FedFin Client Report

Wednesday, December 16, 2020

FedFin Forecast: Capital, Liquidity Rules to Get 2021 Structural Redo

Client Report: **REFORM200**

Executive Summary

In this report, we continue our 2021 forecasts, moving from our assessment of digital finance (see Client Report **DIGITAL6**) and asset-management regulation (see Client Report **RECOURSE6**) to an assessment of the U.S. capital and liquidity framework for large banks and FBOs. While Fed thinking on these standards will remain unchanged due to personnel continuity into 2021, Janet Yellen's presence as chair of the Financial Stability Oversight Council and shifts at the OCC and FDIC will move the needle to tougher standards, especially for the largest banks. FBOs will also come under renewed pressure to comply with U.S. liquidity rules due to growing concerns about MMF-dependent funding strategies. This report also forecasts how the U.S. will adjust capital and liquidity buffers following the COVID crisis, address current temporary exemptions to the leverage-ratio denominator, and implement Basel IV. We also address changes – i.e., broader discount-window access – likely to advance as the new capital and liquidity construct takes shape.

Analysis

Key issues and how they are likely to be addressed in 2021 include:

- Buffers: As noted recently by BIS General Manager Carstens and the FSB's report to the G20, regulators are wrestling with why COVID-motivated injunctions urging banks to draw down their buffers have not led more institutions to do so. One reason, especially in the U.S., is the inherent conflict between requests that banks reduce buffers and stress testing that essentially bars them from doing so if they seek to preserve market capitalization; we do not expect any changes in stress-test methodology that would facilitate buffer use, but structural action on buffers will begin early in 2021. This will likely take the form of revisions to the counter-cyclical capital buffer (CCyB) to invoke it more quickly as asset prices rise. The current restriction of the CCyB only to GSIBs in the Fed's final standard (see FSM Report **CAPITAL225**) will also be revisited in light of arguments that regional economic resilience depends on regional banks as well as U.S. GSIBs. Mr. Carstens has also proposed

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increasing GSIB buffers to ensure greater counter-cyclicality, a proposal surely opposed by GSIBs but one that might advance as Basel reconsiders the overall GSIB construct in 2021.

- Basel Implementation: FRB Vice Chairman Quarles recently indicated (see Client Report **RESCUE77**) that the U.S. will finally advance the 2017 Basel IV standards. This will include changes to the U.S. standardized approach (SA, see FSM Report **CAPITAL200**) to reflect much in the Basel SA (see FSM Report **CAPITAL221**) and the output floors and other changes to the internal-ratings based (IRB) methodology (see FSM Report **CAPITAL222**). These make the SA the default option for many assets, reducing the need for the U.S. to continue to require the largest banks to hold the higher of the SA or IRB approach. The U.S. may thus finally move forward on long-discussed plans to end the advanced approach. It is unclear if the U.S. will also adopt Basel's fundamental rewrite of the trading-book standards (see FSM Report **CAPITAL223**), but the U.S. will at the least initiate a review of its market-risk capital rule (see FSM Report **CAPITAL201**) and revise at least some of it (e.g., banking-book election discretion) to come into better Basel alignment. The U.S. eliminated its operational risk-based capital rules for all but the very biggest banks in the final tailoring standards (see FSM Report **SIFI34**), and we doubt that they will be reinstituted. However, a significant rewrite of the current advanced-measurement approach (see FSM Report **OPSRISK20**) is possible. We do not expect any of these changes to alter consolidated, total capital requirements, but changes with significant portfolio impact are likely.
- Stress Testing: Mr. Quarles last week defended the stress capital buffer as a rigorous standard that obviates the need for additional stress testing. However, in a 2018 speech, Janet Yellen argued that stress testing was insufficiently rigorous because it failed to account for second-order effects that, while hard to model, may prove systemically hazardous. She did not then opine on the SCB or the controversial decision to omit the enhanced SLR from the final standard, but Gov. Brainard will surely recall one of her losses on a point of significant concern to others likely to serve in the Biden Administration. We do not think SCB overhaul or a new stress-test construct likely to prove a short- or near-term FSOC or Fed priority, but it will not be forgotten if Ms. Brainard takes over the Fed chair in 2022 and broader conditions appear to warrant tougher rules.
- Supplementary Leverage Ratio: Earlier this year, the banking agencies provided temporary relief for large banks by eliminating Treasury obligations and central-bank deposits from the SLR denominator (see FSM Report **LEVERAGE22**). Given conclusions such as those in a recent FRB staff analysis finding that the prior SLR denominator exacerbated Treasury-market illiquidity, many believe that the U.S. might permanently revise the SLR when the temporary provisions expire next March. However, global regulators have been emphatic about the need quickly to end COVID-related exceptions to Basel standards. Vice Chairman Quarles, who some thought might support banks on this issue, has also stated that an effective leverage ratio does not permit exemptions even for no- or very-low risk assets. Although FSOC has no direct authority over this issue, Janet Yellen surely will support rapid reinstatement of prior rules. Work to give bank broker-dealer affiliates access to the

discount window might advance in tandem to permit a backstop liquidity facility in the event of renewed Treasury- or repo-market stress.

- Model Parameters: In addition to SLR temporary relief, the banking agencies allowed U.S. banks to continue to use traditional value-at-risk (VaR) models through the pandemic even though historical-loss parameters were blown away by market losses before Fed intervention. Similarly, historical credit-loss parameters in certain industries (e.g., hospitality, commercial real estate) are being rapidly undermined in terms of both probability of default and loss given default. We expect revisions to risk weightings in key sectors as part of the SA rewrite noted above implementing the Basel IV package, although larger banks will counter that the stress capital buffer (SCB, see FSM Report **CAPITAL225**) obviates the need to do so. Regulators will also need to assess the extent to which CECL accounting may provide an additional buffer through loss provisioning even though reserves are generally not reflected in capital calculation. Regulatory changes reflecting new risk parameters will take time to emerge and may be deferred if macroeconomic recovery is swift and balanced early enough in 2021 to prevent serious losses or appreciable financial-sector failures.
- Liquidity: The U.S. only finalized the Basel NSFR in late 2020 (see FSM Report **LIQUIDITY32**), and we anticipate no changes to the overall U.S. liquidity framework for domestic banks. However, we do expect the Fed to revisit a hard-fought decision in 2019 not to impose consolidated liquidity requirements on FBOs reaching into their U.S. branch-and-agency networks. The NSFR rule notably reiterated that this question is under consideration, a warning we believe included in the final rule due to FSB research (see Client Report **NBFI**) finding that banking organizations that relied on prime institutional MMFs experienced significant funding challenges in March ahead of Fed intervention.
- FBO Capital: We do not expect the U.S. also to change the capital construct for FBOs to require consolidation in compliance with U.S. requirements. Doing so heightens the risk that foreign regulators would ring-fence or otherwise force subsidiarization for U.S. banks, further fragmenting the global financial system with adverse consequences now under review by the FSB under FRB Vice Chairman Quarles' direction. However, de facto capital standards are possible if the Fed fears that an FBO's parent organization has weakened to the point at which U.S. operations are in jeopardy.

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