FedFin Client Report

Thursday, April 13, 2023

FedFin Assessment: Implications Of An IRR Capital Charge, New Liquidity Rules

Client Report: IRR8

Executive Summary

As we noted yesterday, the head of the Basel Committee has targeted two capital and liquidity compromises included in the current Basel III construct not addressed in the end-game rules to which the U.S. plans shortly to turn. Actions whether by Basel or, even without it, the U.S. to return to Basel's initial proposals have significant strategic consequence. Thus, this report assesses these options and how the U.S. might act on them. We conclude that the U.S. will quickly impose a de facto interest-rate risk (IRR) capital charge and tighten LCR assumptions related to uninsured deposits.

Analysis

IRR

In his talk, Pablo Hernández de Cos suggested returning to an initial Basel proposal to impose Pillar 1 capital charges on interest-rate risk. This idea was floated along with several other controversial revisions (e.g., to sovereign risk weightings) shortly after the Basel III package was finalized, but Basel's final standards (see FSM Report **IRR7**) wholly reject any express form of IRR-related capital in favor of urging jurisdictions to stress test for it as well as to impose additional risk-management and disclosure standards. Instead, IRR is a Pillar 2 supervisory option under both Basel and U.S. rules, standards that have yet to stress a full range of IRR scenarios or modernize the U.S. risk-management guidance (see FSM Report **IRR5**).

In the near term, we expect the U.S. to indirectly implement a Pillar 1 IRR charge. This would be done via wholesale revisions to current interest-rate guidance (see FSM Report **IRR5**) to bring it up to date and reflect the modern capital and liquidity regulatory framework as well as the hard lessons learned in recent weeks. Banks of all sizes will be told to hold capital based on risk-management standards, with the enhanced risk-management rules for the largest banks (see FSM Report **RISKMANAGEMENT11**) perhaps including an express capital charge under defined circumstances. Stress-test standards will surely be refined to enhance not only their effectiveness, but also the credibility so badly damaged in recent weeks.

LCR

Mr. de Cos also targeted changes to the LCR which, when it was finalized in 2013, was said by many to have been significantly watered down from the initial proposal (see FSM Report **LIQUIDITY9**).

One key change – allowing banks to dip into the liquidity buffers – has since become a more general issue surrounding the extent to which banks should be allowed to use capital and liquidity buffers in conditions such as the Covid crisis to enhance counter-cyclical financial market activity.

However, Mr. de Cos also targeted outflow assumptions in the 2013 rule. Our review of the 2013 rule reminds us that one key change in the final Basel rules reflected in the U.S. LCR (see FSM Report **LIQUIDITY17**) gives favorable treatment to all core deposits in nations with deposit-insurance schemes even if the deposits are uninsured. We expect inflow and outflow assumptions to be revised to differentiate between core deposits, treating uninsured funding far more cautiously. The final Basel standards also provided far more generous treatment to interbank funding and credit lines, but the U.S. rules generally did not do so. It is possible that the U.S. will move to the Basel standards and recognize central-bank liquidity in LCR inflows, but we continue to doubt this based on concerns that doing so would vitiate the already-dubious assumption that the Fed is only a lender of last resort.

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