SMALL BUSINESS

Bank failures, bank rules and the stifling of the American dream

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MOUNTAIN STATES
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Introduction

What does a flooding river and bank regulation have in common? Imagine a rushing river flowing rapidly through its path. A fence borders both sides of the river and the dam above the river is full. Surprisingly, a large snow melt explodes the volume of water flowing down the river, knocking out the fence and destroying much in its path. But instead of recognizing the mismanagement of the snow melt to prevent the situation in the future, the remedy is to build a higher fence.

That is exactly how the American financial industry is being treated. Our nation's 'river' of financial investment is encumbered by a capital requirement 'fence'. Considering recent bank failures overflowing the system, regulators are opting to make this fence higher instead of recognizing the diverse and specific causes of the bank failures. The higher fence of capital requirements will dehydrate a waning economy and deprive citizens of the American dream.

KEY INFORMATION COLUMN

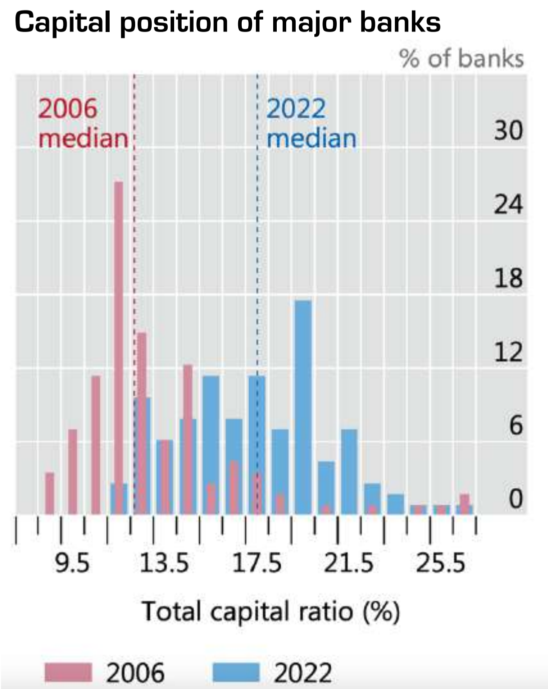
The Basel III regulatory requirements are proposed for banking institutions already exceeding the existing capital requirements.

Background

In the spring of 2023, the failure of Silicon Valley Bank was announced, leaving billions of dollars in uninsured deposits. The bank poorly managed its portfolio, relying on bond investments (which rapidly devalued following interest rate hikes) and allowed large numbers of deposits above the $250,000 insurance limit. The customer portfolio relied heavily on technology companies whose transactions for bills and payroll always had the accounts above the limit. The following days were followed by two more bank failures, each with their own debacles.

The failure of these banks was a perfect opportunity for policy makers to intensify the already proposed regulations for the banking industry known as "Basel III Endgame." The additional regulatory proposals would have increased capital requirements for the largest of all banks and, according to the supporters, only affect the largest financial institutions.[5] But like most government regulations designed to target the largest of the large, it will be the smallest economic participants severely harmed.[6]

The proposed increase in capital requirements will limit the ability for small businesses and low-income consumers to obtain financing. As a small business owner, the challenges in obtaining financing are diverse: credit history and longevity, risk, changing financial ratios, varying opinions within the same bank, inadequate funding, the list goes on and on. To our economy's detriment, farmers, small businesses, and low-income earners are going to have an even more difficult time obtaining financing due to the proposed Basel III Endgame rules.



This regulatory requirement is proposed for banking institutions already exceeding the existing capital requirements. Banks have significantly improved their capital ratios since the financial crisis of 2008. The median capital ratio in 2006 was about 12.5%, whereas

[5] Wessel, David, "What is bank capital? What is the Basel III Endgame?" Brookings, 7 March 2024, available at https://www.brookings.edu/articles/what-is-bank-capital-what-is-the-basel-iii-endgame

[6] Bernal, K. "The Impact of Government Regulations on Small Business Enterprises," ExecutiveGov, 22 June 2022, available at https://executivegov.com/2022/06/the-impact-of-government-regulations-on-small-business-enterprises/#Why_are_small_businesses_most_affected_by_government_regulations

KEY INFORMATION COLUMN

"Basel III Endgame" increases the rules regarding credit, capital, and investment risk.

