As Prepared for Delivery
***EMBARGOED** until Thursday, June 22, 2023 at 9:00 a.m. ET*

Martin J. Gruenberg

Chairman, FDIC

The Basel III Endgame

The Peterson Institute for International Economics

June 22, 2023

Introduction

I would like to thank the Peterson Institute and Adam Posen for inviting me to speak with you today.

The topic I would like to discuss this morning is the Basel III capital framework.

Strong, high quality capital is essential to fostering resilience in the banking system through economic cycles and periods of economic stress. Finalizing the Basel III capital standards in the United States in a timely way continues to be a top priority for the FDIC and the other federal banking regulators. I would like to share some thoughts today on why finalizing Basel III is critical for the safety and soundness of the U.S. banking system, financial stability, and the performance of the U.S. economy.

The Basel III Endgame

This has been a project long in the making.

As we entered into the global financial crisis of 2008, it was clear that neither banks nor regulators understood the magnitude of the financial stability risks that had developed in prior years. We also did not appreciate the vulnerability of our nation's largest, most systemically important financial institutions, which were found to be woefully undercapitalized and over-leveraged.

In response to the global financial crisis, the U.S. banking agencies set out to strengthen the banking system through major revisions to the capital framework. These revisions were consistent with a set of standards issued by the Basel Committee on Banking Supervision in 2010, known as Basel III.

Through the initial implementation of Basel III, the agencies increased the overall quality and quantity of risk-based capital. They also complemented the risk-based framework with an enhanced supplementary leverage ratio requirement for the largest banks, added regulatory capital buffers that incentivize banks to build capital levels, and introduced new quantitative liquidity requirements.

In 2017, the Basel Committee issued a second set of revisions that are intended to bring the Basel III reforms to a close. In the United States, we already have strong leverage ratio requirements. However, there are areas where we can improve the risk-based capital regime to address weaknesses identified during the financial crisis.

The stated objective of these revisions to Basel III is to reduce excessive variability of risk-weighted assets and address certain weaknesses identified during the global financial crisis.[1] These reforms address the calculation of risk-weighted assets and limit the extent to which banks can use internal models to estimate risk to calculate minimum capital requirements.

There are four critical areas of risk under this final phase of Basel III: credit risk, market risk, operational risk, and risk associated with financial derivatives.

Credit Risk

With respect to credit risk, Basel III introduced a new standardized approach that also serves as part of a so-called output floor on modelled risk-weighted assets. The Basel III reforms are intended to increase the granularity and robustness of the credit risk capital framework while addressing flaws associated with internal models. While the international standard does constrain somewhat internally-modelled approaches for credit risk, the FDIC has long had

[1] https://www.bis.org/bcbs/publ/d424.htm

concerns about the use of internal models in establishing minimum capital requirements for credit risk. Basel III offers an opportunity to introduce a standardized approach for credit risk in lieu of the model-based approach to enhance transparency and comparability of the risk-based capital framework.

Market Risk

With respect to market risk, during the global financial crisis banks incurred significant losses in their trading books— that is their portfolios of instruments traded over the short-term— exposing weaknesses of the existing market risk capital framework. For example, credit markets, in particular those related to structured products like Collateralized Debt Obligations (CDOs), collapsed during the financial crisis. This severely impacted liquidity in these markets. Banks were able to use internal Value at Risk models for these positions even though the models inadequately captured the risks. More specifically, these models were calibrated to a 10-day loss horizon even though there was no adequate market liquidity to justify such a horizon. Furthermore, many of the Value at Risk models used proxy risk factors from other more widely traded products as approximations. The heavy use of proxies on less liquid trading positions materially underestimated the risk in these products and contributed to the undercapitalization of many banking organizations during the global financial crisis.

To deal with the most pressing deficiencies in the market risk capital framework, the Basel Committee introduced a limited set of revisions in July 2009 and then set out to address a number of other issues to improve the overall design and coherence of the capital standard for

market risk.[2] This led to the so-called fundamental review of the trading book (or FRTB) as part of this final round of Basel III.[3]

The FRTB represents a notable improvement to the existing market risk framework. It employs a more robust methodology to capitalize for potential tail risks, using the so-called expected shortfall methodology, as well as market liquidity risk under stressed conditions. It also sets out more stringent requirements for the use of internal models for calculating capital requirements. In addition, it introduces a new standardized measurement for market risk that provides a more consistent approach to calculating capital requirements.

