CFA Institute
Systemic Risk Council

QUARTERLY SYSTEMIC REPORT

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INSIDE

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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Each edition of the *Quarterly Systemic Report* (*QSR*) provides a summary of the **CFA Institute Systemic Risk Council's (SRC or the Council)** recent activities and highlights the key systemic challenges affecting global markets and regulators. As the summer heat winds down, many hot spots and concerning issues around the globe continue to pose potential systemic vulnerabilities.

One such area, which remains a top concern for the SRC, is nonbank financial institutions (NBFIs) and their activities, as we highlight in our recent comment letter to the US Treasury. As noted, we believe more action is needed on this crucial issue. We also present our views and recommendations on the US Securities and Exchange Commission's (SEC's) Covered Clearing Agency (CCA) proposals, another key area for systemic risks.

In addition, the Council remains focused on several matters that continue to present systemic challenges for the months ahead, including the following:

- Escalation in the Russian war on Ukraine
- Lag effects of unprecedented rate hikes in the ongoing response to inflation
- Refining bank capital ratios and other resiliency measures
- Climate change's effects on the global financial system
- Chinese economy shocks

We are committed to providing an independent and expert voice on reforms and highlighting regulatory and structural issues related to global systemic risk. As always, we welcome your comments. — Kurt N. Schacht, Executive Director

SRC Updates

US BASEL III ENDGAME PROPOSALS DRAW INDUSTRY PUSHBACK

Joint US agencies issue sweeping proposals: On 27 July, the US bank regulatory agencies, the Federal Reserve System, Office of the Comptroller of the Currency, and Federal Deposit Insurance Corporation (FDIC), issued a significant proposal with the goal of improving the strength and resilience of the banking system by modifying large bank capital requirements. The proposal would implement the final components of the Basel III agreement and is a response to the recent banking turmoil in March 2023 (for context, see the FDIC chair's statement).

Proposed rules: The proposal significantly revises the capital framework for banks with total assets of $100 billion or more in four main areas: credit risk, market risk, operational risk, and credit valuation adjustment risk. The proposal would change the calculation of risk-weighted assets and set an industry standard by limiting the use of internal models to calculate minimum capital requirements. The new rules are the most comprehensive seen in decades requiring banks to hold significantly more capital in case of losses.

Impact: Regulators introduced the new rules to protect the larger economy against financial distress and banking failures (like those experienced recently with Signature and Silicon Valley Bank) and to more fully coordinate US compliance with international standards. The FDIC has estimated that the proposal would increase common equity tier 1 capital requirements by 16 percent for holding companies and 9 percent for insured depository institutions.

Industry reaction and pushback: Not surprisingly, the banking industry is reacting to the substantial increase in capital requirements and compliance costs, saying such moves will limit banks' ability to serve and participate in key financial markets. They worry the higher capital constraints will disadvantage all banks operating in the United States and result in reduced lending capacity, trading, and capital markets activities across the board for all US banks. Some members of the Fed's board of governors have raised concerns over potential consequences, including reduced competition, curtailed lending, and a negative impact on US market liquidity and stability. The proposal drew immediate fire from the House Financial Services Committee, whose leadership said the requirements go well beyond Basel III international standards and threaten US economic competitiveness. The 120-day comment period, ending 30 November, will ensure a robust response from many stakeholders.

SRC Comment Letters

SRC RECOMMENDS ENHANCEMENTS TO THE SEC'S CCA RESILIENCY PLANS

SRC support: The SRC sent a comment letter to the SEC on 30 August, outlining its support along with suggested improvements to the proposed *Covered Clearing Agency Resilience and Recovery and Wind-Down Plans*. We agree with the changes to strengthen CCA's ability to manage stressed markets through monitoring and margining practices as well as its new recovery plans, including specifically the addition of ongoing and intraday monitoring, new pricing accuracy procedures, and more detailed resolution planning.

SRC recommendations: We support further refinements that would significantly strengthen resiliency against a CCA's failure, including changes to counteract both operational and financial risks. In our view, more can be done to strengthen CCA resolution, with two guiding principles: (1) to impose losses on pure financial obligations before applying losses to operational liabilities; and (2) to extinguish owners' equity when a CCA experiences losses that trigger implementation of its recovery and wind-down plans.

