CFA Institute®
Systemic Risk Council

QUARTERLY SYSTEMIC RISK 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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As we wind down this dynamic, far-from-dull year in the world of global finance and markets, the **CFA Institute Systemic Risk Council (SRC or the Council)** continues to provide an independent lens and voice on global systemic risk issues. This edition of the *Quarterly Systemic Risk Report* highlights recent activities and ongoing challenges affecting global markets and regulators, and provides updates on key priorities.

First, we were happy to welcome new experts to our Council and look forward to working closely with them in the months and years ahead. Just issued in December, we provided our support and comments on the US regulatory agencies' proposal to enhance long-term debt requirements for large banks. We also highlight the contentious Basel III endgame proposal's winding journey unfolding against rising industry pushback. Lastly, the Council heard from leaders of EU and US regulatory agencies on important priorities now and in the coming year for safeguarding our global financial system.

We wish you all happy holidays and a healthy, prosperous new year! As always, we welcome your comments and suggestions for future topics and issues to cover.
— Kurt N. Schacht, Executive Director

SRC Updates

SRC WELCOMES NEW MEMBERS TO THE COUNCIL

New members: In October, the SRC welcomed three new members to add new, diverse perspectives and expertise to its group and mission. SRC Co-Chair Erkki Liikanen said, "We are thrilled to add these three very talented and experienced people to the Systemic Risk Council, broadening our European representation and adding further international perspective to our Council discussions."

- **Dr. Elke König** is the former chair of the Single Resolution Board (SRB) and was previously president of the German Federal Financial Supervisory Authority (BaFin) and a member of the International Accounting Standards Board (IASB). She has held top leadership positions at several financial companies, including KPMG Deutsche Treuhandgesellschaft, Munich Re Group, and Hannover Rückversicherung AG.
- **René Karsenti** is senior adviser to the International Capital Market Association (ICMA), was director general of Finance at the European Investment Bank (EIB) and previously served as treasurer of the European Bank for Reconstruction and Development (EBRD). He also held senior positions in the treasury organizations of the World Bank.
- **Christina Romer** is Professor of the Graduate School and Class of 1957-Garff B. Wilson Professor Emerita of Economics, University of California, Berkeley, and a research associate of the National Bureau of Economic Research (NBER). She also served as chair of the Council of Economic Advisers and recently completed terms as president of both the American Economic Association and the Western Economic Association International.

SRC Co-Chair Simon Johnson added, "We are delighted these distinguished experts will be joining our systemic risk discussions. They bring a wealth experience and diverse perspectives to this important work." For the full bios of members and more on the SRC, visit www.systemicriskcouncil.org.

QUESTIONS AND UNCERTAINTY ON BASEL III PROPOSAL'S PATH AHEAD

Basel III criticisms in the US heat up: We have seen a big uptick in how contentious and partisan regulatory debates have become in 2023 and banking regulation has been no exception. A prime example is the acrimony and industry pushback facing the proposed Basel III (B-3) rules issued by the Federal Reserve System, Office of the Comptroller of the Currency (OCC), and Federal Deposit Insurance Corporation (FDIC). The new rules are the most comprehensive seen in years as bank regulators seek to finalize an internationally agreed set of measures developed by the Basel Committee on Banking Supervision in response to the financial crisis of 2007-2009. The measures in the US aim to strengthen the resilience, supervision, and risk management of banks with more than $100 billion in assets. In most cases, they would require banks to hold notably more capital as a buffer against losses.

Many industry players, including members of Congress, have expressed strong reservations about the proposed B-3 reforms, including that they may violate the Administrative Procedures Act (APA) requirements. Critics urge the need for a substantial overhaul of the proposals, casting doubt on advancement without significant modifications. Despite a recent extension of the comment period, some criticize the last-minute Cost/Benefit Economic Impact analysis and insist on a more thorough evaluation.

Rule objections: Key concerns on the proposals include missing data and modeling details in establishing standardized market risk, trading risk, and operational risk approaches. Some industry analysts also believe that the hasty impact analysis was not sufficient, and the economic impact of the proposals was misunderstood, potentially leading to a reduction in risk-weighted assets and related services. Additionally, dissenting opinions within the Federal Reserve Board (FRB) and the FDIC were cited as indicative of design flaws. Critics also point to the significant challenges the proposals pose for regional banks in terms of cost, profitability, and their ability to offer services to businesses and local economies.

