

VI. *Basel III Reforms: Analysis and Potential Impact on U.S. Banks*

Warren Buffet warned, “[Y]ou only find out who is swimming naked when the tide goes out.”⁵⁹⁴ When the tide rolled out during the last global financial crisis, some large banks were swimming naked without adequate capital.⁵⁹⁵ The Basel Committee, a group of banking supervisory authorities from over twenty countries responsible for setting global capital standards, put forth capital regulatory reforms known as Basel III to address banking failures from the financial crises.⁵⁹⁶ While most of Basel III has been implemented, the latest proposals by the Basel Committee to reduce reliance on internal-risk based (IRB) models for credit, market, and operational risks are deeply contested.⁵⁹⁷

Under Basel III, certain banking institutions may use IRB models developed by the bank and approved by regulators to calculate capital ratios.⁵⁹⁸ Basel Committee empirical studies have shown that banks using IRB models, however, are inconsistent in how they measure risk-weighted assets (RWAs) for capital ratios.⁵⁹⁹ The Basel Committee is concerned with not only the lack of uniformity in RWA measurement, but also the possibility that banks are using IRB models

⁵⁹⁴ Letter from Warren Buffet, Chairman, Berkshire Hathaway, to Shareholders (Feb. 28 2002), <http://www.berkshirehathaway.com/2001ar/2001letter.html> [<https://perma.cc/SZ8H-SX2Z>].

⁵⁹⁵ See Anat R. Admati, *The Missed Opportunity and Challenge of Capital Regulation 7* (Stanford Univ.’s Rock Ctr. for Corp. Governance, Working Paper No. 216, 2015) (arguing that the capital retained by banks provided “misleading reassurances” and were “entirely inadequate”).

⁵⁹⁶ BASEL COMM. ON BANKING SUPERVISION, *BASEL III: A GLOBAL REGULATORY FRAMEWORK FOR MORE RESILIENT BANKS AND BANKING SYSTEMS* (2010), http://www.bis.org/publ/bcbs189_dec2010.pdf [<https://perma.cc/NFV6-WGPB>] [hereinafter *BASEL III*].

⁵⁹⁷ See Julia-Ambra Verlaine & Max Colchester, *U.S., Europe Spat Over Bank Risk Set to Drag On*, *WALL ST. J.* (Jan. 4, 2017), <http://www.wsj.com/articles/u-s-europe-spat-over-bank-risk-set-to-drag-on-1483531585> [<https://perma.cc/3XCT-FJ6F>].

⁵⁹⁸ Luca Amorello, Comment, *Beyond the Horizon of Banking Regulation: What to Expect from Basel IV*, 58 *HARV. INT’L L.J.* 21, 24 (2016).

⁵⁹⁹ BASEL COMM. ON BANKING SUPERVISION, *CONSULTATIVE DOCUMENT: REDUCING VARIATION IN CREDIT RISK-WEIGHTED ASSETS—CONSTRAINTS ON THE USE OF INTERNAL MODEL APPROACHES 2* (2016), <http://www.bis.org/bcbs/publ/d362.pdf> [<https://perma.cc/75A8-N6FV>] [hereinafter *BCBS CREDIT REFORM*].

to reach favored outcomes, such as holding less capital than would be required under other models.⁶⁰⁰ To address this problem of banks gaming the capital regulatory framework by using IRB models, the Basel Committee issued proposals for banks to reduce reliance on IRB models and to adopt standardized models when appropriate as part of the final Basel III implementation.⁶⁰¹ Standardized models are uniform ways to measure credit, market, or operation risks across all banks that do not depend on internally developed formulas.⁶⁰² Banking regulators in the United States, under the leadership of Daniel Tarullo, member of the Board of Governors of the U.S. Federal Reserve Board and chairman of the Federal Financial Institutions Examination Council, supported these measures, while European regulators opposed them due to the heightened capital requirements the measures would impose on European banks.⁶⁰³ The election of President Trump and departure of Mr. Tarullo, however, cast into doubt U.S. support for the Basel Committee's reforms.⁶⁰⁴ Accordingly, the Basel Committee has put the final Basel III reforms on hold until 2019, giving the new U.S. administration time to reach a position.⁶⁰⁵

⁶⁰⁰ See Daniel K. Tarullo, Member, Bd. of Governors of the Fed. Reserve Sys., Address at the Fed. Reserve Bank of Chicago: Rethinking the Aims of Prudential Regulation 14 (May 8, 2014), <https://www.federalreserve.gov/newsevents/speech/tarullo20140508a.pdf> [<https://perma.cc/T5FE-Q8ZA>] (“[T]he IRB approach is problematic. The combined complexity and opacity of risk weights generated by each banking organization for purposes of its regulatory capital requirement create manifold risks of gaming, mistake, and monitoring difficulty.”).

⁶⁰¹ BCBS CREDIT REFORM, *supra* note 6, at 2.

⁶⁰² See BASEL CAPITAL ACCORD, INTERNATIONAL CONVERGENCE ON CAPITAL MEASUREMENT AND CAPITAL STANDARDS 7 (1988) <http://www.bis.org/publ/bcb-sc111.pdf> [<https://perma.cc/E3CL-6FMP>] [hereinafter BASEL I] (explaining the standardized approach where “capital is related to different categories of asset or off-balance-sheet exposure, weighted according to broad categories of relative riskiness”).

⁶⁰³ Verlaine & Colchester, *supra* note 4 (explaining the disagreement between U.S. and European regulators).

