CFA Institute®
Systemic Risk Council

QUARTERLY SYSTEMIC REPORT

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SRC Members

CFA Institute Systemic Risk Council (SRC or the Council) is a private sector, nonpartisan body of former government officials and financial and legal experts committed to addressing regulatory and structural issues related to global systemic risk, with a particular focus on the United States and Europe. It was formed to provide a strong, independent voice for reforms that are necessary to protect the public from financial instability. The goal is to help ensure a financial system in which we can all have confidence.

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Welcome to the spring edition of the *Quarterly Systemic Report* (*QSR*). Each quarter, we recap the activities of the **CFA Institute Systemic Risk Council (SRC or the Council)** and highlight the key systemic debates and challenges affecting global markets and regulators. This first issue of the year comes amidst significant concerns in the global banking realm as the disruptions with Credit Suisse, Silicon Valley Bank (SVB), and most recently First Republic Bank, have sparked systemic alarms since early March. As the SRC cautioned in our 2019 comment letter, any weakening of requirements for resolvability planning and stress testing of large, regional banks could easily result in systemic vulnerabilities. It was surprising to witness the speed with which these systemic jolts occurred, but not totally unexpected.

Other systemic areas continue to concern the SRC as we progress further into the "great inflation unwind," which began in 2022. Inflation has remained stubborn despite significant monetary tightening, and further interest rate hikes will require great care and modulation to minimize economic "breakage." In addition to the effects of this inflation unwind, the Council remains focused on several matters that continue to present systemic challenges for the months ahead, including the following:

- Addressing shadow banking and non-bank financial institutions (NBFI) concerning improved disclosures, data tracking, and modeling of leverage and counterparty interconnectedness.
- Maintaining strong bank capital ratios and resisting market-based temptations to roll back the supplemental leverage ratio (SLR).
- Finishing the work of ensuring that money market funds and other open-end fund products have adequate liquidity risk management tools that include swing pricing requirements in certain circumstances.
- Supporting further efforts to assess and prepare our global financial system for the emerging economic shock waves related to climate change.

The Council remains focused on keeping our commitment to addressing regulatory and structural issues related to global systemic risk and to providing a strong, independent voice for reforms to promote financial stability.

Thank you for your attention to our report. We welcome any comments or suggestions for future topics in the report. — Kurt N. Schacht, Executive Director

ALERT: HOW FINANCIAL REPORTING REGULATIONS CAN HIDE CAPITAL AND LIQUIDITY STRESS AT BANKS

Reviewing the effects of hold-to-maturity (HTM) accounting for banks: In the wake of the Silicon Valley Bank (SVB) and other recent bank disruptions, regulators, including the Federal Reserve Bank, are considering whether stresses to bank capital and liquidity are being hidden by how HTM accounting rules are applied by mid-size and other banks in calculating capital ratios they report for regulatory purposes. The Council has been

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tracking whether and how banks reflect unrealized gains and losses for securities labeled HTM and "available for sale" in their all-important capital ratios. Simply put, does the bank have adequate capital and are assets appropriately liquid? In this context, assets held by the reporting entity should reflect current fair values, not the original cost of the asset. While holding such assets at cost is permitted by accounting rules and for financial reporting purposes, such valuations quickly mask interest rate risk and potential capital—and ultimately liquidity—shortfalls. How bank regulators looked at these issues in the context of SVB and other US regional banks is under review by prudential authorities.

NBFIs: THE MOST PRESSING SYSTEMIC VULNERABILITY FOR THE GLOBAL ECONOMY?

Risky non-bank financial institutions (NBFIs): Although not well known to average investors, certain sectors of NBFIs have the potential for serious economic distress, due to high leverage, little transparency, and high vulnerability to recession and tightening of monetary policy. In fact, the biggest systemic risk challenge facing economic stability is the NBFI sector and whether or not regulatory and transparency changes will happen in time. The Council's key concern is that, in general, NBFIs often use significant (often hidden) leverage, an assortment of derivative products, multiple interconnected counterparties, and can operate with nominal capital reserves, depending on regulatory requirements.