Further clarification: The Fed indicated it was accepting additional data from banks on how they would be affected by the pending rules and proposed capital hikes to better inform the final endgame proposal. The comment period has now been extended to January 2024 and the SRC is in the process of developing its comment letter.

SRC Comment Letters

STRENGTHENING BANKING RESILIENCE: SUPPORTING LONG-TERM DEBT STANDARDS

SRC support: In December, the SRC issued a comment letter in support of the OCC, FRB, and the FDIC's proposal requiring large depository institution holding companies and insured depository institutions to issue and maintain a minimum amount of long-term debt (LTD). This multi-agency effort aims to enhance the resolvability of banking organizations with $100 billion or more in total consolidated assets, aligning them with requirements applicable to global systemically important banks (GSIBs).

Promoting stability: The SRC highlights its potential to significantly improve resiliency by nearly doubling the required loss absorbency for regional banks. The SRC emphasizes that the introduction of LTD enhances the FDIC's flexibility in resolving large regional banks, mitigates systemic risks, and instills confidence in the banking system. The requirement will significantly increase the ability of the FDIC to resolve a large regional bank without resorting to the use of extraordinary support measures.

Cost/benefit: Despite the rule's potential costs which the SRC views as modest, the Council contends that the benefits, including protecting the Deposit Insurance Fund and maintaining financial stability, far outweigh potential concerns. The SRC suggests additional considerations, such as the issuance of LTD at the bank level and further addressing uninsured deposit exposures. In that regard, the SRC encourages restoring a program from the Dodd-Frank era known as the Transaction Account Guarantee (TAG) program that provided deposit insurance for noninterest-bearing transaction accounts. The program expired in 2012 and reinstatement would likely require congressional action.

UNPACKING CHALLENGES, RISKS, AND RESILIENCE IN THE EU BANKING SECTOR


José Manuel Campa, Chair, EBA

19 September SRC meeting: The September SRC meeting featured an informative presentation on the risks and vulnerabilities of the EU banking sector given by José Manuel Campa, chair of the European Banking Authority (EBA), a regulatory agency of the European Union.

Disparities among banks: Campa's presentation described a nuanced picture of the industry's current state. While EU banks are experiencing higher profits, with Return on Capital reaching 10.8%, the benefits are not evenly distributed. The increase in net interest income and profitability varies among banks, depending on their asset and liability composition. Campa noted the impact of higher interest rates on different loan types and funding structures, indicating disparities in how banks must navigate the changing financial landscape.

Asset quality: Despite the overall positive trends, concerns arise regarding potential asset quality deterioration. While asset quality remains robust for now, slowed loan growth and economic uncertainties may lead to challenges in the coming quarters. Campa also highlighted shifts in deposit behavior, with a move from sight to term deposits, impacting different sectors and prompting cross-border deposit movements within the single market. Furthermore, he discussed the robust capitalization and strong liquidity of the EU banking sector but also noted increasing political pressures for taxation and potential challenges to solvency ratios.

Non-bank financial institution (NBFI) sector: The EU banking sector faces notable risks due to its significant exposure to the NBFI sector. In Q1 2023, EU banks had considerable asset and funding ties with NBFI entities, including a low number of banks concentrating more than half of their total funding from this sector. NBFI entities play a crucial role as major funding counterparts for EU banks, relying heavily on repos and unsecured wholesale funding. Moreover, about 80% of outstanding debt securities issued by EU banks are held by NBFI entities, particularly concentrated in a few banks, highlighting vulnerability to disruptions in the NBFI landscape.

RISK MANAGEMENT AND REGULATORY PRIORITIES FROM THE SEC

27 October SRC meeting: US Securities and Exchange Commission (SEC) Chair Gary Gensler presented to Council members on important aspects of the SEC agenda, focusing on systemic risk, market resilience, and stability in financial markets, citing ongoing initiatives that contribute to its overarching goal of stability.