Operational Risk

The Basel III reforms associated with operational risk also represent improvements over existing standards. Operational risk refers to the risk of loss resulting from inadequate or failed internal processes, people, and systems, or from external events.[4] Importantly, as the size and complexity of a financial institution increases, there are more opportunities for operational risks to manifest, including through gaps or other deficiencies in internal controls that result in operational losses. Operational risk exposures have been, and continue to be, a persistent and growing risk for financial institutions. For example, large financial institutions faced stiff settlement costs associated with their mortgage activities leading up to the 2008 financial crisis,[5]

[2] https://www.bis.org/publ/bcbs158.htm
[3] https://www.bis.org/bcbs/publ/d457.htm
[4] Operational risk includes legal risk but excludes strategic and reputational risk.
[5] For example, see https://www.justice.gov/opa/pr/justice-department-federal-and-state-partners-secure-record-13-billion-global-settlement and https://www.justice.gov/opa/pr/bank-america-pay-1665-billion-historic-justice-department-settlement-financial-fraud-leading.

while in recent years ransomware attacks, as well as other cybersecurity risks, have increased significantly.[6]

The operational risk framework in the United States is currently based on the advanced measurement approach framework, which requires banks to develop internal models for operational risk. However, modeling operational risk has proven to be problematic.

Internal model estimates can present substantial uncertainty and experience volatility resulting from new data, introducing meaningful challenges to capital planning. Reliance on internal models has resulted in a lack of transparency and comparability as well. The revised Basel III framework moves away from internal models for operational risk, replacing the model-based approach with a standardized approach that is adjusted for banks' own historical loss experience.

Risk Associated with Financial Derivatives

Finally, during the global financial crisis, banks incurred significant losses associated with derivative activities. A derivative transaction's performance is subject not only to the performance of the underlying assets but also to the credit risk of the counterparty. The initial phase of Basel III introduced a capital requirement for potential changes in the value of derivative instruments as a result of the deterioration in the credit worthiness of a counterparty.[7]

This credit valuation adjustment, or CVA, was a major source of losses for banks with derivative trading operations during the global financial crisis. The Basel III reforms would improve the estimation of CVA risk by introducing new frameworks that would be consistent with the more robust methodology under the revised market risk framework.

[6] See 2022 FDIC Risk Review, chart 53; https://www.fdic.gov/analysis/risk-review/2022-risk-review/2022-risk-review-full.pdf.
[7] https://www.bis.org/press/p110601.htm

Upcoming Proposed Rulemaking

This brings me to a few remaining points regarding our path forward.

In the near term, the FDIC, together with the Federal Reserve and the Office of the Comptroller of the Currency, will issue a notice of proposed rulemaking to seek public comment on changes to the U.S capital framework to consider how best to incorporate the finalization of Basel III.

Scope of Application

A key consideration with respect to these revisions is the scope of application – in other words, which banks will be subject to the proposed rule.

For example, the agencies are considering whether to apply the proposed new rule to banks with assets over $100 billion. This consideration has certainly been influenced by the recent experience with three bank failures of institutions with assets between $100 billion and $250 billion. If we had any doubt that the failure of banks in this size category can have financial stability consequences, that has been answered by recent experience.

In this regard, it is worth noting that although Silicon Valley Bank's (SVB) failure was caused by a liquidity run, the loss of market confidence that precipitated the run was prompted by the sale of assets at a substantial loss that raised questions about the capital adequacy of the bank. Had the unrealized losses on available for sale securities on the balance sheet of SVB, that were realized once sold, been required to be recognized in capital, as the Basel III framework would do, it might have averted the loss of market confidence and the liquidity run. That is because there would have been more capital held against these assets.

The lesson to take away is that banks in this size category can pose genuine financial stability risks and the federal banking agencies need to review carefully the supervision of these

institutions, particularly for interest rate risk in the current environment, and the prudential requirements that apply to them, including capital, liquidity, and loss absorbing resources for resolution.

Community banks, which are subject to different capital requirements, would not be impacted by the proposal, given their limited overall size and trading activities.

Impact on Bank Capital

This phase of Basel III is expected to increase risk-based capital relative to the risks I just described. These were serious risks identified during the 2008 global financial crisis that were significantly undercapitalized, and this phase of Basel III seeks to address those risks. The implementation of the latest Basel III reforms would strengthen our banking system while also improving the efficiency and availability of credit through varying economic conditions.

In fact, banks that were most impacted by recent capital and liquidity reforms may see a reduction in their cost of both debt and equity.[8] The estimated capital impact on banking organizations will be described in the notice of proposed rulemaking that will be acted on by the federal banking agencies in the near future and of course will be subject to an extensive public comment period.

