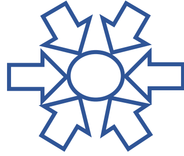

FedFin Client Report

Friday, October 6, 2023

FedFin Assessment: Basel Lays Big Plans for Basel V

Client Report: REFORM228

Executive Summary

As we noted yesterday, the Basel Committee's October meeting concluded not only with plans for new disclosure consultations, but also a report on lessons learned from the 2023 crisis. We have long considered the "end-game" standards so substantive as to constitute Basel IV; now, as this report details, Basel is laying plans for Basel V via new liquidity, interest-rate, capital, and structural changes to the current construct. We thus focus on the supervisory and regulatory action steps Basel posits as necessary responses to the financial-market volatility sparked earlier this year by SVB, SBNY, FRC, and CS's failures. While Basel states that none of its recommendations necessarily presages near-term global standards, they warrant review not only as likely precursors to at least some new proposals, but also as guides to what is top of mind for national regulators beyond finalizing end-game capital rules and dealing with home-country matters such as resolvability. If Basel proposes only some of the regulatory revisions it has in mind or, as the Fed clearly intends, the U.S. does so ahead of time, larger banks will face significant revisions to the LCR and NSFR, capital add-ons for interest-rate outliers, and express ring-fencing to prevent a CS repeat – i.e., a case in which the parent company met applicable standards but key subsidiaries fell far short.

Analysis

1. Supervision

Much in Basel's assessment of the causes of SVB, SBNY, and FRC's failure tracks reports from the FRB and FDIC, as does the committee's supervisory assessment of significant agency lapses in areas such as ensuring management and board follow-up. However, somewhat different from the U.S. inter-agency approach now ensuring operational-readiness for discount-window draws, Basel concludes that this would not have averted failure even though it would have eased resolution. SVB, SBNY, and FRC's failures are also attributed to unduly rapid growth and the absence of appropriate supervisory buffers. CS's failure is largely attributed to poor management and the vulnerability this created to contagion risk as SVB and SBNY failed.

Supervisory recommendations include:

Federal Financial Analytics, Inc.
2101 L Street, NW – Suite 300, Washington, D.C. 20037
Phone (202) 589-0880
E-mail: info@fedfin.com www.fedfin.com

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- better and more rapid use of internal, external, and confidential supervisory data;
- more attention to outlier banks distinguished by factors such as business model or rapid growth. Supervisors should focus on the ability of a bank to have sustainable earnings, here interestingly noting that factors to be considered should ensure resilience to Basel end-game rules;
- better supervisory assessment of bank risk management and governance;
- consideration of changes to the current liquidity-risk supervisory methodology focusing on the speed and volume of deposit outflows, changes in a bank's funding profile, stress resilience, and the role of social media. Possible reforms include more rapid monitoring, especially in stress situations, use of additional data sources, concentration-risk monitoring, inter-affiliate barriers to funding flows, and supervisory stress tests; and
- broader cross-border information-sharing protocols.

2. Regulation

In addition to specific issues, Basel plans to look at the overall complexity of its requirements with particular attention to contingent capital instruments such as the AT1 instruments involved in CS's failure, the usability of liquidity buffers, and proportionality (i.e., tailoring, with Basel here appearing to mean less focus only on size and more on the potential for smaller banks to have cross-border systemic impact). Specific issues to be considered for possible action in the medium-term include:

- liquidity standards, with particular attention to operationalizing the HQLA buffer under stress given problems evident at CS, LCR recalibration given CS's use of the LCR for daily liquidity needs, intra-day liquidity and shorter-term exposure, and express accounting for HTM liquidity risk. Basel is also assessing the overall value of the NSFR, and the current supervisory analytical toolbox. Basel will also assess the extent to which any reform is needed if supervision improves;
- interest-rate risk, with Basel exploring the extent to which its current IRR standards (see FSM Report **IRR7**) would suffice if it were better implemented. However, Basel is also assessing whether the current Pillars 2 and 3 approaches need revision with particular attention to mandatory disclosure of more granular data and the need for capital add-ons;
- treatment of HTM assets, looking not only at capital treatment, but also at whether HTM assets should be considered HQLAs for liquidity purposes;
- the role of additional Tier 1 capital instruments, with Basel here appearing to rethink AT1 instruments. Basel is also looking at the loss-absorbing hierarchy of current Tier 1 instruments;
- applying Basel to all banks, not just those that are internationally active; and
- level of consolidation, assessing the extent to which – as in CS – a bank may be "comfortably" meeting regulatory requirements at the consolidated level but have

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2101 L Street, NW – Suite 300, Washington, D.C. 20037
Phone (202) 589-0880
E-mail: info@fedfin.com www.fedfin.com

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vulnerable subsidiaries or affiliates. Basel is considering whether standards to ensure appropriate legal-entity resource and buffer distribution is appropriate.

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2101 L Street, NW – Suite 300, Washington, D.C. 20037
Phone (202) 589-0880
E-mail: info@fedfin.com www.fedfin.com

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