Gary Gensler, Chair, SEC

Environmental, social, and governance (ESG) reporting: Gensler commented on the forthcoming US approach to sustainability reporting, examining its potential intersection with international standards and state-specific proposals as found in California. He highlighted the issuance of the International Sustainability Standards Board's first two International Financial Reporting Standards Sustainability Disclosure Standards and the EU European Financial Reporting Advisory Group standards, providing foundational frameworks for global consideration.

Crypto assets: Gensler also addressed the complexities surrounding crypto assets, stressing concerns related to money laundering and the need for specific rules governing the crypto space. He acknowledged the SEC's existing regulatory framework for crypto assets for the US markets remains the gold standard, however, more specific rules are needed on safeguarding matters in the crypto area.

Public vs. private markets: Gensler noted the need for a healthy balance between public and private markets in the US, as private markets are attractive to both issuers and investors due to cost, compliance, and lower public scrutiny. He noted his support for further transparency around private market players including Non-bank Financial Intermediaries. The growth of the NBFI sector has accelerated markedly since the global financial crisis and smooth functioning of the nonbank sector is vital for financial stability. The limited reporting by NBFI sector players makes it difficult to track systemic concerns, such as excessive leverage, liquidity risk management and the high levels of interconnectedness among NBFIs. (See the SRC's comment letter here.)

Climate disclosures and risks: Gensler addressed the dual-materiality question in ESG reporting and whether the focus of corporate reporting should be on financial materiality for investors or a corporation's material impacts on climate. He emphasized the SEC's primary focus on providing investors with information about financial materiality and transition risks, and noted the challenges of global coordination in ESG regulations, recognizing the SEC's need to navigate congressional scrutiny while adhering to its legal boundaries.

Artificial intelligence (AI) risks: Finally, Genser discussed the evolving landscape of risks associated with AI, emphasizing the need for vigilance and coordinated efforts from global authorities in addressing potential disruptions. The expansive cross border nature of AI activities and potential for a systemic-level panic of investors in overcrowded and illiquid markets, among other issues, should be reviewed.

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.

- "Former FDIC Chair Bair Says Regulators Must Crack Down on Crypto" (*Bloomberg TV*, 8 December 2023): Former FDIC Chair Sheila Bair discussed the need for a more rigorous approach to the crypto currencies markets by regulators.
- "America's Real China Problem" (*Project Syndicate*, 6 November 2023): Daron Acemoglu and Simon Johnson shine a light on the institutions underpinning US rivals' apparent strengths and comparative advantages.
- "Trichet Joins Lagarde to Predict Inflation Will Reach 2% in 2025" (*Bloomberg*, 7 November 2023): Former European Central Bank president Jean-Claude Trichet said there was a "consensus" among central banks to get inflation back to around 2%.
- "Squabble Between US Conservatives and Liberals Over ESG Won't Derail Global Trend Towards More Reporting, CFA Institute Head Says" (*South China Morning Post*, 29 October 2023): CFA Institute's Managing Director Paul Andrews indicated that more disclosures and more resources are being put into a green-energy agenda in the United States.
- "Petrostates Usually Benefit from War. Let's Make Sure Iran and Russia Don't" (*Washington Post*, 18 October 2023): Simon Johnson and Catherine Wolfram discuss the conundrum and potential solution for US policymakers on how to punish Iran for its suspected assistance to Hamas without helping Russia during its war on Ukraine.
- "Higher Rates for Longer are a Good Thing" (*Financial Times*, 10 October 2023): Sheila Bair argues that the transition to higher rates will be a challenge, but ultimately higher rates will strengthen the economy.
- "Former FDIC Chair Sheila Bair: The Fed Should Pause Rate Hikes" (*CNBC*, 5 October 2023): Sheila Bair joins "The Exchange" to discuss the transition to better capital allocation, concerns over the sustainability of low floating rate debt, and the market impact of Congress failing to pass a budget bill.
- "The College of Central Bankers Conversation Series with Jose Manuel Gonzales Paramo, Ph.D." (Global Interdependence Center (GIC), 2 October 2023): The GIC interviews Paramo on the European Central Bank's monetary policy.
- "Jeremy Grantham on Bloomberg Wealth with David Rubenstein" (*Bloomberg Wealth*, 5 September 2023): Jeremy Granthan predicts the slow-moving influence of rising interest rates will end up torpedoing the economy.
- "The Truth About Proposed Bank Capital Rules" (*Financial Times*, 1 September 2023): Sheila Bair argues the new measures are an important step to protect the US and world economies against future financial crises.

