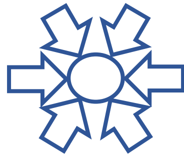

FedFin Client Report

Friday, March 17, 2023

FedFin Assessment: Future of U.S. Bank Capital, Liquidity, Structural Regulation

Client Report: REFORM216

Executive Summary

In this report, we continue our policy postmortem of SVB/SBNY and, now, so much more. Prior reports have assessed the overall political context (see *Client Report* **RESOLVE49**) and likely changes to FDIC insurance (see *Client Report* **DEPOSITINSURANCE118**), with a forthcoming Petrou op-ed in *Barron's* focusing on specific ways to reform federal deposit insurance to protect only the innocent. In this report, we look at some key regulatory changes likely as the banking agencies reevaluate the regional-bank capital, liquidity, and the IDI/BHC construct. As noted in our initial assessment and thereafter, we do not expect meaningful legislative action on the Warren, et. al. bill to repeal "tailoring" requirements, but we do expect bipartisan political pressure not just for supervisory accountability (see another forthcoming report), but also regulatory revisions. While Republicans strongly opposed tougher capital rules when Chairman Powell appeared before them just last week (see *Client Report* **FEDERALRESERVE73**), we expect them now only to make token statements of concern about any changes that do not adversely affect smaller banking organizations. In addition to looking at specific regulatory rewrites, this report assesses timing, noting in particular how the pending end-game rules could serve as the vehicle for changes the agencies hope to muster quickly in order to minimize demands for structural change to their own powers.

Analysis

In order to keep this report to reasonable length, it is necessarily a summary of specific issues rather than an in-depth analysis of what a rule would do and its pros and cons. Clients are asked to let us know via email to INFO@FEDFIN.COM if they have questions or wish a report on particular issues in greater detail.

1. Capital

Key issues here are:

- **AOCI:** In the 2020 tailoring rules (see FSM Report **SIFI27**), all but the very largest, "Category 1 and 2" banking organizations were exempted from prior requirements to adjust capital to reflect unrealized gains and losses captured in AOCI as measured for

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GAAP. Combined with the liquidity rules (see below), this encouraged many banking organizations to house government securities and ABS as HTM. As a result and as all too evident of late, these banks were forced to recognize large losses when they needed urgently to sell securities to meet liquidity demands, moving them quickly from "well-capitalized" to under or even critically-capitalized thresholds. We expect the U.S. end-game capital rules to repeal the AOCI-recognition exemption for banks above $100 billion and reiterate the right regulators have to require it as needed for other institutions.

- **Leverage Ratio:** One reason SVB, First Republic, and a few large regionals were so vulnerable to liquidity risk is that very large holdings of low-RWA assets made the leverage – not risk-based – capital ratio their binding constraint. As we have long noted, a binding LR creates an incentive for small, but significant, high-risk holdings where the applicable RWA still leaves the LR as binding. Sudden losses (see above) suddenly eroded this ratio, especially because it is not only three percent for all but the very biggest banks, but also because the banks failed to anticipate and then buffer market risk. We expect the tailoring rules also to be revised in concert with end-game LR revisions to increase the reach of the FDIC's six percent enhanced supplementary leverage ratio. Efforts to remove Treasury and central-bank deposits from the LR denominator now appear doomed.

- **Sovereign RWAs:** In 2017, Basel continued its efforts to do something about banks with large sovereign holdings subject only to the zero percent RWA, issuing a request for views on how best to proceed (see FSM Report **CAPITAL220**). Nothing was ever done about this longstanding controversy, but we expect it now will be a focus of immediate U.S. attention and near-term Basel work. Specifically, we expect the U.S. to add sovereign exposures to large-exposure measurements requiring mitigation and either impose a nominal new (e.g., five percent) RWA on all lower-risk sovereigns (including U.S. treasuries) or mandate this or higher RWAs for banking organizations with concentrated sovereign exposures.

- **Stress Testing:** Much public attention has focused not only on stress-test exemptions for large regional banks, but also on how the Fed's stress test, even as revised in 2023, fails to reflect most, if not all, of the stress now so evident in banks. We expect significant changes here, but over a slower schedule than the specific capital rewrites noted above and numerous others also in the works to toughen the framework.

2. Liquidity

The U.S. LCR (see FSM Report **LIQUIDITY17**) now requires banking organizations to mark-to-market the Treasury obligations and other high-quality liquid assets (HQLAs) on hand to address liquidity demand under stressed scenarios that are not as severe as the scenarios the largest banks must address in liquidity-specific daily ratios but nonetheless were meant to ensure that banks do not count on raising an unduly-optimistic amount from HTM securities. However, the ratio is calculated based on retrospective data, meaning that sudden changes in

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asset prices reflecting interest-rate increases and/or market volatility are generally not captured until it is too late. We expect the agencies to look hard at these provisions and likely leave them unchanged but reinstate the modified LCR dropped when tailoring proceeded.

Another controversial change in concert with these liquidity revisions was the Fed's decision over strong objections from then-Gov. Brainard to exempt foreign bank branches and agencies from U.S. liquidity requirements (see *Client Report* **SIFI33**). Like former Gov. Tarullo, Ms. Brainard argued that big 2008 foreign-bank discount-window draws posed risk to the U.S. that required U.S. restrictions, but then-Vice Chair Quarles opposed this and the revision was rejected. We expect it to be a significant part of any new U.S. liquidity rule and now also a de facto supervisory requirement. If Credit Suisse was a large user of the discount window over the past week – as seems likely – political pressure may also grow not only to impose rules of this sort, but also require strict FBO ring-fencing.

3. Structure

The FDIC has long sought to erect more significant firewalls between IDIs and parent companies but generally failed to win Fed agreement to doing so. We expect this issue to be revived with particular attention to tougher 23A/23B restrictions and other changes to the firewalls Dodd-Frank demanded never strictly implemented between the banking and trading book.

As previously noted, SVB also engaged in the most unusual practice of mandating deposit placement in exchange for loans and other financing that may have come via the bank or through various holding-company affiliates. This may or may not violate Section 106 of the BHC Act barring tying, leading to post-failure enforcement actions, but it certainly points to possible conflicts of interest we expect regulators quickly to address in new guidance or even rules.

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