⁶⁰⁴ Cf. Patrick Henry, *U.S. Regulators Hang Tough at Basel as Trump Roll-back Looms*, BLOOMBERG (Jan. 27, 2017), <https://www.bloomberg.com/news/articles/2017-01-27/u-s-bank-regulators-hang-tough-at-basel-as-trump-roll-back-looms> [<https://perma.cc/5R4V-WQ52>] (“Trump hasn’t yet turned his attention to the Basel Committee, but there is concern that U.S. commitment to global banking standards may dwindle on his watch.”).

⁶⁰⁵ Caroline Binham, *Basel Puts New Banking Policy Initiatives on Hold Un-*

This article discusses the proposed Basel III reforms and their likely impact on U.S. banks. Section A provides a broad overview of the evolution from Basel I to Basel III. Section B explains the major elements of the proposed reforms to Basel III with respect to credit, market, and operational risks. Next, Section C discusses the likely impact of these proposed reforms on large U.S. banks. Finally, Section D examines European resistance to the Basel III reforms and explains how the Trump administration may either continue or cease support for the reforms.

A. Evolution from Basel I to Basel III

Banks need capital to absorb losses and lower the risk of insolvency.⁶⁰⁶ The more capital that a bank is required to hold, however, the more restricted it is in its ability to invest or lend money.⁶⁰⁷ Thus, capital requirements attempt to balance a bank's need for capital without unduly undermining a bank's growth and profitability.⁶⁰⁸ Basel I in 1988 resulted in internationally agreed upon minimum capital standards for the first time.⁶⁰⁹ The purposes of Basel I were to ensure that banks hold sufficient capital to cover their respective level of risk, to promote uniform capital measures and standards to level the playing field globally, and to facilitate global comparisons of bank capital positions.⁶¹⁰ Basel I only accounted for credit risk, i.e., "the risk of counterparty failure" when borrowers default on loan payments, and prescribed a standardized approach for determining risk-weighted assets (RWAs).⁶¹¹ Under this approach, each asset is placed in "different categories" based on the asset type and "weighted according to broad categories of relative riskiness."⁶¹² Basel I failed to capture the risk sensitivity of assets, because all assets belonging

til 2019 Pending Review, FIN. TIMES (Apr. 25, 2017), <https://www.ft.com/content/0870eeb1-0a90-3ddc-9c66-74787ee33c2d> [<https://perma.cc/F7N3-XFRY>].

⁶⁰⁶ See John Goddard & John O.S. Wilson, *How Much Capital?*, OXFORD U. PRESS BLOG (Jan. 6, 2017), <http://blog.oup.com/2017/01/banking-risk-assets-basel-capital/> [<https://perma.cc/6Y5M-QNGW>].

⁶⁰⁷ See *id.*

⁶⁰⁸ See *id.*

⁶⁰⁹ See BASEL I, *supra* note 9.

⁶¹⁰ *Id.* at 1–2.

⁶¹¹ *Id.* at 8.

⁶¹² *Id.* at 7.

to the same category were weighted equally, without regard to the individual risk profiles of assets and counterparties.⁶¹³

As banks became more complex and developed risk modeling techniques with computers, Basel I's standardized approach evolved. The market risk amendment in 1996 ushered in a new era of capital regulation by allowing banks to use their own value-at-risk (VaR) models to calculate market risk,⁶¹⁴ "the risk of losses in on- an off-balance sheet positions arising from movements in market prices."⁶¹⁵ VaR models measure the risk of investments in a given period so that a bank can gauge the amount of assets needed to cover possible losses.⁶¹⁶ In 2004, Basel II expanded the use of internal credit risk models for banks.⁶¹⁷ The IRB approach allowed the largest banks to use their own empirical models, subject to regulatory approval, to quantify required capital for credit risk.⁶¹⁸ This involved large banks using IRB models to calculate their respective probability of default (PD), exposure at default (EAD), and loss given default (LGD) as inputs into a formula developed by supervisors for calculating minimum capital requirements.⁶¹⁹ The new approach sought to address Basel I's failure to capture risk sensitivity.⁶²⁰ Basel II also required banks to hold capital for operational risk events, the losses "resulting from inadequate or failed internal processes, people and systems or from external events."⁶²¹ Basel II's advanced measurement approach

⁶¹³ BASEL COMM. ON BANKING SUPERVISION, INTERNATIONAL CONVERGENCE ON CAPITAL MEASUREMENT AND CAPITAL STANDARDS, A REVISED FRAMEWORK ¶ 10 (2004) <http://www.bis.org/publ/bcbs107.pdf> [<https://perma.cc/NK7K-CN8A>] [hereinafter BASEL II].

⁶¹⁴ See BASEL COMM. ON BANKING SUPERVISION, OVERVIEW OF THE AMENDMENT TO THE CAPITAL ACCORD TO INCORPORATE MARKET RISKS 2 (1996), <http://www.bis.org/publ/bcbs23.pdf> [<https://perma.cc/92KQ-VRWM>].

⁶¹⁵ *Id.* at 1.

⁶¹⁶ *Id.* ("The objective in introducing this significant amendment to the Capital Accord is to provide an explicit capital cushion for the price risks to which banks are exposed, particularly those arising from their trading activities.").

⁶¹⁷ BASEL II, *supra* note 20, ¶ 211.

⁶¹⁸ See *id.* ("Subject to certain minimum conditions and disclosure requirements, banks that have received supervisory approval to use the IRB approach may rely on their own internal estimates of risk components in determining the capital requirement for a given exposure.").

⁶¹⁹ *Id.* ¶¶ 285–317.

⁶²⁰ *Id.* ¶ 10.

⁶²¹ *Id.* ¶ 644.