SYSTEMIC RISK REPORTS & UPDATES

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

- Financial Stability Oversight Council 2023 Annual Report (14 December 2023): The annual report reviews financial market developments, describes potential emerging threats to U.S. financial stability, identifies vulnerabilities in the financial system, and makes recommendations to mitigate those threats and vulnerabilities.
- "Corporate Debt: High Rates Put Alarming Pressure on Coverage" (*Financial Times*, 27 November 2023): Many companies that gorged on leverage loans are now grappling with liquidity challenges.
- "Capital Supports Lending" by Michael S. Barr, vice chair for supervision, Board of Governors of the Federal Reserve System (The American Bankers Association Annual Convention, Nashville, Tennessee, 9 October 2023): Michael S. Barr remarks on the recent endgame proposal on bank capital and why the benefits would outweigh the costs.
- "Remarks by Jonathan McKernan, Director, FDIC Board of Directors, at the New York State Bar Association and Mayer Brown on the Basel Endgame and Long-Term Debt Proposals" (Federal Deposit Insurance Corporation (FDIC), 4 October 2023): McKernan clarifies his endgame and long-term-debt statements and the consequential rulemakings.
- "Moody's Warns of 'Systemic Risk' From Leveraged Lending Market" (*Financial Times*, 28 September 2023): Rating agency says looming 'race to the bottom' between banks and private debt funds could erode credit quality
- "The FDIC's 2023 Risk Review Shows the Surprising Resilience of Community Banks Despite Inflation and Shifting Interest Rates" (*Fortune*, 11 September 2023): The FDIC recently released its Risk Review for 2023, detailing a substantial increase in unrealized losses, driven in large part by declines in medium-and long-term market interest rates.
- "Wall Street to Biden Bank Cops: We'd Like European Regulation Instead" (*Politico*, 6 September 2023): The dispute underscores the economic and political tensions that have long strained global agreements designed to prevent another banking meltdown.
- "Global Regulators Warn of 'Hidden Leverage' in Financial System" (*Wall Street Journal*, 6 September 2023): Global financial regulators are cautioning that a build-up of borrowed money among non-bank institutions could leave markets vulnerable to widespread stress and financial disruption.

SYSTEMIC RISK COUNCIL MEMBERS

Chair: Simon Johnson
SRC Co-Chair and former IMF Chief Economist

Chair: Erkki Liikanen
SRC Co-Chair and Chair of the IFRS Foundation Board of Trustees

Senior Adviser: Sheila C. Bair
Founding Chair of Systemic Risk Council and former FDIC Chair

Senior Adviser: Jean-Claude Trichet
Former President of the European Central Bank

Members:

Paul P. Andrews
Managing Director, Research, Advocacy, and Standards, CFA Institute; former Secretary General of the International Organization of Securities Commissions (IOSCO)

Brooksley Born
Former US Commodity Futures Trading Commission Chair

Sharon Bowles
Former Member of European Parliament and former Chair of the Parliament's Economic and Monetary Affairs Committee

Bill Bradley
Former US Senator (D-NJ)

Marina Brogi
Full Professor of Banking and Capital Markets at Sapienza University of Rome and a former member of the Securities and Markets Stakeholder Group at the European Securities and Markets Authority (ESMA)

Andreas Raymond Dombret
Former member of executive board, Deutsche Bundesbank, founding member of the Supervisory Board of the European Central Bank, and board member of the Bank of International Settlements

William Donaldson
Former US SEC Chair

José Manuel González-Páramo
Former member of the executive board of the European Central Bank (ECB), member of the Executive Board of Banco Bilbao Vizcaya Argentaria, S.A. (BBVA), and member of the executive board of the Bank of Spain

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