Impact on the Economy

Concern has also been raised that an increase in capital requirements now could be a drag on bank lending and the U.S. economy. There are a couple of points to be made in this regard.

As I indicated, the federal banking agencies will shortly act on a notice of proposed rulemaking. A final rule is not likely to be acted on before the middle of next year. Once a final

[8] https://www.bis.org/bcbs/publ/d544.pdf

rule is acted on, the implementation period once the rule takes effect would be several more years.

In other words, the impact of the rule on the banking system is not likely to be felt for several years, and that impact would be phased in gradually.

In addition, to be clear, stronger capital improves the resilience of our largest banks and enhances their ability to lend through the economic cycle. History has proven that insufficient capital can lead to harmful economic results when banks are unable to provide financial services to households and businesses, as occurred during the 2008 financial crisis. Ensuring adequate amounts of bank capital provides a long-term benefit to the economy by enabling banks to play a counter-cyclical role during an economic downturn rather than a pro-cyclical one.

A key component of the capital framework is the risk-based requirement, which is meant to increase commensurate to any increase in risk that a bank assumes through lending or capital markets activities. Implementing a more risk-sensitive requirement will serve to ensure that banks shoulder the risk of their own operations, preventing the build-up of excessive systemic risk.

Further, equity capital is not locked away in a manner that inhibits its use to support the real economy. Rather it is deployed in numerous ways that benefit the bank, its stakeholders, and the economy. Equity capital funds a bank's operations, is allocated to make loans to local communities, and can be distributed to shareholders when appropriate with sound financial performance.

Lessons from the Pandemic

Since the pandemic, some have argued that the strong performance of the large banks during the pandemic demonstrates that they had adequate capital to withstand a stress environment and that no additional capital requirements are needed.

There are a few points worth making here.

It is true that the first round of Basel III reforms strengthening the quantity and quality of capital for our largest banks served the economy well during the pandemic, reinforcing the role strong capital plays throughout economic cycles. Banks were clearly much more resilient entering the spring of 2020 as a result of Basel III.

However, it would be a mistake to consider the pandemic a true stress test of the capital adequacy of the banking system. COVID-19 was an exogenous event that necessitated a swift and forceful public sector response. In total, federal government support is estimated to be well in excess of $10 trillion.[9] That response helped to bolster the financial health of bank customers, as well as the markets within which banks operate. These actions insulated banks from runs and losses, while some measures served to boost bottom line profits with minimal risk to capital. This should be the context through which we consider overall capital adequacy and the improvements to risk-based capital that are provided by the Basel III revisions.

Leverage Capital

Finally, it has been suggested that since Basel III will raise risk-based capital requirements, leverage capital requirements should be lowered to offset the burden on the largest banks.

[9] See https://www.covidmoneytracker.org/.

Maintaining a strong leverage capital requirement as improvements are made to the risk-based capital framework is an important principle to ensure continued resilience in the U.S. banking system. This is because the leverage capital framework, while relatively simple, does not differentiate assets by risk and ensures banks hold a base of capital proportional to their exposures.

As the federal banking agencies indicated when finalizing the enhanced supplementary leverage ratio for our largest banks, leverage capital and risk-based capital frameworks are complementary and work together to provide a stronger regulatory capital foundation than either would in isolation.[10]

Risk-based capital requirements can be managed by banks to minimize capital impacts, meaning we cannot be confident that increases in the risk-based regime will hold through time. In addition, banks' own models and the regulators may get the risk weights wrong. Leverage capital requirements and the risk-based capital framework are therefore mutually reinforcing, in that they each cover risk which the other is less able to capture. This ensures banks do not operate with excessive leverage and at the same time have sufficient incentives to keep risk-taking in check. That is why maintaining strong leverage capital requirements along with risk-based requirements will ensure the resiliency of the largest, most systemically important banks is not compromised.

Indeed, maintaining robust leverage requirements is important as we move forward with implementation of the revised Basel III risk-based standards. It was an essential post-crisis reform that must not be weakened.

[10] 79 FR 24528, 24533.

Conclusion

In conclusion, a robust regulatory capital framework is the cornerstone of a resilient banking system. Strong levels of capital available to absorb losses ensure that banks have the ability to continue to lend to their customers through business cycles, including during stress.

Basel III finalization and implementation is a top priority for the FDIC and all of the federal banking agencies. It offers us the opportunity to make important modifications to the risk-based regulatory capital framework with the ultimate goal of enhancing the financial resilience and stability of the banking system, better enabling it to serve the U.S. economy.

Thank you again for the opportunity to speak here today.