requirements, the cost of the transaction, including the interest rate, would likely increase to compensate the bank for greater capital requirements. The holders of the underlying property would likely pass their added costs onto the business tenants renting the space. As these added costs flow through the chain, businesses affected could look to compensate for decreased profitability through various means (e.g., fewer employees, reduced expenditures on research and development). The higher rent rates could

cause existing tenants to reduce the space leased or exit leases altogether, which could reduce options such as restaurants or retail shopping for consumers and be a

Lines of Credit to Finance Inventory (Warehouse Lines of Credit)

A foundational product for most financial institutions is lines of credit or credit commitments. These credit products are vital to the operation of small businesses, since they provide flexibility and access to funding on an as-needed basis. This is especially true for businesses that are highly seasonal, such as retail and agriculture. Warehouse lending is a type of credit line extended to non-depository mortgage companies, which, in turn, use it to facilitate providing credit to home buyers. Warehouse lines are typically revolving lines of credit or repo-style transactions.

Assume Bank A has underwritten an inventory line of credit (e.g., non-depository mortgage lender, auto dealer, or agricultural equipment dealer) totaling \$100 million, with the current amount drawn totaling \$50 million. The credit RWA calculation in the Proposal would treat the funded portion differently from the unfunded portion. Under the Proposal, the funded portion (i.e., \$50 million) would be subject to a 110% risk weight, totaling \$55 million RWA. The unfunded portion (i.e., \$50 million) would likely be subject to a 50% risk weight, totaling \$25 million RWA. This differs from the current rules, under which the funded portion would be subject to a 100% risk weight (i.e., “Corporate”) and the unfunded portion would be subject to a 20% risk weight (assuming 1-year maturity). So, under the Proposal, the credit

drag on economic growth. In turn, these factors could further decrease property values that are already under stress given current economic conditions.

RWA for this transaction would be \$80 million, as opposed to \$60 million under the current rules, or a 33% increase.

The increase in the risk weight (i.e., from 20% to 50%) on the unfunded portion is likely to cause banks to reduce commitment amounts to their borrowers, removing a key source of capital and liquidity from the largest consumer lending market in the country. But non-depository mortgage lenders are not the only ones that might be adversely affected by the Proposal. There are broad implications for all businesses and consumers that take out lines of credit.

The increased capital requirements for these credit facilities are likely to raise interest rates and other credit costs for the borrower. This could reduce profitability for businesses—including being the difference between staying operational and going out of business. These increased costs could also curtail the establishment of new small businesses. Individual consumers who take out lines of credit could also see their borrowing costs increase with the corresponding erosion of their personal financial situations. These broad implications, in aggregate, would ultimately harm the overall economy and lead to slower economic growth.

Cancelable Commitments

The Proposal introduces a 10% risk weight for commitments, such as lines of credit noted in the prior paragraph, even if the bank can unconditionally cancel the commitment. This is a change from the prior rules, in which these types of transactions carried a 0% risk weight. As a result, banks will likely limit credit availability because each extra dollar committed but not used will carry a cost. This scenario increases the bank's costs, which are likely to be passed on to borrowers in the form of higher interest rates or decreased commitments.

Assume John, who maintains a credit score of 700, has a credit card with Bank A with a credit limit of \$10,000 that has been open for five years. John's utilization rate averages 30%, with maximum utilization over the past two years of 50%; however, four years ago, unplanned car repairs forced John's utilization rate to jump to 95%.

Auto Loan Retail Exposure

The introduction of the retail exposure classification has implications for banks that currently apply the advanced approaches method for calculating credit RWA. Institutions that currently use the internal model approach will likely face increased capital requirements on retail exposures, such as auto loans.