Uniform action needed: The world's standard-setting bodies have made some important progress on addressing NBFI risks; however, there have been no homogenous action, authority, or enforcement. We need prompt action on a better framework for enhanced NBFI line-of-sight on a global level. The Council has identified several priority areas for financial stability policy, including NBFI transparency and disclosures, interconnectedness of credit exposures across borders and parties, hidden leverage and resolution capabilities, and adequate liquidity preparedness and risk management.

Moving forward: Global leaders must reexamine the design, funding, and authority of various prudential regulators to ensure that resources and access levels are appropriate to monitor the exposures of firms designated as systemically important in the NBFI sector. This would be a major advancement for transparency and mitigation efforts in the face of NBFI financial exposures that could threaten economic stability. The economic heft and financial complexity of the NBFI sector is no trifling matter when it comes to its potential to trigger systemic disruptions. To that end, the Financial Stability Oversight Council (FSOC) recently released proposals to improve its analytical capabilities around systemic risk assessment and potential oversight of NBFI firms and activities.

SUPPORT OF SECURITIES AND EXCHANGE COMMISSION (SEC) RULES TO REDUCE OPEN-END FUND LIQUIDITY RISK

SEC proposed rule: In February 2023, the Council filed its comment letter in response to the Securities Exchange Commission's (SEC) proposed rule, *Open-End Fund Liquidity Risk Management Programs and Swing Pricing*. The Council supports and commends this proposal as part of the SEC's efforts to reduce the open-end fund industry's potential for market-wide risk, especially given the recent challenges in the wake of the COVID-19 pandemic. Since 2015, the SRC has beat a steady drum on the need to examine open-end and money market mutual funds more thoroughly to avoid the costs of failure in this sector.

Support and recommendations: In support of the rules' new enhancements to overall liquidity risk management, the Council concurs with changes to liquidity classifications and minimum requirements for portfolio investments, as well the more timely and detailed reporting disclosures. In addition, to mitigate potential problems around investors' ability for daily redemption of shares, we support the idea of mandatory swing pricing for all funds. As recently 2020, the Federal Reserve was once again forced to step in with a separate facility to backstop a variety of open-end investment funds for liquidity purposes and to prevent broader systemic contagion as a result of the pandemic. The changes proposed by the SEC will better prepare funds for these stressed conditions.

Moving forward: The Council will continue to offer support for regulatory efforts to remedy the systemic risk gaps that linger in the money market and open-end fund industry. During the 2020 pandemic, *ex post* liquidity fees and gates proved insufficient to prevent serious runs and potential knock-on effects to economic stability without government intervention. In our view, it is high time that enhanced liquidity requirements and swing pricing are added once and for all to reduce the systemic externalities associated with open-end funds.

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MONITORING SYSTEMIC VULNERABILITIES IN UNCERTAIN TIMES

27 January SRC meeting: Martin J. Gruenberg, chair of the FDIC Board of Directors, joined the Council meeting to offer comments and discussion on important systemic risk areas, including updates on the Basel III (B3) reforms and issues surrounding NBFI.

FDIC Board Chair Martin J. Gruenberg

Needed reforms: In response to the great financial crisis (GFC), a range of adjustments were made to strengthen the unstable environment, improve resilience, and prepare the US and European economies to better meet future financial stress and systemic disruptions. Chair Gruenberg noted these changes have helped in large part to improve systemic risk protections around the world. The latest round of B3 reforms and their implementation recognize the need for continuous evolution and development to keep pace with markets and products. The goal in the US is to have an implementation framework that is fully B3 consistent, which signals global collaboration and sets an example for implementation that is comparable, thorough, and consistent.