(AMA) allowed banks to use their own models, subject to regulatory approval, to calculate how much capital they needed to set aside for operational risk.⁶²² When the last financial crisis occurred, large bank failures exposed Basel II's weakness: it did not require banks to hold enough high quality capital and failed to account for systemic risk.⁶²³

Basel III was approved in 2010 and increased requirements concerning the quantity and quality of capital.⁶²⁴ With respect to quantity, Basel III increased the overall amount of Tier 1 capital that banks must hold from 4 percent to 6 percent.⁶²⁵ Tier 1 capital is considered to be the best quality capital consisting of common equity and retained earnings.⁶²⁶ Tier 2 capital, in contrast, consists of less reliable debts and loans.⁶²⁷ Additionally, Basel III introduced capital conservation and countercyclical buffers that require banks to hold up to an additional 2.5 percent of common equity Tier 1 capital to withstand future periods of financial stress.⁶²⁸

Regarding the quality of capital, Basel III established more stringent qualifications for what qualifies as Tier 1 and Tier 2 capital.⁶²⁹ It required that the best quality capital, common equity Tier 1, be increased from 2 percent to 4.5 percent.⁶³⁰ Basel III introduced a minimum leverage ratio of 3 percent that divides a bank's Tier 1 capital by total non-risk weighted assets.⁶³¹ This leverage ratio "reinforce[d] the risk based requirements with a simple, non-risk based 'backstop' measure."⁶³² Further, Basel III introduced liquidity requirements known as the liquidity coverage ratio (LCR) and the net stable funding

⁶²² *Id.* ¶¶ 655–56.

⁶²³ See Asli Demirguc-Kunt et al., *Bank Capital: Lessons from the Financial Crisis* 3–4 (IMF, Working Paper No. 286, 2010) <https://www.imf.org/external/pubs/ft/wp/2010/wp10286.pdf> [<https://perma.cc/7N9F-U2B4>] (“The recent financial crisis undoubtedly demonstrated that existing capital regulation, in its design or implementation, was inadequate to prevent a panic in the financial sector, and once again governments around the world had to step in with emergency support to prevent a collapse.”).

⁶²⁴ BASEL III, *supra* note 3, at 2.

⁶²⁵ *Id.* at 2.

⁶²⁶ *Id.* at 13.

⁶²⁷ *Id.* at 17.

⁶²⁸ *Id.* at 54–60.

⁶²⁹ *Id.* at 15.

⁶³⁰ *Id.* at 12.

⁶³¹ *Id.* at 61.

⁶³² See *id.* at 60–61.

ratio (NSFR).⁶³³ LCR requires a bank to hold sufficient liquid assets to cover thirty days of net cash outflows and the NSFR requires a bank to retain stable funding to cover a one-year period of extended stress.⁶³⁴

Despite these improvements to the quality and quantity of banking capital, Basel III did not improve the use of IRB approaches to calculating RWAs.⁶³⁵ Banks use IRB approaches for calculating RWAs because they are more sensitive to capturing the risks behind each individual asset than a standardized approach that assigns the same risk weight to assets within a particular class.⁶³⁶ Some banks, however, are required to hold less capital under the IRB approach than under the standardized approach.⁶³⁷ The Basel Committee's 2013 studies concluded that IRB approaches lead to different capital results for similar portfolios.⁶³⁸ The Basel Committee found "significant variation" across banks in the calculation of market risk and operational risk and "considerable variation" in the calculation of credit risk.⁶³⁹

⁶³³ *Id.* at 9.

⁶³⁴ *See id.*

⁶³⁵ Lee Reiners, *Basel Committee is on the Clock*, FINREG BLOG (Dec. 12, 2016), <https://sites.duke.edu/thefinregblog/2016/12/12/basel-committee-is-on-the-clock/> [<https://perma.cc/X6KC-YWWW>].

⁶³⁶ *See id.*; BRAD CARR ET AL., INST. OF INT'L FIN., *BASEL'S EVOLUTION: A RETROSPECTIVE* 3–5 (2016), <https://www.iif.com/publication/regulatory-report/basels-evolution-retrospective> [<https://perma.cc/2BMK-3JVX>] (arguing that IRB approaches are more risk sensitive than standardized approaches).

⁶³⁷ Reiners, *supra* note 42.

⁶³⁸ *See* BASEL COMM. ON BANKING SUPERVISION, *CONSULTATIVE DOCUMENT: STANDARDS, REVISIONS TO THE STANDARDISED APPROACH FOR CREDIT RISK 4* (2015) <http://www.bis.org/bcbs/publ/d307.pdf> [<https://perma.cc/H5WT-AFEC>] ("Moreover, given the level of variability in risk-weighted assets across banks using the IRB approach (with respect to portfolios with similar risk profiles), the Committee is proposing to impose a standardised approach floor on modelled credit risk capital requirements with the aims of constraining variation in risk-weighted assets . . .").

⁶³⁹ Press Release, Bank for Int'l Settlements, *Second Report on the Regulatory Consistency of Risk-Weighted Assets in the Trading Book* Issued by the Basel Committee (Dec. 17, 2013), <http://www.bis.org/press/p131217.htm> [<https://perma.cc/29B9-9SHJ>]. ("[T]he results show significant variation in the outputs of market risk internal models used to calculate regulatory capital."); Reiners, *supra* note 42 ("A similar study of RWAs for credit risk also identified 'considerable variation' across banks, and that this variation cannot be explained simply by differences in the risk composition of assets. Significant variation has also been found in operational risk RWAs.").

B. Proposed Reforms to Basel III

To address the wide variation of capital calculations based on IRB approaches and to improve the simplicity and comparability of capital ratios, the Basel Committee has released a series of consultative documents with proposed reforms to the current Basel III framework.⁶⁴⁰ Critics call these proposals Basel IV.⁶⁴¹ In particular, the Basel Committee hopes to reform requirements for credit risk, market risk, and operational risk.