Specific actions: Our comment letter provides a detailed summary of the SRC's expert views on each of the SEC's proposed changes and procedures that will ensure that CCAs create and implement strong resiliency and resolution plans. We also outline a specific to-do list to guide SEC's efforts in addressing the growing risks to financial stability posed by CCAs.

SRC SUPPORTS FSOC'S NBFI PROPOSALS AND URGES PROMPT ACTION

Emphasizing the need for action: On 24 July, the SRC issued a letter to US Treasury Secretary Janet Yellen regarding the Financial Stability Oversight Council (FSOC)'s proposals *Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies* and *Analytic Framework for Financial Stability Risk Identification, Assessment, and Response*. The SRC supports the proposals' new frameworks for determining and assessing financial risks of NBFIs as well as making the designation process for systemically important NBFIs more efficient and timelier. Such actions are a key step for improving transparency around the growing risks surrounding NBFIs and their activities.

Clarifying designation and reviews: The SRC recommends further refinements on the proposal's design for nonbank designations to better meet the urgency of the systemic dangers to economic stability represented by a rapidly expanding NBFI sector. The FSOC should ensure that the time periods for the designation stages and risk reviews are well-timed and comprehensive enough to fully assess the size, complexity, and interconnectedness of NBFI risks. Furthermore, the Council has encouraged more clarity and detail on the role of the primary regulator in the FSOC decision to designate an NBFI as systemic and on the scope of nonpublic information to be collected.

Mitigating risks: Creating a better system to detect and mitigate growing systemic NFBI vulnerabilities requires efficient detection, designation, and clear steps to mitigate destabilizing activities. The SRC has encouraged the FSOC to consider stronger language and specific actions for systemic risk reviews. Specifically, a designated NBFI should be *directed,* not just *encouraged*, to implement corrective steps when its actions and activities put financial stability at risk to such a degree that it results in the systemic designation for such NBFIs. In our view, reducing systemic risk vulnerabilities at the designated NBFI should include specific steps and a timely process to reduce any material threats to economic stability.

Resources and ongoing support for the NBFI designation process: Overall, we support the FSOC's improvements to the designation process and its capabilities to gather necessary data and improve its line-of-sight on nonbank leverage, interconnectedness, liquidity, and risk management gaps. FSOC members and the Office of Financial Research should have adequate resources to ensure proper staffing, monitoring capabilities, and high-quality financial data analysis to implement the newly proposed analytical framework.

EXAMINING THE STATE OF EU BANKING AND HOW TO MOVE FORWARD


Oliver Wüensch, Partner, Oliver Wyman

23 May SRC meeting: Oliver Wüensch, partner at the global management consulting firm Oliver Wyman, presented to the SRC's May 2023 meeting. His remarks stemmed from the report, *The EU Banking Regulatory Framework and Its Impact on Banks*, which provides an independent, noncommercial review of the Euro-region banking industry to better inform the ongoing debate on regulatory and supervisory costs.

Considering upgraded reforms: Since the great financial recession (GFC), the EU's banking regulatory framework has gained strength; however, it is unclear if the post-GFC reforms are really battle-tested in today's complex and volatile marketplace, including the COVID crisis, UK disruption, and the latest US regional bank failures. In addition, the advance of online technology and social media have complicated the EU's current bank resiliency practices and tools. Questions persist as to whether resolution plans would be executed and organized in a timely and effective way if there was a significant disruption similar to the Credit Suisse situation.

EU bank competitiveness: Despite its strength, the EU banking sector today is not earning its cost of capital, whereas US competitors have returned to precrisis profitability levels. This has been driven by several factors, including poor economic growth in the Eurozone, high fragmentation, structural obstacles to bank consolidation, and underdevelopment in the EU's capital market union (CMU), including lack of a securitization market.

Takeaways and recommendations: According to the report, political and regulatory reforms are needed to eliminate restrictions in the EU that prevent the emergence of universal bank business models across borders. Changes to requirements that impede liquidity transfers within the banking union as well as the further development of the EU's CMU initiative will go a long way toward improving market opportunities. Last, better efficiency is needed in the process of bank regulation and in banks' operations and digitization.

HOW BANKS CAN MITIGATE SYSTEMIC RISKS IN THE NBFI SECTOR TO THEIR BENEFIT

14 July SRC meeting: At the SRC's most recent meeting, we heard from Andrea Enria, Chair of the Supervisory Board of the European Central Bank (ECB), who recapped insights from his recent speech at the ECB conference on Counterparty Credit Risk, on the role of banks in mitigating systemic risks arising in the nonbank financial sector.