The Proposal would likely continue the migration of consumer auto loan products from banks to other lenders (e.g., credit unions and finance company subsidiaries of auto manufacturers) due to the banks' competitive disadvantage

If the proposed changes are enacted, banks would likely compensate for the increased capital requirements by reducing credit line availability. This is a plausible assumption because banks would now be penalized for the unutilized portion of the line (10% risk weight compared with 0% currently), regardless of whether they can unconditionally cancel the commitment. As a result, they would look for ways to keep utilization rates higher than before, and one way to do that is to lower the amount made available. Thus, the Proposal and the rational response from banks could lead to higher credit card utilization ratios, which can produce lower credit scores for consumers and contribute to higher interest rates or costs for them.²⁵ This example points to another instance where the Proposal is likely to negatively affect average Americans, particularly low- and moderate-income individuals.

from higher costs. This would lead to decreased competition and potentially higher prices for consumers. This change also may lead to adverse effects on auto dealers and generally disrupt the auto and auto finance markets, which, like other consumer markets, currently are under incredible stress.

Assume Bank A has an auto lending business with a total exposure of \$100 million, composed of retail exposures/loans to consumers. The Proposal would assign an 85% risk weight, totaling \$85 million, to these loans. The Bank Policy

25. <https://www.banking.senate.gov/hearings/11/29/2023/annual-oversight-of-wall-street-firms>

Institute estimated the implied current risk weight to retail exposures (e.g., auto, personal) at an average risk weight of approximately 50% from 2014 through 2022.²⁶ The Proposal's elimination of the internal model methodology in favor of a standardized approach could mean an increase in credit risk capital requirements of approximately 70%.²⁷

Additionally, many banks have relationships with businesses such as auto dealers to provide financing to an auto dealer's customers (e.g., individual consumer) as

Private vs. Public Borrowers

The Proposal introduces a range of risk weights on corporate borrowers; however, the risk weight determination disproportionately affects privately held companies. Specifically, companies that are investment grade²⁹ and have (or are controlled by a company that has) publicly traded securities would garner a 65% risk weight, while privately held companies would be risk weighted at 100%, all else being equal. Approximately 99% of all U.S. companies are privately held,³⁰ and the Proposal would penalize these companies relative to their publicly traded competitors.

Assume Bank A received a loan application from an investment-grade public company (Borrower A) and a privately held small business (Borrower B). For identical \$5 million principal amounts amortized at 10 years, Bank A would likely price the loan

well as the auto dealer itself for inventory purposes. The Proposal would negatively affect not only banks from the individual consumer perspective but also the auto dealer (through the changes to lines of credit).²⁸ As with all other aspects of the Proposal, this increase in the cost to banks will be passed on at least in part to borrowers, who in turn will pass on those costs or cut back on spending in other areas. The increased regulatory costs will not be borne by banks alone but by the entire productive economy.

to Borrower B at a higher rate, assume 10.5%,³¹ than the loan to Borrower A, assume 7%, even if both borrowers have identical risk profiles. Borrower B would be charged a higher rate only because the Proposal mandates an increased capital requirements for that loan. This would result in Borrower B paying approximately 51% more than Borrower A in interest costs over the life of the loan—only because of different regulatory treatment and not because of any real-world difference in risk.

This aspect of the Proposal disincentivizes bank lending to privately held SMEs. As a result, privately held companies, which are already at a disadvantage given their lack of access in public markets, will be placed at a further disadvantage due to the Proposal.

26. The Basel Proposal: What It Means for Retail Lending.

27. This will vary from institution to institution since each bank using the internal models methodology would maintain an internal model calibrated of its observable loss history.

28. Refer to 4.5.4 for an example of the Proposal's detrimental effect to lines of credit.

29. 12 C.F.R. 217.2.

30. Why Your Favorite Companies Are Privately Held.

31. Credit RWA for Borrower A equals \$3.25 million (i.e., \$5 million times 65%) compared with \$5 million (i.e., \$5 million times 100%) for Borrower B. Thus, the rate differential in this example approximates interest rates based on the approximate return on risk-adjusted capital using Borrower A as the base. The 7% interest rate for Borrower A was randomly selected.