1. Credit Risk

To reduce variation in credit risk calculations, the Basel Committee has proposed reforms to eliminate the use of IRB approaches for certain exposures.⁶⁴² For example, banks would need to use the standardized approach instead of IRB approach to calculate credit risk from portfolios belonging to “banks and other financial institutions; large corporates (defined as corporates belonging to consolidated groups with total assets exceeding EUR50bn); and equities.”⁶⁴³ This standardized approach for credit risk would be more risk-sensitive and rely less on external ratings than previous standardized models.⁶⁴⁴

For the other exposures that may be calculated using the IRB approach, the Basel Committee introduced parameters and formulas to determine PD, EAD, and LGD in an effort to reduce the variability of these measurements among banks.⁶⁴⁵ Although the proposed reforms

⁶⁴⁰ See BCBS CREDIT REFORM, *supra* note 6; BASEL COMM. ON BANKING SUPERVISION, STANDARDS: MINIMUM CAPITAL REQUIREMENTS FOR MARKET RISK (2016) <http://www.bis.org/bcbs/publ/d352.pdf> [<https://perma.cc/SX6M-5JJ2>] [hereinafter BCBS MARKET RISK]; BASEL COMM. ON BANKING SUPERVISION, CONSULTATIVE DOCUMENT: STANDARDISED MEASUREMENT APPROACH FOR OPERATIONAL RISK 1 (2016), <http://www.bis.org/bcbs/publ/d355.pdf> [<https://perma.cc/W22K-BZNP>] [hereinafter BCBS OPERATIONAL RISK].

⁶⁴¹ GREGORY LYONS ET AL., DEBEVOISE & PLIMPTON, PRUDENTIAL REGULATION IN AN AGE OF PROTECTIONISM 1 (2016), http://www.debevoise.com/~media/files/insights/publications/2016/12/20161205_prudential_regulation_in_an_age_of_protectionism.pdf [<https://perma.cc/JB9Q-M6T7>].

⁶⁴² See BCBS CREDIT REFORM, *supra* note 6, at 2.

⁶⁴³ *Id.*

⁶⁴⁴ BASEL COMM. ON BANKING SUPERVISION, SECOND CONSULTATIVE DOCUMENT: STANDARDS, REVISIONS TO THE STANDARDISED APPROACH FOR CREDIT RISK 3 (2015).

⁶⁴⁵ BCBS CREDIT REFORM, *supra* note 6, at 7–10.

do not eliminate the use of IRB approaches, the Basel Committee is considering the adoption of an “aggregate output floor, which could be calibrated in the range of 60% to 90%.”⁶⁴⁶ The output floor would operate as a minimum floor that banks would need to meet when calculating RWAs under a standardized approach.⁶⁴⁷ For example, if the output floor is 60 percent, a bank using the IRB approach to calculate credit risk RWAs cannot come up with a value that is below 60 percent of what the credit risk RWAs would be under the standardized approach. The percentage of the output floor has not yet been determined because a higher percentage floor and corresponding increased capital requirement must be balanced against the resulting decrease in lending by banks.⁶⁴⁸

2. Market Risk

The Basel Committee’s proposed reforms to market risk are known as the Fundamental Review of the Trading Book (FRTB).⁶⁴⁹ The financial crisis revealed that banks were engaging in arbitrage by placing capital in the banking book instead of the trading book.⁶⁵⁰ Assets on the banking book are held to maturity whereas assets in the trading book are regularly traded.⁶⁵¹ Because market risk charges are higher for trading book assets, arbitrage occurred when banks placed assets in the banking book.⁶⁵² The FRTB attempts to resolve this issue of arbitrage by drawing a more distinct boundary between the trading and banking books.⁶⁵³ Under FRTB, more assets will be placed in the

⁶⁴⁶ *Id.* at 2.

⁶⁴⁷ *Id.* at 1.

⁶⁴⁸ *See id.*

⁶⁴⁹ BCBS MARKET RISK, *supra* note 47 (detailing the proposals that constitute the Fundamental Review of the Trading Book).

⁶⁵⁰ *Id.* at 1, 3–4.

⁶⁵¹ *See id.* at 7.

⁶⁵² *See id.* at 10.

⁶⁵³ *Id.* at 7–8 (“The following instruments must be assigned to the banking book, unless specifically provided otherwise in this framework: (a) unlisted equities; (b) instrument designated for securitisation warehousing; (c) real estate holdings; (d) retail and SME credit; (e) equity investments in a fund, including but not limited to hedge funds, in which the bank cannot look through the fund daily or where the bank cannot obtain daily real prices for its equity investment in the fund; (f) derivative instruments that have the above instrument types as underlying assets; or (g) instruments held for the purpose of hedging a particular risk of a position in the types of instrument above.”).

trading book, as the Basel Committee provided a list of instruments that are presumed to be in the trading book.⁶⁵⁴

In addition, the FRTB proposal encourages banks to adopt a standardized approach to calculating market risk instead of an internal model approach.⁶⁵⁵ Internal model approaches would no longer use VaR models to calculate market risk.⁶⁵⁶ Instead, banks must use an Expected Shortfall measure that better captures tail risk, the risk that an asset moves more than three standard deviations from its current price.⁶⁵⁷ Further, all internal model approaches must undergo Profit and Loss (P&L) attribution testing to ensure the model captures the material drivers of actual P&L and backtesting to determine how well the risks in the internal model are captured.⁶⁵⁸ The result of these changes to the internal model approach under FRTB is to encourage banks to use a standardized approach for calculating market risk.⁶⁵⁹

3. Operational Risk

Since Basel II, banks have used the advanced measurement approach (AMA) to calculate operational risk.⁶⁶⁰ The AMA allows banks to rely entirely on their own models, subject to regulatory approval, when determining how much capital to hold for operational risk events.⁶⁶¹ Because there has been significant variation between banks with similar portfolios, the Basel Committee's proposal prohibits the use of the AMA approach.⁶⁶² Instead, banks would be required to use a standardized measurement approach (SMA) to

⁶⁵⁴ *Id.* at 7 (“Any instrument a bank holds for one or more of the following purposes must be designated as a trading book instrument: (a) short-term resale; (b) profiting from short-term price movements; (c) locking in arbitrage profits; (d) hedging risks that arise from instruments meeting criteria (a), (b) or (c) above.”).