12 years later the ratio had risen by more than five percent. According to a G-SIBs (Global systemically Important Banks) employee interviewed by MSPC for this study, during the last stress test in April 2024 all banks passed well above the mandatory floor.[7]

The Basel III Endgame requirements unfairly punish healthy banks, because of the mismanagement of three short-sighted and poorly managed operations. In fact, the new regulations would not have prevented any of the bank failures in March of 2023.[8] But the federal government has proceeded with the new rules anyway. Growing rumors and recent commentary from banking regulators indicate a revised and scaled down version of the previously proposed Basel III Endgame rules is imminent.[9]

Basel Committee on Banking Supervision (BCBS)

The Basel Committee on Banking Supervision (BCBS) was established in 1974 and meets in Basel, Switzerland. It sets global recommendations for regulations to be adopted within its 28 member countries/jurisdictions.[10] Basel III was developed over several iterations following the financial crisis.[11]

In 2010, the BCBS released its original response to the financial crisis, using its Basel II standards as a foundation. This became known as Basel III. More technical details and standards were issued in 2017.[12] The final portion of these rules dubbed, "Basel III Endgame," increases the rules regarding credit, capital, and investment risk. The purposed of these revisions according to the BCBS committee is,

> *"A key objective of the revisions ... is to reduce excessive variability of risk-weighted assets (RWAs) ... [and] help restore credibility in the calculation of RWAs by: (i) enhancing the robustness and risk sensitivity of the standardized approaches for credit risk and operational risk, which will facilitate the comparability of banks' capital ratios; (ii) constraining the Bank Capital Requirements: Basel III Endgame Congressional Research Service 3 use of internally-modelled approaches; and (iii) complementing the risk-weighted capital ratio with a finalized leverage ratio and a revised and robust capital floor."*[13]

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[7] MSPC Interview with GSIB on Tuesday 6 August 2024.
[8] Benton, Hu and Hugh Carney, "Fact check: debunking seven key misconceptions in the Basel III proposal," ABA Banking Journal from the American Bankers Association, 13 October 2023, available at https://bankingjournal.aba.com/2023/10/fact-check-debunking-seven-key-misconceptions-in-the-basel-iii-proposal/
[9] "Capital: FRB Remarks Outlining Basel III Endgame Re-Proposal," KPMG, September 2024, https://kpmg.com/us/en/articles/2024/capital-frb-remarks-outlining-basel-iii-ndgame-reproposal-reg-alert.html
[10] Basel Committee membership, BIS: Bank for International Settlements, 14 May 2024, available at https://www.bis.org/bcbs/membership.htm
[11] Wessel, David, "What is bank capital? What is the Basel III Endgame?" Brookings, 7 March 2024, available at https://www.brookings.edu/articles/what-is-bank-capital-what-is-the-basel-iii-endgame
[12] "Bank Capital Requirements: Basel III Endgame," Congressional Research Service, R47855, 30 November 2023, available at https://crsreports.congress.gov/product/pdf/R/R47855
[13] BCBS, Basel III.

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The United States has been slow to adopt this final rule. Most other member countries have moved forward in approval and are in the process of implementing the new guidelines. Not to be outdone because of procrastination, U.S. regulators gold plated the requirements proposed in July 2023, for U.S. banks, downgrading the country's potential for international competitiveness.[14]

The United States government has already implemented and fine-tuned domestic policy solutions to prevent a repeat of the 2007-2008 financial crisis.

Notably, the Basel recommendations were not performed in a vacuum. The United States government has already implemented and fine-tuned domestic policy solutions to prevent a repeat of the 2007-2008 financial crisis. The Dodd-Frank Act is a major component of these preventions. But for the banking industry and most especially the loan-seekers, Basel III adds to the regulatory burden instead of complimenting existing efforts.