ECB Chair Andrea Enria

Banks' role: While NBFIs and their potential for systemic risk continue to grow and policy discussions on their regulatory framework also evolve, banks have a clear and beneficial role to play in this sector. In his speech, Chair Enria noted that banks' investments and focus on the assessment and management of their nonbank counterparties' credit risk, are among the most important means by which systemic risk can be mitigated.

Interconnection: The increased role for banks stems from the banking system's exposure to risks coming from the NBFI sector, and how interconnectedness among systemically important banks and NBFIs can act as an amplification channel for systemic risk. Even with some improved regulation around margining practices and the use of central counterparties (CCPs), multiple connections remain that enable financial stress to be transmitted from the NBFI segment across the banking sector, including through loans, securities and derivatives exposures, and funding dependencies. Financial stress in recent years, including disruptions surrounding AIG, Archegos Capital Management, and most recently, Credit Suisse, are examples of this crucial interconnected risk.

Risk management urgency: The need for improved global policy regulation of the NBFI sector is evident, but it takes time, and the critical risks are facing us now according to Chair Enria. He affirmed his view that effective counterparty credit risk management is the best tool available right now to mitigate these systemic risks. The ECB Banking Supervisors urge banks to develop good practices, including developing appropriate stress-testing capabilities for counterparty credit risk, to protect their own exposure as well as ensure the stability of the financial system as a whole. See Chair Enria's full ECB conference remarks here.

FDIC CHAIR ON THE RESOLUTION OF LARGE REGIONAL BANKS

Lessons learned: On 14 August, Martin J. Gruenberg, chair, FDIC, made remarks to the Brookings Institution Center on Regulation and Markets, on issues around the resolution of large US regional banks in light of the recent banking failures. Specifically, he asserts that important changes to capital regulation and resolution planning requirements, including long-term debt, bank supervision, and deposit insurance pricing, are necessary to learn from past distress and to create a more stable environment.


FDIC Chair Martin J. Gruenberg

Fatal flaws: The three bank failures in March 2023 (Silicon Valley Bank, Signature Bank, and First Republic Bank) had common characteristics that are useful in understanding the issues—and working to prevent future calamities. Chair Gruenberg noted these banks suffered from a toxic combination of poor management, rapid growth, heavy reliance on uninsured deposits for funding, unrealized losses on securities, and minimal long-term debt. Creating remedies and policies that address each of these flaws will help strengthen and stabilize the industry.

New regulatory requirements: Gruenberg outlined several areas that federal agencies plan to address regarding the systemic vulnerabilities that large regional banks pose:

- **Capital:** Federal agencies recently issued new Basel III endgame proposals that would require large banks to hold capital against the unrealized losses on their available-for-sale securities. With more capital held against these assets, it could have potentially averted the loss of market confidence and the liquidity run that occurred with Silicon Valley Bank.
- **Long-term debt:** The US banking agencies have launched a new proposal for a long-term debt requirement for banks with $100 billion or more in assets. This type of requirement would absorb losses, lower the incentive for uninsured depositors to run, and provide a buffer if an institution does fail.
- **More effective resolution plan:** The FDIC has proposed changes to the Insured Depository Institutions (IDI) resolution plan requirements that would make them significantly more effective and transparent.
- **Supervision:** Last, the FDIC has proposed more stringent supervision of large regional banks—including a reexamination of risk-based deposit insurance pricing—to address the liquidity risks with the growing reliance on uninsured deposits for funding. The bank failures earlier this year highlighted the quickly evolving vulnerabilities for deposit "runs" that can result from a high proportion of uninsured deposit balances.

Action needed: Gruenberg concluded that the recent bank failures make a compelling case for regulatory action by federal agencies to learn lessons from the past and address the vulnerabilities that large regional banks can pose to financial stability. See the latest proposals here.

Systemic Risk in the News

SRC MEMBERS WEIGH IN ON SYSTEMIC RISK ISSUES

Expert voices weigh in on key news and issues: Our members are in the news—and making news—on important financial issues.

