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Raising the Barr

Fed vice-chair pitches for tighter capital norms, expanding coverage, different approaches to modelling risks

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Analytical contacts:

Anshuman Prasad
Senior Director
CRISIL - Global Research & Risk Solutions
anshuman.prasad@crisil.com

Mudit Goel
Director
CRISIL - Global Research & Risk Solutions
New York
mudit.goel@crisil.com

Samir Bhatnagar
Associate Director
CRISIL - Global Research & Risk Solutions
New York
samir.bhatnagar@crisil.com

Projecting caution, suggesting higher ringfence

On July 10, 2023, Michael S Barr, Vice Chair for Supervision of the Board of Governors of the Federal Reserve (Fed) System, delivered a speech titled 'Holistic Capital Review' at the Bipartisan Policy Center, Washington DC.

He emphasized the need to strengthen capital standards for banks and discussed proposals on how to create a more resilient financial system[1] in the United States (US).

Though the Fed had initiated the holistic review of capital standards earlier in 2022, Barr's speech takes on renewed urgency in light of the US banking crisis that began in March 2023[2] with the failure of three regional banks in quick succession.

The first to go under was Silicon Valley Bank (SVB), succumbing to asset-liability mismatch and unrealized losses after the Fed hiked interest rates at the fastest pace on record — 5 percentage points in a span of just 14 months to ranges last seen in 2007 — in an attempt to tamp inflation.

The upshot of the rapid hikes? Minimal-interest-bearing deposits started flowing out towards the money market seeking better returns.

Pushed to the wall, and to pay back depositors, SVB announced the sale of its Treasury bond portfolio for a large loss of $1.8 billion[3]. The unbridled speculation that followed, especially on social media, accelerated the run on SVB, leading to its cave-in on March 10, 2023.

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[1] *Speech by Vice Chair for Supervision Barr on bank capital - Federal Reserve Board*

[2] *FDIC: Bank Failures in Brief*

[3] *SVB says Goldman Sachs was buyer of portfolio it booked losses on | Reuters*

Two days later, Signature Bank was shuttered by federal authorities, ostensibly for crypto/digital assets exposure, and on May 1, 2023, First Republic Bank was wound up by Californian authorities after a run. JP Morgan Chase then acquired it through a competitive, non-public auction.

Barr brought to the front and center the importance of capital as the foundation of a bank's soundness. Citing the SVB case, he argued good supervision or management cannot, by itself, ensure safety of banks without adequate capitalization.

He spoke in detail about multiple measures of risk, the Basel III endgame, and stress testing to improve risk capture.

Following are some of the key takeaways from his speech:

1. **Ending reliance on internal models to estimate credit risk:** Barr proposed to end reliance on the use of internal credit risk models in favor of standardized credit risk measurement approaches to compute risk-based capital that banks need to hold. The aim is to introduce a more transparent and uniform measurement of credit risk across the banking sector. This proposal is also rooted in the experience that banks tend to underestimate credit risk. Moreover, the lack of data and infrequent defaults make modelling and back testing credit risk unreliable, at best.

2. **Modelling market risk at the individual trading desk:** Barr emphasized the importance of modelling risk at the individual trading desk for each asset class instead of measuring risk at firm level. The proposal would allow banks to use internal models to measure market risk in most situations. Unlike internal models of credit risk, it is easier to validate internal models of market risk because of availability of daily data. This is broadly in line with the speech by Federal Deposit Insurance Corporation (FDIC) Chairman Martin J Gruenberg on finalizing the Basel III capital standards in the US and addressing deficiencies in the market risk capital framework as per the Fundamental Review of the Trading Book, or FRTB[4].

3. **Measurement of operational losses:** Barr also proposed rules that would replace banks' internal models for operational risk with a standardized approach adjusted to banks' own historical loss experience.

4. **Stress testing framework:** Barr concluded that the current stress testing framework remains sound; however, some changes may be required to improve risk capture. Barr had highlighted merits of reverse stress testing[5] on June 20, 2023, at the 2023 Governance and Culture Reform Conference organized by the Federal Reserve Bank of New York.

5. **Proposal to introduce long-term debt requirement:** Barr argued that long-term debt facilitates bank resolution and restructuring upon failure, as such debt could be converted into equity to absorb losses. Hence, stipulating long-term debt requirements would reduce losses borne by the FDIC's Deposit Insurance Fund and facilitate restructuring and wind down of failed banks in future. This requirement would also reduce the risk of contagion.

Importantly, Barr has proposed expanding the coverage of institutions to which the proposed rules would apply. They would apply to banks with over $100 billion in total assets, compared with over $700 billion, or banks with international operations, in the current framework. This highlights Barr's view that smaller banks also play a systemic role in the financial system, and hence, require greater oversight.

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[4] *FDIC: Speeches, Statements & Testimonies - 6/22/2023 - Remarks by Chairman Martin J. Gruenberg on the Basel III Endgame at the Peterson Institute for International Economics*

[5] *Governance and Culture Reform Conference - FEDERAL RESERVE BANK of NEW YORK (newyorkfed.org)*

Implications of the proposals

The objective of these proposed enhancements is to make the US financial system more resilient against bank runs and risk of contagion.

The proposed changes are likely to improve transparency of capital ratios computed by banks. Moreover, for smaller banks that do not currently have internal models, the proposal to use standardized risk measurement would work out less expensive.

On the other hand, the changes might raise capital requirements for the largest banks and push some of the lending to non-banks.

To be sure, there would be some pushback on Barr's proposals.

Rob Nichols, President and CEO, American Bankers Association, recently said regulators already have the tools to manage risk and forcing banks to hold more capital would cost the economy[6].

Moreover, while Barr's proposals could be far-reaching, they are unlikely to be implemented any time soon, as these would go through due process: solicit comments from banks and offer them a timeline for transition.[7]

[6] *Fed Vice Chair Barr Remarks on Bank Capital | American Bankers Association (aba.com)*

[7] *Speech by Vice Chair for Supervision Barr on bank capital - Federal Reserve Board*

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