The Need for Public Comment on a Revised Economic Analysis of Basel III

December 11, 2023

On October 20th, the Board of Governors of the Federal Reserve System (the "**Board**")—joined by the Federal Deposit Insurance Corporation (the "**FDIC**") and the Office of the Comptroller of the Currency (the "**OCC**")—announced an extension of the public comment period on the agencies' pending proposal to increase bank capital requirements (the "**Proposed Rule**"). [1]

The Proposed Rule is designed to bring the capital requirements applicable to certain large banking organizations and other banking organizations with significant trading activity into general alignment with the international Basel III standards. Simultaneously, the Board announced a "data collection to gather more information from the banks affected by the [Proposed Rule]" in order to "further clarify the estimated effects of the proposal and inform any final rule, with summaries to be made public."[2]

However, missing from the agencies' updated agenda is any further opportunity for public notice and comment on their revised economic analysis. Federal banking agencies should first complete a thorough economic analysis of a proposal and then expose the economic analysis to the rigors of public comment and debate, as the Administrative Procedure Act requires.[3] The Committee on Capital Markets Regulation (the "**Committee**") therefore calls upon the banking agencies to provide the public with the opportunity to comment on the revised economic analysis before any finalization of the Proposed Rule.

Regulatory Background

The Proposed Rule was jointly published on July 27, 2023 by the Board, FDIC, and OCC.[4] If adopted, the Proposed Rule would "substantially revise the capital requirements applicable to large banking organizations and to banking organizations with significant trading activity."[5] Among other things, the Proposed Rule would alter the rules governing the calculation of banks' risk-based capital requirements, including replacing current requirements for credit, operational risk, and credit valuation modeling, and revising the regulatory approach to market risk.[6] The comment deadline for the Proposed Rule was initially set at November 30, 2023, but pursuant to the recent announcement has been extended to January 16, 2024.[7]

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[1] BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM ["FEDERAL RESERVE BOARD"], FEDERAL DEPOSIT INSURANCE CORPORATION ["FDIC'], OFFICE OF THE COMPTROLLER OF THE CURRENCY ["OCC"], *Agencies extend comment period on proposed rules to strengthen large bank capital requirements* (Oct. 20, 2023), https://www.federalreserve.gov/newsevents/pressreleases/bcreg20231020a.htm?source=email [the "Deadline Extension Release"].

[2] FEDERAL RESERVE BOARD, *Federal Reserve Board launches data collection to gather more information from the banks affected by the large bank capital proposal it announced earlier this year* (Oct. 20, 2023), https://www.federalreserve.gov/newsevents/pressreleases/bcreg20231020b.htm.

[3] 5 U.S.C. § 553(b) and (c).

[4] FEDERAL RESERVE BOARD, *Agencies request comment on proposed rules to strengthen capital requirements for large banks* (July 27, 2023), https://www.federalreserve.gov/newsevents/pressreleases/bcreg20230727a.htm; DEPARTMENT OF THE TREASURY, OCC, FEDERAL RESERVE SYSTEM, FDIC, *Regulatory Capital Rule: Large Banking Organizations and Banking Organizations with Significant Trading Activity*, 88 FED. REG. 64,028 (Sept. 18, 2023) [the "Proposed Rule"].

[5] Proposed Rule at 64,181.

[6] *Id*.

[7] Deadline Extension Release, *supra* note 1.

Economic Analysis & Administrative Process

Although the Proposed Rule includes a section entitled "Impact and Economic Analysis," this analysis does not support the conclusion that the Proposed Rule's economic benefits would outweigh its costs, for the following principal reasons:

- The estimates rely heavily on banks' Basel III quantitative impact study submissions from 2021[8] and banks' assumptions on how the reforms would have been implemented in the US before the Proposed Rule was issued in 2023. However, the Proposed Rule includes "gold plating" of Basel III risk weights that are 10-20% higher than the final Basel III standards, among many other significant differences. The Impact and Economic Analysis therefore likely underestimates the increase in bank capital requirements.
- The analysis does not quantify the Proposed Rule's economic costs or benefits. While the analysis acknowledges that the Proposed Rule's capital increases could reduce banks' lending and capital markets activities, it does not quantify those reductions or the resulting economic costs. Nor does the analysis substantiate or quantify the Proposed Rule's purported benefits for financial stability.
- The analysis fails to acknowledge that the contemplated capital increases could adversely affect banking activities other than lending and capital markets activities, such as custody and asset management. The analysis thus omits consideration of major costs potentially stemming from the Proposed Rule.

In view of these shortcomings, a more robust analysis is needed. As the Committee has previously argued, a rigorous cost-benefit analysis showing that the economic benefits of a proposed rule will outweigh its economic costs should be a prerequisite for rulemakings by federal regulatory agencies.[9] We therefore welcome the Fed's data collection exercise launched on October 20, which the agencies intend to use to expand their economic analysis. However, by declining to allow the public an opportunity to review and respond to the revised economic analysis before any finalization of the Proposed Rule, the agencies would likely fail to fulfill the mandate of the Administrative Procedure Act, which requires that the public be given an opportunity to comment on the evidence and substantive rationale for a proposed rule before it is finalized.[10]

Indeed, previous iterations of Basel implementation by the agencies have hewed to higher standards. For example, in 2005, the banking agencies delayed the release of the proposed rulemaking for the Basel II Framework so as "to better assess the results of a recently completed quantitative impact study," ultimately deciding to "issue the [notice of proposed rulemaking] at the earliest possible date after considering issues raised by the [quantitative impact study] results."[11]

The Committee therefore recommends that the banking agencies provide the public with the opportunity to comment on the revised economic analysis once it is complete before any finalization of the Proposed Rule.

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[8] BASEL COMMITTEE ON BANKING SUPERVISION, *Basel III Monitoring Report* (2022), https://www.bis.org/bcbs/publ/d541.htm.

[9] *See*, *e.g.*, COMMITTEE ON CAPITAL MARKETS REGULATION, *U.S. Financial Regulatory Agencies and the Rule of Law* (2022), https://capmktsreg.org/wp-content/uploads/2022/11/A-Balanced-Approach-to-Cost-Benefit-Analysis-Reform-1.pdf.

[10] 5 U.S.C. § 553(c).

[11] FEDERAL RESERVE BOARD, *Banking Agencies to Perform Additional Analysis Before Issuing Notice of Proposed Rulemaking Related to Basel II* (Apr. 29, 2005), https://www.federalreserve.gov/boarddocs/press/bcreg/2005/20050429/default.htm.