U.S. Regulatory Proposal for Basel III Endgame

After much delay, the Basel III Endgame was acted upon by U.S. federal regulators and proposed through the rule making process of the executive branch in July of 2023.[15] The Basel III Endgame rules apply to banks with over $100 billion in assets targeting 29 banks.[16]

A broad view of these rules means larger banks must increase their capital requirement. Theoretically, an increasing capital ratio improves the solvency of the bank. This is true in part, but the increasing capital requirement has negative impacts on the economy and can create unintentional harm on the banking institutions when the level is raised too high. Capital requirements are calculated by capital over the risk weighted assets (RWA).

A broad view of these rules means larger banks must increase their capital requirement.

$$capital\ ratio = \frac{capital}{risk\ weighted\ asset}$$

Capital is a bank's assets (loans and securities investments) minus its liabilities (deposits and debts).[17] Capital is an essential requirement to mitigate the risk inherent in loaning money, because some people will default. The magnitude of

[14] "Basel III implementation: global consistency challenges," EUROFI Seminar, February 2024, Banking and Insurance Regulation, available at https://www.eurofi.net/wp-content/uploads/2024/04/the-eurofi-financial-forum_ghent_basel-iii-implementation-global-consistency-challenges_summary_february-2024.pdf
[15] "Bank Capital Requirements: Basel III Endgame," Congressional Research Service, R47855, 30 November 2023, available at https://crsreports.congress.gov/product/pdf/R/R47855
[16] "Large Commercial Banks," Federal Reserve Statistical Release, As of June 30, 2024, available at https://www.federalreserve.gov/releases/lbr/current/
[17] "Bank Capital Requirements: A Primer and Policy Issues," Congressional Research Service, R47447, 9 March 2023, available at https://crsreports.congress.gov/product/pdf/R/R47447

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As capital requirements increase because of new RWA calculations, borrowing will become more expensive, dividends will be complicated, and consumer lending will see reductions in credit cards, auto loans, and mortgage loans.

the default risk varies between different assets (loans) and so the calculation must reflect the variance.

Risk Weighted Assets addresses this variability of risk among different assets. It is important that RWA is used versus a non-weighted asset measurement. Banks should not be incentivized to make risky investments without accounting for liquidity. RWA is a tool to account for risk and safety in investments, though in 2008 the tool failed to weigh the risk accurately and large losses incurred.

A large portion of the Basel III Endgame proposal focuses on the RWA calculation for larger banks. Unfortunately, the new weighted risks were made by U.S. regulators without quantitative evidence for the new metrics. Reweighting the risk assets will knock many parts of the economy askew.

As capital requirements increase because of new RWA calculations, borrowing will become more expensive, dividends will be complicated, and consumer lending will see reductions in credit cards, auto loans, and mortgage loans. This will be a surmountable fence for wealthier, high credit scoring members of our economy, but for most Americans the new fences will be insurmountable.

The Basel III Endgame will cause capital increases through:[18]

- *Fundamental Review of the Trading Book (FRTB) which requires a new Profit and Loss Attribution Test (PLAT) in addition to the existing Boundary Test (BT) for market risk assessment*
    - *Both tests must be passed, or bank must use the regulator's risk assessment model, increasing capital requirements*
- *New Standardized Capital Buffer (SCB) exceeds the global buffer and duplicates the FRTB. SCB is set as a floor and can fluctuate, whereas the global Capital Conservation Buffer (CCB) is set at 2.5%*
- *The interaction between the FRTB and the Collins Floor, an amendment of the Dodd-Frank Act, will put U.S. businesses at a distinct disadvantage to EU banks*
- *Excessive regulations and oversight will encourage banks to forgo specific and advanced risk modeling techniques*

Basel III Endgame Impact on the United States

Is there a benefit to the proposed Basel III Endgame requirements in the U.S.? The only benefit seems to be for other global players who have lower requirements, creating a competitive edge over the U.S. financial industry. On a $15 million dollar loan in the U.S., banks would need at least $975,000 in