Derivatives

Although the Proposal maintains (with minor technical amendments) the standardized approach for counterparty credit risk (“SA-CCR for derivative transactions, the Proposal does introduce a material change from the existing rules. Specifically, the Proposal eliminates both the current exposure methodology (“CEM”) and the internal models methodology.

Although it is difficult to quantify the effect due to bank-specific positions, this change would increase expenses at the affected banks. For example, banks would need to implement new systems and technology solutions for computational purposes. Banks would incur significant new costs to reconfigure their entire credit risk modeling and management processes. Model validation would need to review and validate any models, and the banks would need to assess personnel to determine if additional resources with subject matter expertise would be needed to ensure compliance. In aggregate, these additional expenses would present another form of opportunity cost: resources that are used for regulatory purposes could have otherwise been allocated to revenue-generating activities.

The Proposal would likely increase expenses and capital requirements for banks due to the transition from CEM or internal models methodology to SA-CCR methodology. As is the case with other products, these added costs would likely flow through to pricing, making markets less efficient and affecting various commercial end users (e.g.,

agricultural producers, oil producers) and businesses that rely on swaps and futures to hedge commercial business risk. Derivatives are critical for all manner of businesses to minimize price volatility and accurately forecast revenues and expenses. Further, derivatives not only benefit the individual company; the benefit flows through the economy to the individual consumer because stable prices in various types of commodities result in more price stability in the final product produced for the consumer.

Assume Bank A currently applies the non-complex CEM methodology. In response to the Proposal, Bank A must convert to the SA-CCR approach, requiring the bank to deploy significant resources to overhaul its systems to comply with the proposed changes. The change in methodology will likely increase credit RWA associated with derivative transactions. Bank A provides derivative products (e.g., options, futures, swaps) to numerous counterparties that use these products to hedge commercial business risks. The costs associated with the change in methodology and increased RWA are passed from Bank A to its counterparties through increased transaction costs on the derivatives. As a result, the counterparties consisting of oil producers, airline companies, retail grocery chains, shipping companies, and other critical providers of consumer goods will likely raise the prices it charges its customers. Every aspect of the supply chain would likely be affected—and the cost borne through reduced economic growth.

Repo-Style Transactions

Another notable element of the NPRM is multiple changes made to the collateral haircut approach, including to the formula itself more broadly and a new requirement surrounding the establishment of minimum haircut floors applicable to certain repo-style transactions and specific eligible margin loans with unregulated financial institutions. Collectively, the changes to the formula and establishment of the minimum haircut floor requirement are likely to increase collateral requirements for covered transactions with unregulated financial institutions. The revised formula is designed to recognize netting and correlations in the movement of market prices for instruments lent and received while also recognizing the effect of portfolio diversification.

Transactions with unregulated financial institutions could be treated as unsecured if an institution fails to satisfy the minimum haircut floors. The key difference between the Proposal and the current rule is that under the current rule, the institution would still receive the benefit of the collateral (i.e., net of supervisory haircut) securing the transaction even if the collateral value were less than the value of what was lent. Conversely, the Proposal would ignore the collateral altogether. Due to market volatility, institutions that engage in these transactions in high volume would need to have robust monitoring and reporting processes to ensure they remained over collateralized and above the haircut floors in the event market movements forced rapid changes in prices.

Assume Bank A engages in a reverse repurchase agreement/securities borrowing transaction with Pension Fund B (i.e., Unregulated Financial Institution). The transaction involves Bank A sending \$100 million cash to Unregulated Financial Institution B, which, in turn, collateralizes the transaction with \$100 million of Apple stock. Under the current rules, the exposure amount (subject to a risk weight) would total \$25 million. However, under the Proposal, this transaction would not meet the minimum haircut floor requirement and result in the exposure amount (subject to a risk weight) totaling \$100 million.