⁶⁵⁵ *Id.* at 13.

⁶⁵⁶ *Id.* at 1.

⁶⁵⁷ *Id.* at 53.

⁶⁵⁸ *Id.* at 52.

⁶⁵⁹ *See id.* at 14.

⁶⁶⁰ BCBS OPERATIONAL RISK, *supra* note 47, at 1.

⁶⁶¹ *See id.*

⁶⁶² *Id.* (“The inherent complexity of the AMA and the lack of comparability arising from a wide range of internal modeling practice have exacerbated variability in risk-weighted asset calculations The Committee has therefore determined that the withdrawal of internal modelling approaches for operational risk regulatory capital from the Basel Framework is warranted.”).

calculate operational risk,⁶⁶³ which uses a combination of financial statement information and banks' internal loss experience to calculate operational risk.⁶⁶⁴ The SMA reflects the past operational losses of a particular bank as a proxy for future operational capital needs.⁶⁶⁵

C. U.S. Reaction to Basel III Proposals

1. Credit Risk

Under the Obama administration, the U.S. regulatory representative to the Basel Committee's Group of Governors and Heads of Supervision, the Federal Reserve, strongly supported the proposed Basel III reforms to credit risk.⁶⁶⁶ Daniel Tarullo, who resigned from the Federal Reserve System's Board of Governors in April 2017, supported the credit risk reforms to place constraints on IRB models and to implement an output floor.⁶⁶⁷ With his departure from the Board of Governors and President Trump's pending appointment of three individuals to the seven-member body, however, it is uncertain whether the Federal Reserve will continue to push for more stringent regulation of credit risk.⁶⁶⁸ Given President Trump's general deregulatory outlook on Dodd-Frank and banking regulations,

⁶⁶³ *Id.* at 3.

⁶⁶⁴ *Id.*

⁶⁶⁵ *See id.*

⁶⁶⁶ Jesse Hamilton & Robert Schmidt, *Forget Treasury Secretary. This Pick Matters Most to Banks*, BLOOMBERG (Nov. 22, 2016), <https://www.bloomberg.com/news/articles/2016-11-22/forget-treasury-secretary-this-trump-pick-matters-most-to-banks> [<https://perma.cc/CLD6-UD4C>] (discussing Tarullo's reputation as an "alpha dog," aggressively pursuing capital regulation and supporting Basel III reforms).

⁶⁶⁷ *See* Tarullo, *supra* note 7, at 15 ("But, in light of all that has happened in the last decade, I see little reason to maintain the requirements of the IRB approach for our largest banks."); John Kehoe, Opinion, *Donald Trump Can Shake Up Global Banking*, AUSTRALIAN FIN. REV. (Feb. 13, 2017), <http://www.afr.com/opinion/columnists/donald-trump-can-shake-up-global-banking-20170212-gub9d0> [<https://perma.cc/MSJ5-6HU2>] ("Under Tarullo, the US is pushing for a capital floor that is at least 75 per cent of the standard approach.").

⁶⁶⁸ Binyamin Appelbaum, *Fed's Proponent for Regulation to Depart, Leaving 3 Vacancies*, N.Y. TIMES (Feb. 10, 2017), https://www.nytimes.com/2017/02/10/us/politics/daniel-tarullo-federal-reserve.html?_r=0 [<https://perma.cc/6VGV-THVH>].

it would not be surprising if his appointments to the Federal Reserve oppose the current proposals on credit risk.⁶⁶⁹

For U.S. banks, the impact of the proposed reforms to credit risk under Basel III would not be significant.⁶⁷⁰ First, U.S. banks with under \$250 billion in assets already use a standardized approach to calculate credit risk, and thus would not be impacted by the removal of IRB approaches.⁶⁷¹ For those U.S. banks with assets over \$250 billion that use an IRB approach for credit risk, the proposals would not be a significant change,⁶⁷² because U.S. banks that use an IRB approach are already subject to additional credit risk capital requirements under the Collins Amendment to the Dodd-Frank Act “that are more stringent than the [Basel Committee’s] proposal’s restrictions on the use of internal models.”⁶⁷³ Under the Collins Amendment,⁶⁷⁴ U.S. banks must calculate credit RWAs under both the IRB and standardized approach and are bound by the approach that yields a higher value for RWAs.⁶⁷⁵ Thus, U.S. banks are already subject to an output floor of 100 percent of RWAs.⁶⁷⁶ Therefore, the Basel III proposed reforms would help “narrow the gap between US and non-US banking entities” so that U.S. banks are not at such a competitive disadvantage.⁶⁷⁷

⁶⁶⁹ See Hamilton & Schmidt, *supra* note 74 (“On the campaign trail, Trump frequently argued that government red tape was stifling the economy, and his official transition website says the incoming administration wants to dismantle Dodd-Frank.”).