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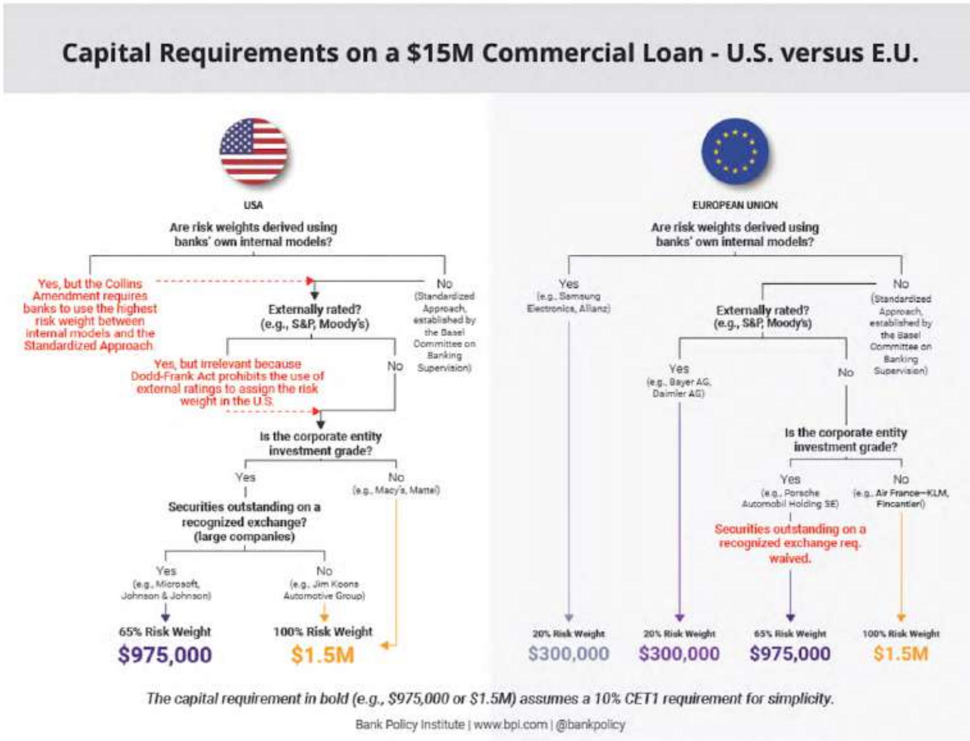
[18] Moore, Stephen and David Malpass, "The Cost of Implementing the Basel III Endgame Framework: Higher Capital Rules Will Hurt Small Businesses and Middle Class Borrowers the Most," Committee to Unleash Prosperity, 9 February 2024, available at https://www.federalreserve.gov/SECRS/2024/February/20240209/R-1813/R-1813_011624_156900_343476632430_1.pdf

KEY INFORMATION COLUMN

This summer, competing countries like the European Union chose to postpone adoption for one year, to "ensure[s] a global level playing field and… to see what others are doing."

capital to cover the loan if it is publicly traded company or $1.5 million if it is not investment grade. In the EU more options exist for the loans, with capital requirements beginning at $300,000 up to $1.5 million. A bank has a lot more flexibility to do business when fewer dollars are set aside to meet capital requirements.[19] This summer, competing countries like the European Union chose to postpone adoption for one year, to "ensure[s] a global level playing field and… to see what others are doing."[20]



Public comments received on the proposed Basel III Endgame made clear how dangerous this rule will be for the United States. The Banking Agencies of the United States including the Federal Reserve, Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC) received the public commentary until January 16, 2024. According to a study by Latham & Watkins, more than 97% of the comment letters (356 in total) opposed the proposal in full or in part. Only nine letters supported the rule.[21]

Diverse voices commented on the proposed rule change, with 86% of the negative comments coming from outside of the banking sector. Domestic and international interests in addition to a large portion of Congress opposed the