NBFI issues: Chair Gruenberg also commented on the challenges around assessing and monitoring NBFI exposures as global financial conditions tighten. In the US, the Financial Stability Oversight Council (FSOC) is advancing a new work stream to consider oversight and transparency actions as debt financing has grown significantly in the NBFI realm.

UKRAINE-RUSSIAN CONFLICT: ONE YEAR LATER

Senior Adviser Laura Solanko

10 March SRC meeting: The Council had a special meeting to discuss the systemic implications of the Russian-Ukraine conflict with an update from Laura Solanko, Senior Adviser, BOFIT, Bank of Finland, who returned after her March 2022 meeting to share perspectives one year later.

Economic stresses: Solanko updated the Council on the effects the Russia war on Ukraine is having on global and regional economies, including evolving undercurrents for social and civil conditions in Russia. Importantly, the war has forced the Russian economy and government into significant structural changes to deal with access to goods and services, currency convertibility, and export capabilities. Economic and social stresses have forced Russia into a syndrome known as reverse industrialization.

Continuing trouble: The impact of global sanctions, lack of foreign investment, and extremely high public expenses have taken a toll on Russian's economic and financial health. Solanko noted that deficits will continue to increase, and economic recessionary pressures will persist. Much remains unknown as to the full impact of sanctions, as well as the details of an evolving China-Russian relations framework. What is clear is the importance of continued US military funding and that the ongoing conflict remains a top concern to global leaders, particularly in the Euro region.

NEW FAST-PACED MARKET NEWS AND MISINFORMATION ON BANKING FIRMS CALLS FOR UPDATED RESOLUTION RULES

31 March SRC meeting: The SRC was joined by systemic risk resolution expert Dr. Elke König, former chair of the European Union Single Resolution Board (SRB). König shared her views on the recent banking failures and how to move forward. Since the great financial crisis (GFC), many new developments in markets and economic activity have revealed loopholes and gaps in regulations that need to be addressed. With recent interest rate hikes, the size and speed of deposit flight, liquidity management and held-to-maturity (HTM) valuation effects, new times call for new planning and rule recalibration. The Council discussed expanding deposit insurance, recalibrating total loss-absorbing capacity (TLAC), better stress-testing for liquidity and not just capital adequacy, and the level of (or lack thereof) global cooperation.

Former SRB Chair Dr. Elke König

GFC reforms need to keep pace: König noted the biggest issue surrounding current stress in the banking environment is the enormous increase in pace and speed of failure. In today's environment, a tool for allowing

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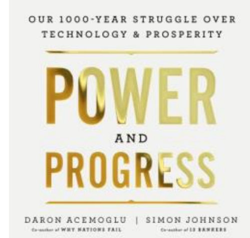
regulators time to manage and resolve issues before they escalate is critical. For example, a refinement of Dodd-Frank's orderly liquidation authority (OLA) and/or TLAC tools would better protect markets against the risk of accelerated contagion. "One must question if the OLA plans, as originally envisioned during the early days of Dodd-Frank implementation, are still fit for purpose," concluded König.

SRC MEMBERS WEIGH IN ON SYSTEMIC RISK ISSUES

Prominent, expert voices weigh in on key news and issues: Our members had a lot to say on systemic risk issues and the recent banking crisis.



Simon Johnson and Daron Acemoglu: *Power and Progress: Our Thousand-Year Struggle Over Technology and Prosperity*: With their breakthrough economic theory and specific policy recommendations, Acemoglu and Johnson provide the vision needed to reshape how we innovate and organize finance, allowing many more people to gain from generative artificial intelligence (AI) and other technological advances.

Simon Johnson: "Opinion: Beyond Saving Silicon Valley Bank's Depositors, Here's What Needs to Happen Next" (*Los Angeles Times*): Johnson discusses the underlying problem that weakened Silicon Valley Bank and that also may leave other banks susceptible.

