FDIC Director McKernan Discusses Basel III Endgame

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This week, Federal Deposit Insurance Corporation ("FDIC") Director Jonathan McKernan gave remarks to the ISDA Conference on Trading Book Capital on Basel III Implementation.

As the title suggests, he focused on the interplay of the Fundamental Review of the Trading Book ("FRTB") and the US Basel III Endgame proposal. He noted his view was that there were at least three lessons on weakness in the trading book framework:

- One lesson of the financial crisis was that the value-at-risk (VaR) measure, which had been designed to measure the risk of short-term fluctuations in market prices, did not appropriately capitalize low probability tail events, market liquidity risk, or credit risk and, more generally, was not calibrated to a period of significant stress.
- Another lesson was that regulators did not have a credible option for withdrawing approval of internal market risk models in part because the standardized approaches did not pose a credible backstop and, in part, because model approval was done at the banking organization-level instead of some subdivision, like the trading desk.
- Yet another lesson was that the boundary between the trading and banking books created opportunities for capital arbitrage by incentivizing banks to classify instruments as "held with trading intent" even where there was no regular trading so as to benefit from the reduced capital requirements on the trading book.

He noted that " . . . the Endgame reforms offer the potential to better align capital requirements with the underlying market risks and reduce incentives to take on tail risk or arbitrage the trading book boundary. These strike me as appropriate objectives for our Endgame proposal." Implicit, if not explicit in the speech, is that Director McKernan's views are that the Basel III Endgame proposal falls short on this front.

He reiterated concerns he mentioned in his dissent on the Basel III Endgame proposal in July about design decisions made by the Basel Committee, and followed in the U.S. proposal, but suggested "that the Endgame debate need not be binary." He said he was supportive of efforts to enhance the regulatory capital framework, but "I oppose efforts to reverse engineer higher capital requirements without regard to the costs and benefits or the underlying calibration framework. That does, however, seem to leave open an approach that moves to finalize the less contested aspects of the Endgame market risk reforms and then finalizes the rest through future notice-and-comment rulemakings that can rationalize our own U.S. implementations."

Given the bipartisan pushback on the proposal, Director McKernan's suggestion of taking a phased approach may offer a path to at least some progress of finalizing parts of the Basel III Endgame proposal.

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