[19] Moore, Stephen and David Malpass, "The Cost of Implementing the Basel III Endgame Framework: Higher Capital Rules Will Hurt Small Businesses and Middle Class Borrowers the Most," Committee to Unleash Prosperity, 9 February 2024, available at https://www.federalreserve.gov/SECRS/2024/February/20240209/R-1813/R-1813_011624_156900_343476632430_1.pdf
[20] Jones, Huw, "EU to delay core element of Basel bank capital reforms by one year," Reuters, 18 June 2024, available at https://www.reuters.com/business/finance/eu-says-delay-core-element-basel-bank-capital-rules-2024-06-18
[21] "Comments on the Basel III Endgame Proposal, Opposition and significant concerns dominate the record,"Latham & Watkins, 2 February 2024, available at https://www.lw.com/admin/upload/SiteAttachments/comments-basel-III-endgame-proposal.pdf

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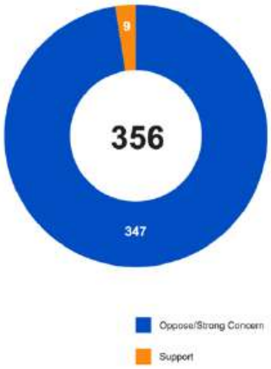
proposal. Of upmost concern to this paper is understanding the regional impacts of the Basel III Endgame. From an analysis of the commentary, the largest number of comments were received from the southeast and the upper Midwest.

Public comments on Basel III Endgame regulations



Geographic distribution of comments

These regional differences highlight some of the key concerns of the proposal, that low-income consumers will be discouraged and hurt by the new capital requirements, small businesses will struggle to find financing, and the cyclical nature of agricultural business lending will limit funding for farm and ranch loans.

According to a study by Latham & Watkins, more than 97% of the comment letters (356 in total) opposed the proposal in full or in part. Only nine letters supported the rule.

What exactly is the economic hurt? The Securities Industry and Financial Markets Association (SIFMA) recently found that for every one percentage point increase in capital requirements, the availability of assets will decrease by $16.26 billion.[22] On the low-end, with just the FRTB involved in the estimate the capital requirement will increase over 8% resulting in over $136 billion disappearing from the financial investment pool of the United States. That is about 0.5% of annual GDP disappearing from our economy.

The Federal Reserve, the FDIC, and the Office of the Comptroller of the Currency (OCC) heard this outrage and the onerous financial restrictions proposed and are currently reconsidering a re-proposal. No official statement has been made, but previewed changes suggest lower capital burdens, simpler calculations for banks between $100 and $700 billion, and restricting the most difficult requirements to the eight U.S. G-SIBs.[23]

[22]Zhang, Guowei, Peter Ryan, and Carter McDowell, "Identifying an Optimal Level of Capital and Evaluating the Impact of Higher Bank Capital Requirements on US Capital Markets," SIFMA, 15 May 2023, available at https://www.sifma.org/resources/news/identifying-an-optimal-level-of-capital-and-evaluating-the-impact-of-higher-bank-capital-requirements-on-us-capital-markets

[23] "Updated Rules of the Endgame: What Financial Institutions Should Know," Forvis Mazars, 24 September 2024, available at https://www.forvismazars.us/forsights/2024/09/updated-rules-of-the-endgame-what-financial-institutions-should-know

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For every dollar of banking assets in the banking industry, 81 cents is subject to the new regulations.

Housing is already a pressing concern in the Mountain States, as housing costs have skyrocketed due to tightening supply and increasing interest in the region.

Costs of Basel III Endgame

Basel III Endgame is expected to increase capital requirements up to 16% for banks with assets over $100 billion, or only the 8 G-SIBs under the hinted re-proposal. The few supporters may argue that the costs are warranted and that the changes will only affect the largest institutions. However, like almost every regulation targeting the largest players, it will be the smallest players substantially harmed.

For every dollar of banking assets in the banking industry, 81 cents is subject to the new regulations.[24] These eight banks hold $93 billion in small business loans and $811 billion in consumer loans. By the capital requirements toppling over 16%, there will be higher borrowing costs and less access to capital for smaller and mid-size consumer and businesses.