As a result of the increased exposure, the cost of a transaction would increase, making it more costly for the bank, which, in turn, would likely pass the costs on to its counterparty. This could not only lead to an effect on the bank's counterparty but also damage market liquidity. As Goldman Sachs CEO David Solomon stated during the Senate Banking Committee hearing on December 6, 2023, the modifications to capital requirements surrounding securities financing transactions would particularly affect pension funds, because banks borrow stocks and in return pay fees to these funds.³² Mr. Solomon highlighted that the changes in the Proposal would increase capital requirements approximately eight times, making these transactions uneconomical for the banks and potentially resulting in banks exiting the business.

32. Annual Oversight of Wall Street Firms.

Operational Risk

The Proposal expands coverage-related operational RWA, extending this requirement to all Category I–IV banking institutions, whereas the current rules apply only to Category I and II banking institutions. Like the other risk areas, the Proposal eliminates the current Advanced Approaches method (i.e., based on internal models) and introduces a consistent standardized approach for operational RWA (“SA-OR”). This new calculation is a function of the BIC and the ILM. The BIC is a function of the business indicator and the BIC coefficient, with the business indicator measure consisting of a sum of three components that measure various categories of business activity. The BIC coefficient changes based on the size of the business indicator. Specifically, the business indicator includes three broad categories of activities: (1) interest, lease, and dividend income (ILD); (2) services; and (3) financial. In general, each of the components of the business indicator measure would be calculated based on a three-year rolling average, based on specific financial statement line items. The BIC is then adjusted and scaled based on broad business indicator ranges (i.e., \$0 to \$1 billion, \$1 billion to \$30 billion, and greater than \$30 billion), with the coefficient increasing in each of these bucketed ranges. The ILM is based simply on historical operational loss events (i.e., at or above \$20,000), averaged over a 10-year period, and would depend on the ratio of a banking organization’s average annual total net operational losses to the banking organization’s BIC.

Although the rule caps the net interest margin component of ILD at 2.25% of total interest-earning assets, it is noteworthy that the ILD component would negatively affect an institution as it becomes profitable. For example, the ILD component is primarily based on (the absolute value) of net interest income minus interest expense (plus dividend income). Thus, a more profitable institution, which may not necessarily be so due to increased risk taking, would have a larger ILD component than a less profitable peer, resulting in a calculation that is based more on a quantitative number than a function of risk.

The services component also affects certain activities, such as fee and commission income. This component does not allow for the net amount; it is based solely on the higher of the gross income or the expense. As a result, institutions with business lines that provide fee-based financial services (e.g., insurance activities, underwriting private/public financing, underwriters of loans sold to government-sponsored entities) would effectively have an RWA charge tied to these activities. This would likely result in increased costs that would flow through to an institution’s customers, making the costs higher and incentivizing solutions in the non-prudentially regulated space. Additionally, this could affect institutions that have more branches and operations centers and broader product lines, resulting in banks rethinking their operations in both physical space and products offered.