⁶⁷⁰ DAN RYAN ET AL., FIVE KEY POINTS FROM BASEL’S PROPOSED RESTRICTIONS ON INTERNAL MODELS FOR CREDIT RISK, PwC 1 (2016), <https://www.pwc.com/us/en/financial-services/regulatory-services/publications/assets/basel-models-credit-risk-march-2016.pdf> [<https://perma.cc/9XH5-6CEJ>].

⁶⁷¹ Press Release, Bd. of Governors of the Fed. Reserve Sys., 2007 Banking and Consumer Regulatory Policy (Nov. 2, 2007), <https://www.federalreserve.gov/newsevents/press/bcreg/20071102a.htm> [<https://perma.cc/X7QX-2KEF>].

⁶⁷² RYAN ET AL., *supra* note 77.

⁶⁷³ *Id.*

⁶⁷⁴ See 12 U.S.C. §5371(b)(2) (2012) (“[T]he minimum risk-based capital requirements established under this paragraph shall not be less than the generally applicable risk-based capital requirements, which shall serve as a floor for any capital requirements that the agency may require, nor quantitatively lower than the generally applicable risk-based capital requirements that were in effect for insured depository institutions as of July 21, 2010.”).

⁶⁷⁵ See *id.*

⁶⁷⁶ RYAN ET AL., *supra* note 77.

⁶⁷⁷ *Id.*

2. Market Risk

The FRTB proposals to place more instruments on the trading book and to restrict and tighten the internal models for calculating market risk would affect U.S. banks.⁶⁷⁸ An interim quantitative impact study (QIS) from the Basel Committee on the FRTB revealed that the average increase in the total market risk capital requirement would be 41 percent,⁶⁷⁹ which would increase the overall Basel III minimum capital requirements for banks by 4.7 percent.⁶⁸⁰ In addition to the extra capital that may be required under the FRTB proposal, the P&L attribution testing and backtesting may lead to additional compliance costs in the short term for banks that use an internal model approach.⁶⁸¹

3. Operational Risk

The proposal to replace the AMA approach with the SMA approach will likely have a minimal impact on U.S. banks, although the extent of the impact remains unknown until the Basel Committee's QIS is finalized.⁶⁸² Most large U.S. banks that use an AMA approach measure operational risk using a loss distribution approach that is similar to the proposed SMA.⁶⁸³ Under the loss distribution approach, banks quantify the frequency and severity of operational risk losses for each business line or event type over a one-year horizon.⁶⁸⁴ On average, the five largest U.S. banks report operational risk at 28 percent of RWAs, which is considerably higher than similarly situated

⁶⁷⁸ DELOITTE, NAVIGATING THE YEAR AHEAD: BANKING REGULATORY OUTLOOK 2017 11 (2016), <https://www2.deloitte.com/us/en/pages/regulatory/articles/banking-regulatory-outlook.html> [<https://perma.cc/STK4-38X5>].

⁶⁷⁹ See BASEL COMM. ON BANKING SUPERVISION, FUNDAMENTAL REVIEW OF THE TRADING BOOK—INTERIM IMPACT ANALYSIS 3 (2015), <http://www.bis.org/bcbcs/publ/d346.pdf> [<https://perma.cc/N8LC-XRLV>].

⁶⁸⁰ *Id.* at 2.

⁶⁸¹ See DELOITTE, *supra* note 85, at 12.

⁶⁸² DAN RYAN, PwC, TEN KEY POINTS FROM BASEL'S STANDARDIZED MEASUREMENT APPROACH FOR OPERATIONAL RISK 3 (2016), <http://www.pwc.com/us/en/financial-services/regulatory-services/publications/assets/basel-operational-risk-proposal-march-2016.pdf> [<https://perma.cc/CA6A-Y9RL>].

⁶⁸³ See LYONS ET AL., *supra* note 48, at 3.

⁶⁸⁴ BASEL COMM. ON BANKING SUPERVISION, CONSULTATIVE DOCUMENT, OPERATIONAL RISK 11 (2001) <https://www.bis.org/publ/bcbcsca07.pdf> [<https://perma.cc/BAE7-XMLS>].

European banks that report operational risk at 12 percent of RWAs.⁶⁸⁵ Thus, the SMA change for operational risk will likely have a greater impact on non-U.S. banks that rely more on scenario-based models to calculate operational risk than U.S. banks that use the loss distribution approach.⁶⁸⁶

D. Reaching Consensus on Basel III's Proposed Reforms

1. European Resistance

European banks and regulators have been most critical of the proposed reforms to Basel III.⁶⁸⁷ Since European banks are heavily dependent upon IRB approaches for credit, market, and operational risk, movement towards standardized approaches will require them to hold more capital.⁶⁸⁸ One study estimates that European banks in aggregate will need to hold an additional €860 million in capital.⁶⁸⁹ One important structural difference between the United States and Europe is the ability of U.S. banks to securitize mortgages and off-load them to government agencies such as Fannie Mae and Freddie Mac.⁶⁹⁰ Since European banks must retain mortgages, this greatly increases the size of their RWAs under a standardized approach.⁶⁹¹ Further, Europe's economy is far more dependent on banks for financing than

⁶⁸⁵ LYONS ET AL., *supra* note 48, at 3.

⁶⁸⁶ *See id.*

⁶⁸⁷ *See, e.g.,* Silla Brush, *EU Calls for Sweeping Changes to Basel Bank-Capital Proposal*, BLOOMBERG (Sept. 29, 2016), <https://www.bloomberg.com/news/articles/2016-09-29/eu-calls-for-sweeping-changes-to-basel-bank-capital-proposals> [<https://perma.cc/S2NQ-FMRE>] (“Global banking regulators need to make sweeping changes to proposed new rules to protect European Union lenders against a spike in capital requirements . . .”).

