FEDERAL RESERVE BANK OF BOSTON™

Simplicity and Complexity in Capital Regulation

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Strengthening Financial Sector Supervision and Current Regulatory Priorities

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Capital Requirements

- Bank capital requirements
  - an area where we have made substantial progress
  - an area that has become increasingly complex
- Some complexity is unavoidable for complicated financial institutions
- There is a potential cost to complexity – it can erode market discipline if it makes it more difficult to evaluate banking organizations

Preview of Today's Talk

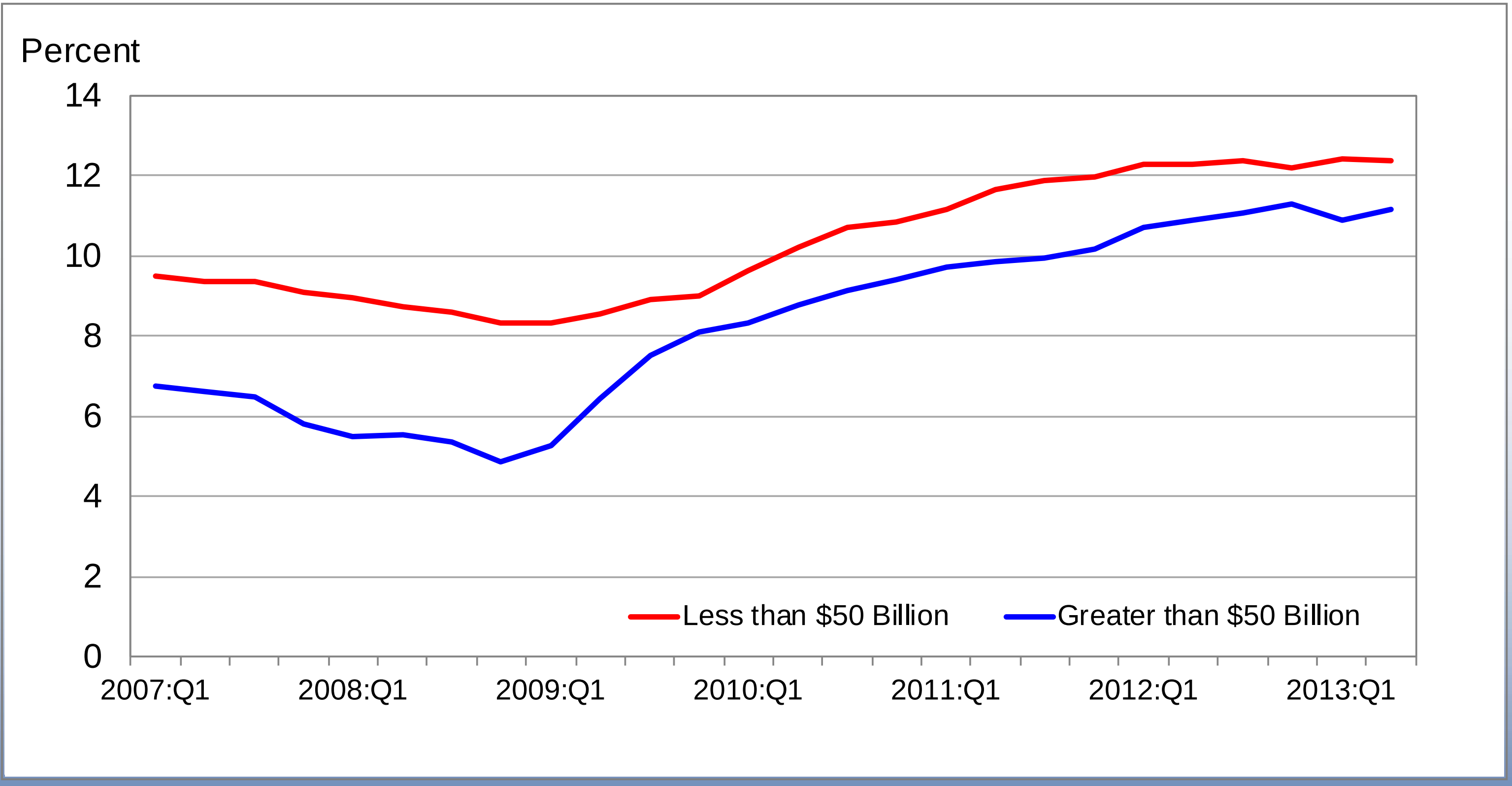
- There has been an increase in the quantity and quality of capital that most U.S. banking organizations have to withstand possible future shocks
- Complexity could and probably should be pared back if the so-called "Pillar 3" goals of increased transparency and market discipline are to be achieved

Preview Continued

- *Both* risk-based and leverage-based capital requirements are likely to continue to be needed
- A number of global banking organizations have low leverage ratios
- For banking organizations with large broker-dealer operations dependence on wholesale funding makes them inherently more susceptible to runs, suggesting that low leverage-ratio capital may not be appropriate

Figure 1
Tier 1 Common Equity Capital Ratio for U.S. Bank Holding Companies by Asset Size

2007:Q1 - 2013:Q2



Source: Consolidated Financial Statements for Bank Holding Companies (FR Y-9C).