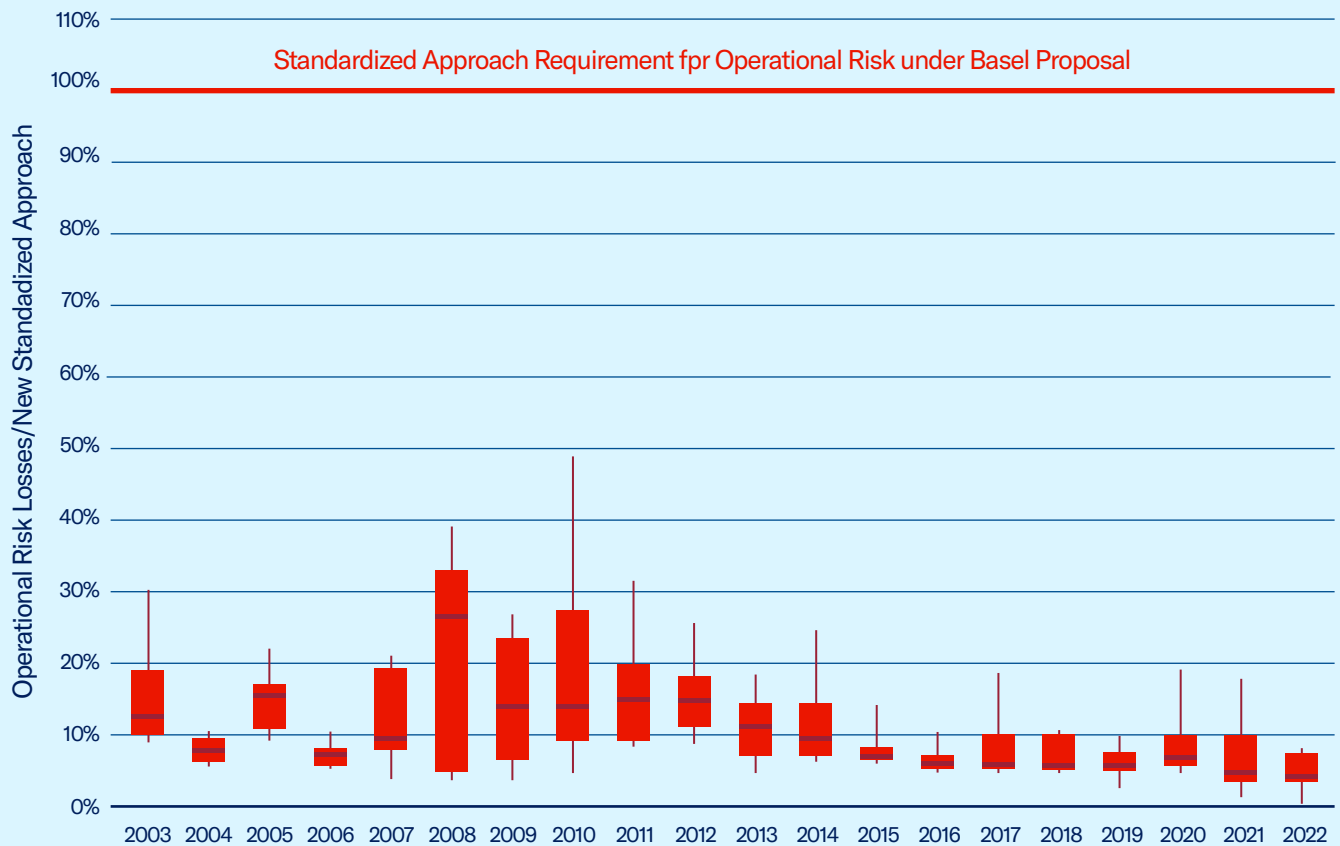
Broad View

In October 2023, ORX published a report³³ aiming to analyze the standardized approach defined in the Proposal and comparing the estimated increase to

operational risk capital requirements with observed historical losses. The report analyzed 21 years of operational loss data obtained anonymously from its members.

Figure 1. Annual Historical Loss vs. Proposal

Source: About Excessive Calibration of Capital Requirements for Operational Risk.



As Figure 1 shows, actual operational losses incurred, on average, never exceeded 30% of the estimated operational risk capital requirement that would be required by the Proposal. In a stress environment, such as the 2008 Great Financial Crisis, it is likely banks would experience heightened operational-related losses.

Exhibit 2 indicates that the losses during one of the most extreme stress scenarios barely exceed 30% of the proposed operational risk requirement.³⁴ Quite simply, the data suggest that the Proposal would require financial institutions to maintain substantially more risk capital than likely would be required in times of stress.

33. PowerPoint Presentation (hubspotusercontent-na1.net).

34. It is also important to note that the ORX loss data are reported at event level, meaning events that span several years are fully recorded in a single year. The consequence is that there is more volatility in this data than would generally be experienced with an accounting view of the losses, which would reflect a smoother distribution across years.