⁶⁸⁸ *See id.* (explaining how major European banks such as HSBC, Deutsche Bank, Societe General, and Credit Agricole rely on IRB approaches).

⁶⁸⁹ LYONS ET AL., *supra* note 48, at 2.

⁶⁹⁰ *Id.* at 3; **Frédéric Oudéa**, *New Basel Banking Rules' Impact on European Economy*, FIN. TIMES (Nov. 28, 2016), <https://www.ft.com/content/6b2642b4-b54d-11e6-961e-a1acd97f622d> [<https://perma.cc/DYM9-QHK2>].

⁶⁹¹ **Oudéa**, *supra* note 97 (“[F]avourable weights for well-rated and well-secured credits have encouraged EU banks to keep these [residential mortgage] loans on their balance sheets.”); LYONS ET AL., *supra* note 48, at 3 (“European banks tend to retain mortgages originated by them . . .”).

the U.S. economy.⁶⁹² For example, banks in Europe account for 70 percent of financing for businesses while banks in the U.S. account for 30 percent.⁶⁹³ The increased capital requirements would impede the ability of European banks to lend to businesses and therefore have a much bigger macroeconomic impact than in the United States where capital markets supply funding and loans for businesses.⁶⁹⁴ The European Union will not implement any of the Committee's final rules according to European Commission Vice President Vladis Dombrovskis, because "when [Europe is] focused on supporting investment, [Europe] want[s] to avoid changes which would lead to a significant increase in the overall capital requirements shouldered by Europe's banking sector."⁶⁹⁵

2. Consensus and Trump's Impact

The Basel Committee has put its proposals to strengthen credit, market, and operational risk requirements on hold until 2019,⁶⁹⁶ and the results of the Basel Committee's QIS for proposed revisions to credit and operational risk have yet to be released.⁶⁹⁷ The United States and Europe are having difficulty reaching consensus on the proposed output floor for credit risk.⁶⁹⁸ U.S. regulators have lobbied for a high output floor so that it has a meaningful impact, while Europe has lobbied for either a low output floor or no floor at all.⁶⁹⁹ The election of President Trump further complicates the ability to reach a

⁶⁹² See LYONS ET AL., *supra* note 48, at 3 ("[I]n the European Union SMEs are more reliant upon bank funding compared to the United States, where there is better access to capital markets to provide debt financing.").

⁶⁹³ *Id.*

⁶⁹⁴ Brush, *supra* note 94 ("A solution we could not support is one which would weigh unduly on the financing of the broader economy in Europe[.]") (internal quotes omitted).

⁶⁹⁵ *Id.*

⁶⁹⁶ Binham, *supra* note 12.

⁶⁹⁷ Reiners, *supra* note 42.

⁶⁹⁸ Caroline Binham & Emma Dunkley, *Basel Postpones Banks Reform Vote Amid Policy Differences*, FIN. TIMES (Jan. 3, 2017), <https://www.ft.com/content/589f1ce0-d1a1-11e6-9341-7393bb2e1b51> [<https://perma.cc/PJ9B-D979>].

⁶⁹⁹ See *id.* ("The US has pushed for output floors but European banks—and recently, some policymakers—have argued the measure will force some banks to significantly increase their capital at a time when they are already subject to headwinds such as historically low interest rates and low profitability.").

consensus.⁷⁰⁰ The Vice Chairman of the Financial Services Committee has instructed the Federal Reserve to halt all negotiations on Basel III until the new administration provides guidance.⁷⁰¹

The new Trump administration will either continue or cease U.S. support for the Basel III reforms.⁷⁰² President Trump's administration may continue U.S. support for the Basel III reforms,⁷⁰³ especially if Thomas Hoenig replaces Tarullo as the Head of Supervision on the Federal Reserve.⁷⁰⁴ Janet Yellen, the Chairman of the Federal Reserve until January 2018, will likely exert her influence to support the Basel III reforms regardless of who replaces Tarullo.⁷⁰⁵ Further, the Trump administration may support the Basel III reforms to bring about competitive equality between U.S. and non-U.S. banks.⁷⁰⁶ Since U.S. banks are already subject to more stringent capital requirements under Dodd-Frank, supporting the Basel III reforms would require non-U.S. banks to be held to similar standards.⁷⁰⁷

On the other hand, the Trump administration may effectively cease support for Basel III reforms.⁷⁰⁸ First, Trump will influence the Federal Reserve System's Board of Governors with three new appointments.⁷⁰⁹ Large U.S. banks are hopeful that the new Federal

⁷⁰⁰ *Id.*

⁷⁰¹ See Letter from Patrick T. McHenry, Vice Chairman, Comm. on Fin. Servs., to Janet L. Yellen, Chair, Bd. of Governors of the Fed. Res. Sys. (Jan. 31, 2017), <https://ftalphaville-cdn.ft.com/wp-content/uploads/2017/02/02104940/McHenry-letter-to-Yellen.pdf> [<https://perma.cc/UZ5X-4NUB>].

⁷⁰² See Julia-Ambra Verlaine, *Global Financial Regulation Faces Uncertain Future After Trump's Order*, WALL ST. J. (Feb. 6, 2017), <https://www.wsj.com/articles/global-financial-regulation-faces-uncertain-future-after-trumps-order-1486405041> [<https://perma.cc/LNP3-JXNU>].

⁷⁰³ See Kehoe, *supra* note 74.

⁷⁰⁴ Hamilton & Schmidt, *supra* note 73.

⁷⁰⁵ *Id.* ("While the Fed supervision chief would likely be a key role for regulating banks under Trump, the job still doesn't carry the clout that Janet Yellen wields as chairman. So if Trump's vice chairman tried to weaken Dodd-Frank, the official could face a tough first year should Yellen fulfill her promise to stick around until January 2018.")