- "The Federal Reserve Needs to Stay Put on Rates" (*Financial Times*, 24 July 2023): Sheila Bair, former Federal Deposit Insurance Corporation (FDIC) Chair, discusses how, with inflation falling, further tightening of monetary policy only heightens the risk of recession and financial instability.
- "The Fed's 'Stress Tests' Overlook the Dangers Facing Banks" (*The Washington Post*, 11 July 2023): Sheila Bair writes on why the Fed is asking banks to prepare for the wrong stress test. We must test the system in a high rate, high inflation, recessionary scenario.
- "Legendary Investor Jeremy Grantham Says the Stock Market Has a 70% Chance of Crashing—and It Could Be an Epic Burst Like the 1929 Crisis" (*Fortune*, 5 July 2023): Jeremy Grantham, cofounder of GMO, says the stock market may be heading toward a burst bubble and recession.
- "The Great Inflation Unwind: Is the Breakage Just Beginning?" (*NASDAQ.com*, 13 June 2023): Paul Andrews, managing director for Research, Advocacy, & Standards for CFA Institute, discusses how regulators and legislators are assessing causes of recent banking failures and the need for action to address gaps in laws and regulatory supervision.

- "Big Tech Is Bad. Big A.I. Will Be Worse" (*New York Times*, 9 June 2023): Daron Acemoglu and Simon Johnson, authors of *Power and Progress: Our 1,000 Year Struggle Over Technology and Prosperity,* raise key concerns about the top tech companies' handing of the power of artificial intelligence based on the history of information technology.
- "Trichet on the Real Source of European Inflation" (*BNN Bloomberg*, 17 May 2023): Former ECB President Jean-Claude Trichet discusses the differences between European and US inflation, and the actions by the ECB.
- "Congress Must Act to Protect Smaller Banks From Investor Nerves" (*Financial Times*, 9 May 2023): Sheila Bair writes on why Congress should authorize temporary guarantees on business transaction accounts to protect the deposit franchises of smaller banks.
- UK Parliament, Economic Affairs Committee meeting (*Parliamentlive.tv,* 2 May 2023): Dr. Andreas Dombret, member of the Supervisory Board of the European Central Bank, discusses how the Bank of England's independence is working.

SYSTEMIC RISK REPORTS & UPDATES

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

- "Federal Reserve Updates Framework for Stablecoins, Digital Assets, and Other New Tech Activities" (*JD Supra*, 24 August 2023): The Federal Reserve released new guidance for supervised banking organizations on how they can engage in certain crypto-asset-related activities.
- "Economist Behind Popular Recession Gauge Worries She Created a 'Monster'" (*Bloomberg*, 1 August 2023): Claudia Sahm thinks her eponymous rule may fail this time, meaning the US may dodge a downturn even if unemployment goes up modestly.
- "Regulators Announce 'Basel III Endgame' Rules for Large US Banks" (*Financial Times* (behind a paywall*)*, 27 July 2023): New framework could require the biggest lenders to put aside billions of dollars collectively.
- "'The Global Economy Is Due for a Reality Check,' Warns the Central Banks' Bank" (*Fortune*, 3 July 2023): The global economy is at a critical juncture that could weigh on prosperity for years to come, with a combination of high inflation and financial fault lines.
- "Three Uncomfortable Truths for Monetary Policy" (International Monetary Fund, European Central Bank Forum on Central Banking 2023, 26 June 2023): Gina Gopinath, IMF first deputy managing director, presented on how the central banks must continue to fight high inflation and how monetary policy strategy may need to change in the future.
- "Report from the Commission to the European Parliament and the Council on the Adequacy of Regulation (EU) 2017/1131 of the European Parliament and of the Council on Money Market Funds from a Prudential and Economic Point of View" (European Commission, 20 June 2023): European Commission published report on the functioning of the money market funds regulation.
- "Inflation Puts the Fed on Its Heels" (*Wall Street Journal*, 13 June 2023): Economist Mickey D. Levy discusses how the economy is holding up well, but the central bank needs to get out in front of its biggest challenge.
- "A New Threat to Financial Stability Lurks in the Cloud" (*Financial Times* (behind a paywall), 15 June 2023): Regulators are getting nervous about the risks emanating from data storage and processing platforms dominated by a handful of big companies.
- "Next Financial Crisis Could Come from AI, SEC Chair Says" (*Wall Street Journal*, 16 May 2023): Gary Gensler sounded a cautious note on the technology that joined skepticism from other US officials.

SYSTEMIC RISK COUNCIL MEMBERS