Sheila Bair: Drawing from her tenure as FDIC chair and having overseen the orderly resolution of hundreds of bank failures, Bair offers her perspective and commentary on the recent banking crisis in several media outlets:

- "US Regulators Are Setting a Dangerous Precedent on Silicon Valley Bank" (*Financial Times*): Bair offers her views on why the bailouts of uninsured depositors set a dangerous precedent.
- "FDIC Helping Companies with Funds in Failed Bank Would Be 'Extraordinary Procedure': Sheila Bair" (*Meet the Press*, nbc.com): Bair discusses the systemic risk determination and why it should be done only in extraordinary circumstances.
- "Silicon Valley Bank's Collapse with Mark Cuban and Sheila Bair" (*The Problem with Jon Stewart Podcast*): Bair weighs in on why uninsured depositors at Silicon Valley Bank did not need a bailout.
- "Bank Bailout 'Very Troubling,' 'Putting Pressure' on Smaller Banks: Former FDIC Chair Sheila Bair" (*Foxbusiness.com*): With Neil Cavuto, Bair speaks on why the bailouts of midsize banks put pressure on community banks.
- "Former FDIC Chair Warns of 'Moral Hazard' in Bank Regulation Process" (*msnbc.com*): With Ali Velshi, Bair remarks on problems with unlimited deposit insurance and why the United States needs market discipline to backstop imperfect bank supervision.
- "Former FDIC Chair Sheila Bair: U.S. Regulators Are Setting a Dangerous Precedent on SVB" (*cnbc.com*): Bair breaks down how banks work and the "Jimmy Stewart" problem of bank runs.
- "Regional Banks 'Reasonably Stable' but Regulators Need to Provide 'More Clarity': Former FDIC Chair" (*Foxbusiness.com*): With Liz Claman, Bair discusses the need for regulators to provide more clarity on what is insured and what is not.
- "Bank Stress Tests Need to Focus on Interest Rate Increases, Says Former FDIC Chair Sheila Bair" (*cnbc.com*): On CNBC's Closing Bell, Bair discusses the Fed's failure to stress interest rate risk at all banks, something she's been writing about for more than a year.

Former FDIC Chair Sheila Bair on *Meet the Press*

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SYSTEMIC RISK IN THE NEWS

In case you missed it: Following is a selection of other recent important news reports on systemic risk.

- "Fed Blames Trump-Era Policies, SVB Leaders — and Itself — for Bank's Stunning Collapse" (*Politico*): In a widely anticipated report, the Fed faulted SVB's leadership for allowing glaring problems to build up in the leadup to the run by depositors that left the once-high-flying bank insolvent and shook the global financial system.
- "Fed Rethinks Loophole That Masked Losses on SVB's Securities" (*Wall Street Journal*): The Federal Reserve is actively considering closing a loophole that allows some midsize banks to effectively mask losses on securities they hold, a contributing factor in the collapse of Silicon Valley Bank. This potential change would reverse a 2019 decision to loosen rules for midsize banks.
- "The Fed's Recent Bank Stress Tests Used Scenarios with Little Variation. None Examined Higher Interest Rates" (*Peterson Institute for International Economics, PIIE*): This analysis examines the Federal Reserve's published macroeconomic scenarios for the 2023 stress test of large banks under the Dodd-Frank Act.
- "Opinion: From Bank Runs to a Credit Crunch, the Financial Future Looks Bleak" (*Washington Post*): Sebastian Mallaby discusses the broader level of bank assets underwater.
- "Business Trends, Risks and People to Watch in 2023" (*Financial Times*): This preview highlights what to look for in 2023 in the corporate world in sectors from energy to private capital and technology.
- "The Financial Turmoil Is Not Over" (*Financial Times*): Ian Harnett offers insight and suggests that if 2022 was about the repricing of capital, then 2023 is likely to be about the reduction in the quantity of it.
- "How Much of a Systemic Risk Is Clearing?" (*Financial Times*): Patrick Jenkins offers his perspective on how much greater the too-big-to-fail risk is today for a central counterparty (or CCP).

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