FINANCIAL SERVICES FORUM

Basel III Endgame Capital Requirements Would Handicap Small Businesses

Proposed capital rules would negatively impact small business lending.

Federal regulators have issued a proposal to increase capital requirements. Although the entire proposal would lead to reduced availability and increased costs for loans to small businesses, one aspect of the proposal magnifies those impacts.

What are Risk Weights for Corporate Loans?

Currently, all corporate loans receive a “risk weight” of 100 percent. For example, if a bank has a capital requirement of 10 percent, that bank would need to use $10 of equity capital to make a $100 loan. The other $90 would be sourced from a bank’s deposits. Loans requiring more equity capital are more expensive and less available than loans requiring less equity capital.

Risk Weights for Corporate Loans Under the Basel III Endgame Proposal

The proposal creates an inflexible, two-tier approach for assigning risk weights for corporate loans. Loans to companies that are publicly traded, would be eligible to be classified as “Investment Grade,” and would be assigned a 65 percent risk weight. Non-publicly traded companies, being ineligible for this classification, would always receive the higher 100 percent risk weight. **The proposal therefore severely limits the application of Investment Grade status to only the largest public companies.**

Why This is Problematic

1. **There is no connection between whether a company is high risk or low risk and whether it issues publicly traded securities.**

   Only the largest companies have the scale to issue public securities, which means smaller companies with an established strong credit record would be excluded from the Investment Grade designation.

2. **Smaller companies rely most heavily on bank borrowing.**

   According to the Census Bureau, the U.S. economy has over 28 million companies and only about 4,200 – or .015% – of these companies are publicly listed. As a result, **denying smaller creditworthy companies access to less expensive funding excludes the majority of U.S. companies** and these firms don’t have as many alternative funding sources.

Other Countries are Addressing this Issue

The UK and the EU are also implementing the reforms and have taken steps to ensure that small businesses are not denied Investment Grade status. In addition to the disadvantage relative to U.S. public companies, **small and mid-market companies in the U.S. will be disadvantaged relative to UK and EU companies,** which means they could lose out on valuable business overseas.

The Bottom Line:

Limiting the application of Investment Grade status to only the largest public companies is not based on any sensible measure of risk, is not appropriate, and would result in higher borrowing costs and reduced credit for small businesses.

For specific questions on the capital proposal, please contact **capital@fsforum.com.**