Basel III Endgame Market-Making Requirement Threatens Liquidity, Economy, and Financial Stability

FINANCIAL SERVICES FORUM

Proposed capital rules would substantially increase the cost of market-making and drive activity to less regulated nonbanks.

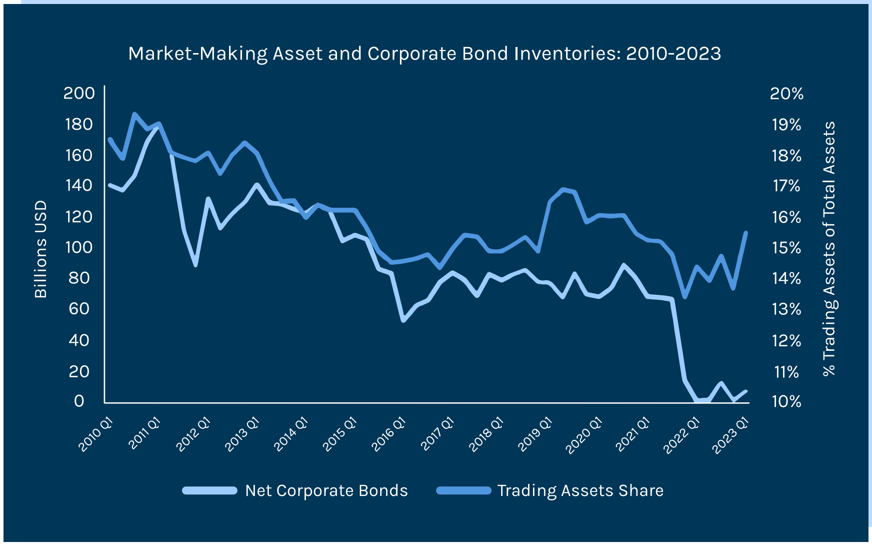
Federal regulators have issued a proposal to increase capital requirements. One aspect of the proposal – the market-making capital requirement – would increase costs and reduce availability for those wanting to hedge their risks, companies seeking investment capital, and savers looking for a solid financial return on their capital.

What is Market Making?

U.S. capital markets are the envy of the world, and **the nation's largest banks account for roughly three-fourths of this market-making activity in the U.S. Companies use these markets to raise funding for needed investments that grow our economy, such as assisting private companies to go public, financing municipal infrastructure projects and companies through bond offerings, and ensuring companies can responsibly hedge their risks.** At the same time, savers use these markets to find a liquid and valuable store of value for their hard-earned savings.

Capital Requirements for Market Making and Economic Impact

The Basel III Endgame proposal would dramatically increase required capital for market-making activities by at least an additional 75 percent for large banks. Market liquidity has broadly declined in response to previous increases in bank capital requirements, raising costs for companies seeking investment capital and savers looking for a solid financial return on their capital. **Dramatic increases in required capital for market-making activity would exacerbate the issue.**



Past capital requirement increases led to decreased market liquidity

Capital Requirements and Hedging

Hedging is a way for companies and individuals to reduce risk utilizing capital markets tools such as futures contracts. People and businesses use hedges to reduce risk for a wide variety of items, such as foreign currencies, interest rates, and commodities, such as energy and grains and meat.

For example: A rancher depends on a predictable price for the cattle they raise and plan to sell into the market. To protect themselves from large swings in cattle prices, the rancher could enter into a futures contract to sell its cattle in the future at a fixed price that is negotiated today.

Driving up the costs for market-making activity would mean increased costs for such hedging activity. Higher hedging costs would affect people and companies in a wide range of industries, including agriculture, services, and manufacturing. That translates to higher prices for all U.S. services and goods for American consumers and businesses when they do everything from putting food on the table, to heating their homes and offices, to buying a new car.

The Basel III Endgame Capital Requirement Is Duplicative with the Stress Tests

The largest U.S. banks already undergo rigorous stress tests more severe than the financial crisis to ensure they have enough capital to absorb losses associated with unexpected losses. The stress tests include a global market shock, which stresses market-making activity, and the results of the stress tests determine a bank's capital requirements on an annual basis.

Increased Market-Making Capital Requirements Would Drive Activity Outside the Banking System

Capital market activity has migrated out of the highly regulated banking system and into less well-regulated nonbanks over the past decade. **Increasing bank capital requirements for market-making services would result in banks becoming less competitive in offering these services, driving more activity into the nonbank financial sector** where there is less regulation, supervision, and oversight, arguably weakening financial stability.

The Bottom Line:

Imposing unnecessary costs for market-making activities would hurt companies, savers, and investors, acting as a drag on our economy. U.S. regulators should revisit their proposal to avoid further strain on market liquidity and increased potential for financial instability.

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