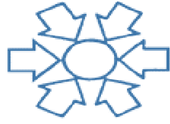

FedFin Client Report

Thursday, December 10, 2020

FedFin Forecast: The Systemic Risk of Implicit Recourse and What Regulators Will Do About It

Client Report: **RECOURSE6**

Executive Summary

In this report, we assess the regulatory consequences of one of the ironies of March's market turmoil: among the reasons it was not worse is because some large banks stepped in and backed customers or investors despite the lack of any legal obligation to do so. While this may have been stabilizing, regulators believe it exposes banks to risk and exacerbates moral hazard. This form of implicit recourse has been flagged since at least 1994 as a significant credit risk, but Obama Administration Treasury and Fed officials also highlighted it as a systemic concern for bank asset managers (see FSM Report **SYSTEMIC75**). Given incoming Treasury Secretary Janet Yellen's role in the 2014 FSOC inquiry and recent events, FedFin anticipates a significant shift to more stringent implicit-recourse standards when regulators turn to post-COVID regulatory reform.

This is a far from technical matter – reforms would have far-reaching structural and strategic impact. This report thus forecasts the shape of these changes, their impact on the banking and MMF sectors, and prospects for change.

Analysis

In 1994, the Riegle-Neal Act told U.S. regulators to penalize implicit recourse given the role it played in bank failures in the early part of that decade. A final rule took until 2001 (see FSM Report **RECOURSE2**), when the banking agencies defined recourse as credit risk in form or substance, imposing punitive capital charges when it is found to have occurred. In 2002, the agencies expanded this rule also to govern asset-backed securities (see FSM Report **RECOURSE3**).

The 2001 rule is cross-referenced in the 2013 U.S. Basel III capital rules (see FSM Report **CAPITAL200**), but these standards again do not address the many questions regulators readily acknowledge they left unanswered twenty years ago.

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Although post-2008 accounting standards address some remaining credit-risk concerns by generally consolidating securitizations and SIVs in ways that add capital charges, the Basel Committee in 2016 finalized global standards on what it calls "step-in" risk (see FSM Report **RECOURSE4**) because it found that consolidation failed adequately to restrict implicit recourse due to reputational risk.

However, Basel's standards are far less stringent than regulators initially envisioned, only adding supervisory assessment of implicit risk as an area that could lead to additional Pillar 2 capital charges. During work on this guidance, U.S. regulators reviewed the issues left unresolved in prior recourse standards, considering for example the extent to which barriers to "support" in the Volcker Rule could apply to sponsored MMFs. We think this faces statutory barriers, but U.S. regulators have also considered internal ring-fencing standards akin to 23A and 23B within banks to wall off asset-management operations.

U.S. and global regulators also considered a specific capital charge for asset-management operations (see FSM Report **ASSETMANAGEMENT4**), but this never advanced. The FSOC 2014 consultation referenced above sought comment on these and other recourse questions based on the view that inter-connectivity between banks and sponsored funds posed systemic risk. No action on the consultation occurred in part because the U.S. awaited final global standards that never arrived.

As noted, events in 2020 have demonstrated anew that implicit recourse may well exist in bank asset-management activities. While the SEC and FSOC consider MMF-specific reforms such as new capital or liquidity thresholds, the banking agencies will renew their focus on banks and seek to address a significant risk well within their own jurisdiction. The options for action include enforcement sanctions for the banking organizations that in 2020 supported sponsored funds to deter other banks from doing the same, but we expect the banking agencies to demand more stringent, ex ante rules based on bank assurances before 2020 that fund sponsors would never rescue investors. Over time, we expect FSOC to issue a new asset-management consultation and, working with the Fed and other banking agencies, move quickly to impose additional capital, operational, and/or structural safeguards segregating insured depositories from asset-management risk.

The extent to which the options summarized above or other policies disproportionately affect bank-sponsored funds versus other MMFs will determine the competitive impact of these standards. It seems most likely that the SEC will act only on alternative liquidity benchmarks for prime institutional funds and other investment funds highlighted in the Federal Reserve's latest financial stability report (see Client Report **SYSTEMIC89**), but these standards could prove stringent enough to satisfy the Fed if banks persuade regulators that tougher standards just for them would lead only to fund migration to riskier nonbank sponsors. The extent to which global standards for MMFs move to the "self-insurance" demanded recently by the BIS head will also affect both the SEC and banking agencies. However, regardless of these specifics, we expect strong action next year to reduce implicit recourse at banks and lessen the odds of still more central-bank facilities backing the sector as a whole.

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