In a discussion with a large GSIB, MSPC found that this bank would be forced to only fund mortgages from the wealthiest of clients with the highest credits scores of at least 760-780.[25] Currently this banking institution considers credit scores at 620 or above. As noted in the public commentary of many housing non-profits, this proposal will negatively impact low- and moderate-income borrowers, especially minority groups.

Impact of Basel III Endgame in the Mountain States

The Mountain States region is poised to be heavily impacted by the Basel III Endgame proposal. A quick look at the region shows we have consumers extremely vulnerable to housing challenges, many people employed by small businesses, and even more employed by agriculture.

Housing is already a pressing concern in the Mountain States, as housing costs have skyrocketed due to tightening supply and increasing interest in the region. Many of the counties in Idaho, Montana, Washington, and Western Wyoming are unaffordable for median-income households looking for a median-priced home. The proposed regulations will exasperate this existing challenge and make it harder for these median-income households to access mortgages.[26]

The Mountain States are proudly home to many small businesses, with some of the largest shares of employees working at small businesses within the state. According to the Statistics of U.S. Businesses, Montana, Wyoming, and Idaho have large shares of employees working at small businesses. However, if

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[24] Hagenbaugh, Barbara, "The Basel III Endgame Proposal – Separating Fact from Fiction," Financial Services Forum, 14 November 2023, available at https://fsforum.com/news/the-basel-iii-endgame-proposal-separating-fact-from-fiction
[25] MSPC Interview with GSIB on Tuesday 6 August 2024.
[26] Cui, Jasmine and Matthew Danbury, "The homebuying affordability gap is widening across the country, creating 'an impossible market,'" NBC News, 11 June 2024, available at https://www.nbcnews.com/data-graphics/housing-affordability-worst-and-costs-highest-rcna155285

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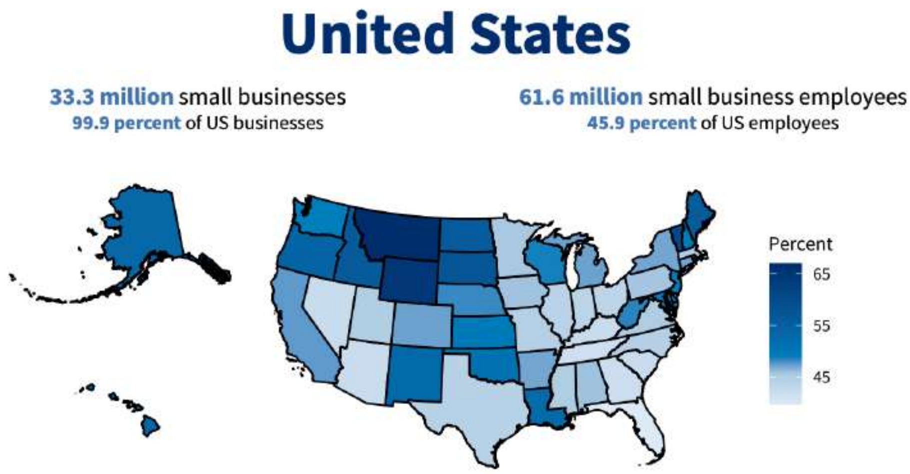
capital requirements are increased small businesses will have a harder time accessing capital to fund costs, including paying employees. There is a significant threat of an increase in unemployment in the region if these regulations are not revised.



Share of employees working at small businesses by state
Source of original data: Statistics of US Businesses (Census) [27]

Finally, the Mountain States region is poised to be heavily impacted by financing limitations to agriculture. At least 26% of jobs in Idaho and 32% of jobs in Wyoming and Montana are related to agricultural employment. When these businesses are barred from accessing capital it is only a matter of time before consolidation and bankruptcy occur. According to MSPC's interview with a GSIB, the hardest part of funding agriculture is the cyclical nature of repayment which makes it extremely difficult in meeting capital requirements. This consequence of Basel III Endgame is a large reason for the bipartisan opposition in the received comments.