Credit Cards

The Proposal incorporates an operational risk capital charge into the capital requirements for credit cards. Credit card fees would be associated with the services component of the operational risk charge and would be reflected on a gross basis. The Agencies claimed that the gross approach would account for the different business models better than a netting approach, which could lead to variances in the services component that exaggerate differences in operational risk. For example, using income net of expenses as the indicator would result in the services component for institutions that distribute only products bought from third parties, for which expenses would be netted from income, being substantially lower than the services component of banking organizations that originate products to distribute, which would generally not have many financial expenses to net from income.

Assume Bank A holds \$20 billion in revolving credit card balances that generate gross credit card fees of \$1 billion and Bank A's ILM is 1.0.³⁵ This example also assumes the lowest coefficient of 12%, which would correspond to institutions with gross fee income of \$1 billion or

less. This would result in additional operational RWA of \$1.5 billion³⁶ when compared with the current requirements, or 7.5% RWA add-on for operational risk related to credit card activities.

The added component of operational risk capital requirements, paired with the changes to the credit risk capital requirements, would likely increase the cost of card borrowing and reduce the affordability of credit cards. Additionally, this cost would likely fall on the more vulnerable individuals in society, such as those with low income and limited or no credit record or impaired credit histories. This scenario could lead to fewer individuals having access to credit cards and force them to rely on other high-cost options provided by non-banks (e.g., consumer finance companies, payday loans), making them vulnerable to further financial difficulties. Lastly, when zooming out from the effect on single individuals, it is relatively safe to assume that the aggregate effect will be a net negative for the economy overall. As credit availability is reduced, demand for discretionary (and nondiscretionary) items is likely to decrease and negatively affect economic growth.

Wealth Management

Wealth management is a crucial service provided by banks, particularly for owners of private businesses. Broadly, banks' wealth management clients look to the

employed financial advisors to manage their finances throughout the life cycle of the business. This includes assistance with post-sale spending and investing needs,

35. ILM assumed was randomly selected and reflects the floor in the Proposal because banks with low historical losses are not allowed to have a multiplier below 1.0.

36. Add-on = (\$1 billion gross fee income * 12% coefficient) * 1.0 ILM * 12.5 (standard multiplier).

financial planning, and other related needs. A recent study conducted by UBS indicated that 66% of business owner respondents who recently sold their business sought advice from a trusted financial advisor.³⁷

Assume Bank A has strategically positioned itself as a market leader in offering wealth management services. The operational RWA approach in the Proposal would impose capital requirements on the bank without reference to risk-based principles. As a result, Bank A may be forced to reduce its clientele or increase costs associated with these services, both outcomes harming individuals and families who rely on these services. For example, if Bank A reduced its clientele, these individuals/families would be forced to obtain services through other sources, which at a minimum would increase transaction costs but also could lead to obtaining these services through providers that do not have the level of expertise Bank A holds. Alternatively, Bank A could increase fee-based costs to compensate for the increased capital costs. Both potential outcomes would harm the client, either through increased costs and/or through a decline in expertise provided.

37. Wind in Your Sales.



Appendix

Summary of Examples Based on Affected Person³⁸

- Rental/Investment Properties (e.g., short- and long-term rentals, vacation properties): Section 4.5.2
- Agricultural Businesses (e.g., farmers, ranchers): Section 4.5.4 / 4.4.2.2
- Agricultural Equipment Dealers: Section 4.5.4.
- Auto Dealers: Section 4.5.4 / 4.5.6
- Pension Funds: Section 4.5.9
- Individual Consumer: All Examples³⁹
- Individuals Purchasing Primary Residences: Section 4.5.1
- Low/Moderate Income Individuals: Section 4.5.5
- Non-bank Mortgage Lenders: Section 4.5.4
- Senior Living Facilities (e.g., nursing home): Section 4.4.2.3
- Lessors and Lessees of Office/Retail Buildings: Section 4.5.3
- Oil Producers: Section 4.5.8
- REITs: Section 4.4.2.3

38. Appendix identifies persons referenced in examples discussed throughout the white paper.

39. Affected either directly or indirectly.