Gaping holes in banking regulatory system

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A report released last week has pointed to the fact that there are large gaps in the so-called Basel Framework, the international regulatory mechanism aimed at preventing the kind of global financial crisis which erupted in 2008.

The update was issued by the Basel Committee on Banking Supervision of the Bank for International Settlements. It expands on an analysis, published by the Committee in October 2023, on the crisis which engulfed three mid-sized American banks in March 2023 and the collapse and liquidation of the global bank Credit Suisse.

The US crisis was only overcome through a significant intervention by the Federal Reserve Board. The Credit Suisse crisis required its takeover by rival Swiss bank UBS, in a controversial operation organised by the Swiss government which broke previous liquidation conventions.

In its latest report the Committee again underscored the significance of the 2023 events.

It said the turmoil was the "most significant system-wide banking stress since the Great Financial Crisis in terms of scale and scope. Over the span of 11 days—from 8 to 19 March 2023—four banks with total assets of about $900 billion were shut down, put into receivership or rescued."

None of this was supposed to happen.

As the report explained: "The Committee issued supervisory principles for managing liquidity risks in 2008 and found that they remained fit for purpose in 2019. Nevertheless, the 2023 banking turmoil highlighted clear challenges in overseeing banks' liquidity risks."

Nothing in the report indicates that these challenges have been overcome and in fact there is evidence to suggest they may have grown.

The report said that "all of the distressed banks during the 2023 banking turmoil experienced a series of liquidity shocks" and that "the turmoil raised questions about the design and calibration of the Basel III liquidity standards."

But nothing was advanced as to how this issue might be addressed. The report merely said that these developments "prompt consideration by supervisors" as to whether "their monitoring of bank, sectoral and market information" provided "the relevant information, in a timely manner, for them to identify when material liquidity outflows start to take place."

Here the Committee raised a core problem which arises from the very structure of the global capitalist economy and its financial system. While financial markets are global in nature, regulation is determined on a national basis.

"The Basel Framework applies on a consolidated basis to internationally active banks. It does not define the concept of internationally active banks. Jurisdictions [that is, national governments beholden to their "own" sections of finance capital] have full responsibility in deciding on the scope of banks beyond internationally active ones and have opted for different approaches in implementing Basel III."

The establishment of a system of regulation based on so-called "Basel Core Principles" might be thought to provide a mechanism for the prevention of a global crisis. But it does not, as the Committee itself made clear, not least because the global character of the financial system means that turmoil even in a relatively small area can rapidly have international consequences.

As it noted, the 2023 events showed that "the failure of a bank can have systemic implications through multiple channels, including first- and second-round propagation effects. For example, the distress of relatively small banks (which are not subject to the full Basel III Framework) can trigger broader and cross-border systemic concerns and contagion effects."

In its examination of the failure of Credit Suisse, the

report pointed out that, even where regulations were adhered to, this did not prevent a crisis.

The Basel regime requires that global banks hold enough assets that can be easily sold to cover 30 days of cash outflows if they come under stress. Credit Suisse met this requirement almost up to the end but then went to the edge of a collapse when customers withdrew a quarter of its assets in just a few days.

Credit Suisse faced another problem, in that assets which had been counted to meet liquidity standards could not be used because they were assigned to other entities within the organisation and so were "trapped liquidity." Had they been sold, this would have had to be disclosed to investors leading to a crisis of confidence.

In the case of the three US banks, their problem was that the market value of the Treasury bonds they had on their books, purchased as supposed security when money was flowing in, fell below their book value when interest rates began to rise with the tightening of the Fed's monetary policy starting in 2022.

Had they been sold to meet cash demands, then the banks would have had to realise the losses they had incurred, leading to a lowering of their capital.

There have been efforts to claim that the failure of the three US banks, starting with the collapse of the Silicon Valley Bank, was simply due to bad management. No doubt this played a role. But the report noted that "irrespective" of liquidity rules "not being applied to the US banks that failed," the speed of the outflows "far exceeded" the assumptions on which those rules were based.

In other words, the entire system for determining the stability of banks, based on whether they are considered to have sufficient liquidity, turned out to be useless in a period of instability.

The report itself went some way to acknowledging this. It noted that "recent events have demonstrated that the liquidity regulations alone cannot prevent all liquidity runs in an age characterised by easy access to information as banking services via various digital tools."

But this is the age in which the financial system operates.

The Committee's report did not advance any solution, saying only that it would continue "prioritising work to strengthen supervisory effectiveness and identify issues that could merit additional guidance at a global level."

And even if new rules are drawn up at a global level, whether they will be adopted is another question as recent experience in the US has demonstrated.

In the wake of the March 2023 US bank failures, Michael Barr, the Fed official in charge of bank regulation, insisted he was going to press ahead with rules that required banks to maintain an increased level of capital to deal with losses.

In September this year, following a massive campaign by the banks, because the new regulations would eat into their profits, Barr announced that the proposed regulations had been scrapped and underscored his total capitulation and subservience to finance capital, saying life had given him the opportunity "to learn and relearn the lesson of humility."