The Mountain States region is poised to be heavily impacted by financing limitations to agriculture. At least 26% of jobs in Idaho and 32% of jobs in Wyoming and Montana are related to agricultural employment.

A study examining previously adopted requirements of Basel, shows that banks subject to additional capital requirements decrease their agricultural lending and exposure to agricultural risk relative to exempted banks.[28] Additional capital requirements are likely to decrease agricultural lending from large GSIBs further.

Future Steps for Basel III Endgame

The overwhelming opposition to the U.S. proposal has many in the banking agencies back pedaling or at least pausing before proceeding. Federal Reserve

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[27] 2023 Small Business Profile, U.S. Small Business Administration Office of Advocacy, available at https://advocacy.sba.gov/wp-content/uploads/2023/11/2023-Small-Business-Economic-Profile-US.pdf

[28] Nooree Kim, Kevin and Ani L Katchova, "Impact of the Basel III bank regulation on US agricultural lending," Agricultural Finance Review, Emerald Insight, 23 January 2020, available at https://www.emerald.com/insight/content/doi/10.1108/AFR-11-2019-0124/full/html#abstract

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If federal banking agencies had done their jobs and followed through on SVB's failed performance indicators earlier in the year, the bank failure could have been prevented or at least managed without excessive costs to other banks and taxpayers.

Nothing in this publication shall be construed as an attempt to aid or hinder the passage of any legislation.

chair Jerome Powell is feeling significant congressional pressure to withdraw the proposal, or at least revise. For the benefit of the mountain states, the Basel III Endgame needs to be walked back significantly. The minimum change is to bring the U.S. requirements in line with other global players, and prevent any competitive disadvantage caused by regulatory hurdles. For now, the banking industry and the other opponents are waiting on the next word from the federal banking agencies.

Conclusion

The growing fence around the river of financial opportunity in the United States hurts small and mid-sized players most of all. No amount of capital would have stopped the billions of dollars in outflows that caused the mismanaged SVB to fail along with the two other banks. In fact, if the federal banking agencies had done their jobs and followed through on SVB's failed performance indicators earlier in the year, the bank failure could have been prevented or at least managed without excessive costs to other banks and taxpayers.[29] Individual institution mismanagement and government slothfulness is not cause for industry wide reform and national economic hurt.

Low and middle income consumers cannot afford additional costs to accessing mortgages and other loans. Small business owners and their employees need access to capital to move from season to season within the business cycles. Farmers and ranchers need capital to move from planting to harvest. Basel III Endgame as proposed in the U.S. version will only hurt the economy and add unnecessary burdens to already healthy banking institutions. Instead of acting like chicken little, regulators need to see the small overflows in the system for what they are and allow Americans access to capital and the American dream.

[29] Bashur, Bryan, "Regulatory Capital Rule: Large Banking Organizations and Banking Organizations With Significant Trading Activity," Public Comment from Americans for Tax Reform, 14 January 2024, available at https://www.atr.org/letter/atr-submits-comments-in-response-to-arbitrary-bank-capital-rule

ABOUT THE AUTHOR

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Madi holds a master's degree in Agricultural and Resource Economics from Colorado State University as well as a B.S. in Environmental Economics, Policy, and Management from Oregon State University.

She is the former Director for the Initiative on Agriculture at Washington Policy Center, one of the first free market think tanks in the nation to launch a focus on Agriculture.

Before joining WPC, she worked for Ag Association Management in Tri-Cities, Washington, working with growers and industry across Washington, Oregon, and Idaho. She also spent two years as an associate of The Context Network. Her time involved working as a business analyst on various agriculture projects in production, wholesale, retail, and policy Ag sectors. She was also a wildland firefighter for four summers.

Madi's work has been published in the Idaho Statesman, The Capital Press, Tri-City Herald, and the Spokesman-Review. She is the author of several children's books that are part of MSPC's *Free Markets are for Everyone* campaign.

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