⁷⁰⁶ See RYAN ET AL., *supra* note 77.

⁷⁰⁷ *See id.*

⁷⁰⁸ *Shearing and Shaving: Remaking American Financial Regulation*, THE ECONOMIST (Feb. 11, 2017), <http://www.economist.com/news/finance-and-economics/21716622-donald-trump-starts-long-struggle-overhaul-dodd-frank-act-remaking> [<https://perma.cc/98R4-LGAD>].

⁷⁰⁹ See Appelbaum, *supra* note 75 (addressing Republican pressure for Trump

Reserve of Supervision will not share Tarullo's views in imposing strict capital requirements on banks.⁷¹⁰ Second, the Trump administration may support efforts of Republicans in Congress to withdraw from international banking agreements in favor of national regulation.⁷¹¹ Gary Cohn, Trump's chief economic advisor, supports this sentiment that international competition through national regulation is better than international cooperation.⁷¹² Thus, even if the Federal Reserve supports and implements the proposed Basel III reforms, these efforts could be undermined by new legislation in the United States.⁷¹³

For example, Republicans' Financial CHOICE Act proposes for making significant changes to Dodd-Frank.⁷¹⁴ If enacted in its current state, the Financial CHOICE Act creates an "off-ramp" for banks to exempt them from all Basel III regulations.⁷¹⁵ Under the Financial CHOICE Act, banks would need to have a one or two Capital adequacy, Asset quality, Management, Earnings, and Liquidity score (CAMELS) and a Tier 1 leverage ratio that exceeds 10 percent to be exempted from Basel III regulations.⁷¹⁶ The eight largest U.S. banks do not currently have a leverage ratio in excess of 10 percent, and the average is approximately 5.75 percent.⁷¹⁷ Unless these banks are effective at lobbying to change the proposed legislation, they would not be able to take advantage of the Basel III exemptions without

to fill the vacant seats on the Federal Reserve Board of Governors with individuals supportive of deregulatory efforts and lower capital standards).

⁷¹⁰ See Hamilton & Schmidt, *supra* note 73.

⁷¹¹ See McHenry, *supra* note 108 (emphasizing the importance of placing a higher value on America's self-interests than "secretive" international agreements among "global bureaucrats").

⁷¹² Tracy Ryan, *Gary Cohn's Vision for a Regulatory Rethink*, WALL ST. J. (Feb. 3, 2017), <https://www.wsj.com/articles/white-house-plans-broad-rethink-on-regulating-big-financial-firms-1486116003> [<https://perma.cc/KWH6-NMPA>].

⁷¹³ See DELIOTTE, *supra* note 85, at 12.

⁷¹⁴ See generally Norbert J. Michel, *Money and Banking Provisions in the Financial CHOICE Act: A Major Step in the Right Direction*, BACKGROUND-ER (Heritage Found., Wash. D.C.), Aug. 31, 2016, <http://www.heritage.org/markets-and-finance/report/money-and-banking-provisions-the-financial-choice-act-major-step-the> [<https://perma.cc/297S-PUUC>].

⁷¹⁵ *Id.*

⁷¹⁶ See DELIOTTE, *supra* note 85, at 12.

⁷¹⁷ THE ECONOMIST, *supra* note 115.

acquiring additional capital.⁷¹⁸ Thus, a retreat from Basel to national solutions will still place strict capital requirements on U.S. banks.⁷¹⁹

E. Conclusion

During the financial crisis and beyond, banks under the Basel III regulatory framework used IRB models to calculate RWAs to their own advantage.⁷²⁰ In an effort to thwart the use of IRB models, the Basel Committee released proposals to encourage the use of standardized approaches and to greatly restrict the use of IRB models for calculating credit, market, and operational risks.⁷²¹ While U.S. banks would not be severely impacted by these proposals, European banks will likely struggle to implement the new proposals due to additional capital requirements.⁷²² President Trump and a Republican-controlled Congress leave the future uncertain for further Basel III reform implementation.⁷²³ The United States could continue to support the proposed Basel III reforms so that European banks are held to higher capital standards,⁷²⁴ or the United States could effectively abandon its commitment to the Basel III reforms with legislation exempting qualified large U.S. banks from Basel III requirements.⁷²⁵ Still, even under this second scenario, U.S. banks will likely be subject to high leverage ratios and capital requirements.⁷²⁶

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⁷¹⁸ See Yalman Onaran, *Trump Will End Bank Rules. No He Won't. A Guide for the Puzzled*, BLOOMBERG (NOV. 30, 2016), <https://www.bloomberg.com/news/articles/2016-11-30/trump-will-end-bank-rules-no-he-won-t-a-guide-for-the-puzzled> [<https://perma.cc/E7EY-EQ3F>].

⁷¹⁹ *Id.*

⁷²⁰ See Markus Behn et al., *The Limits of Model-Based Regulation 3* (Eur. Central Bank, Working Paper No. 1928, 2016), <http://www.ecb.europa.eu/pub/pdf/scpwps/ecbwp1928.en.pdf> [<https://perma.cc/B6WX-8AMQ>].

⁷²¹ See discussion *supra* Section B.

⁷²² LYONS ET AL., *supra* note 48, at 2–3.

⁷²³ See Kehoe, *supra* note 74.

⁷²⁴ See RYAN ET AL., *supra* note 77.

⁷²⁵ See DELOITTE, *supra* note 85, at 12.

⁷²⁶ See Onaran, *supra* note 125.

⁷²⁷ Student, Boston University School of Law (J.D. 2018).