U.S. Bank Capital

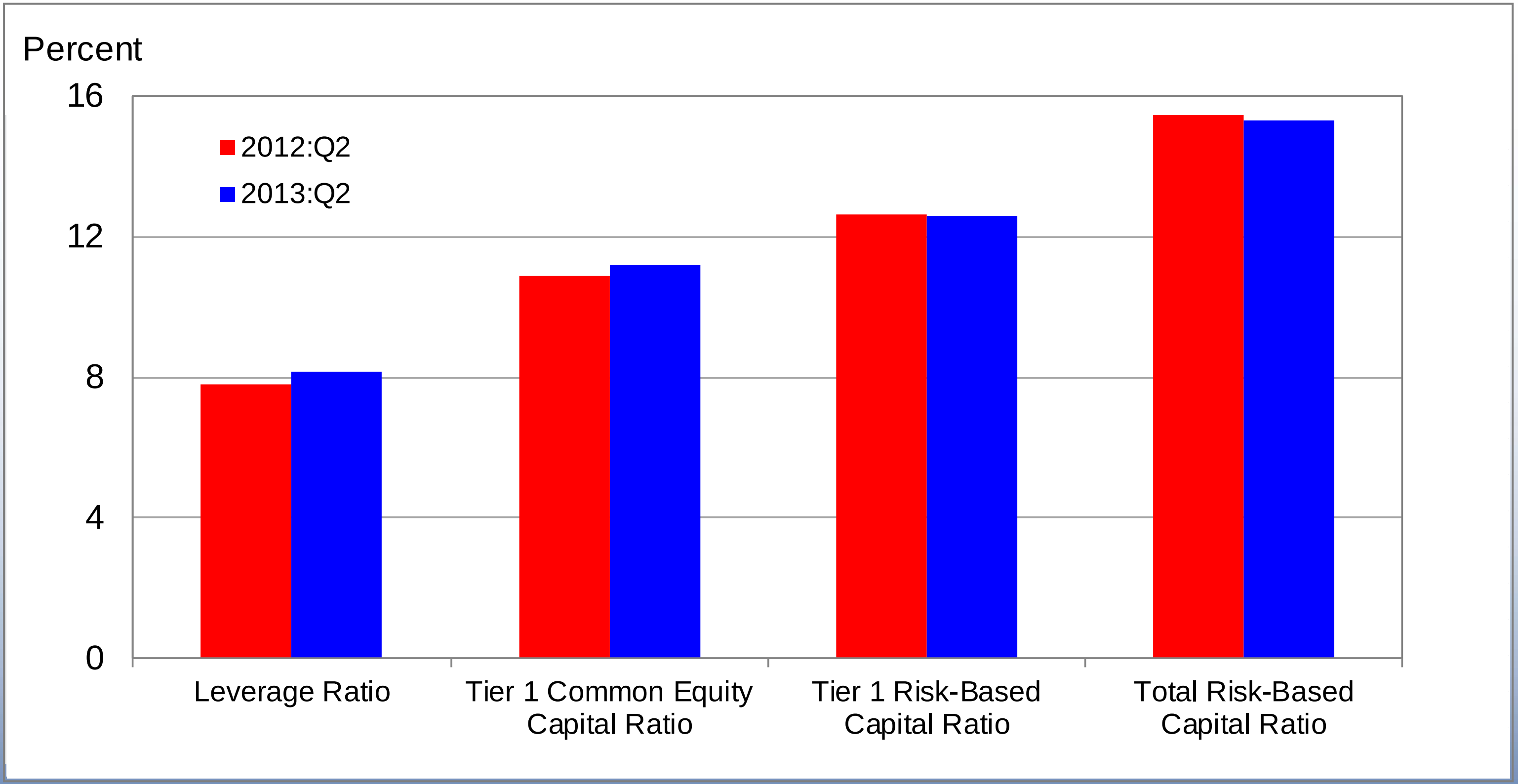
- A renewed emphasis on increasing the quantity and quality of capital has improved the capital cushion in the banking system
  - New regulations
  - Stress tests
- Much more complexity – Annual reports often have 20 or more pages describing the banking organization’s capital position

Why So Complex?

- Transition – Banks report relative to Basel I, II, and III in most discussions of bank capital
- The variety of measures of capital
  - One potential simplification: Focus on narrow definition such as Tier 1 common equity
  - Tier 1 common equity used in stress tests

Figure 2
Measures of Capital for U.S. Bank Holding Companies with Assets Over $50 Billion

2012:Q2 and 2013:Q2



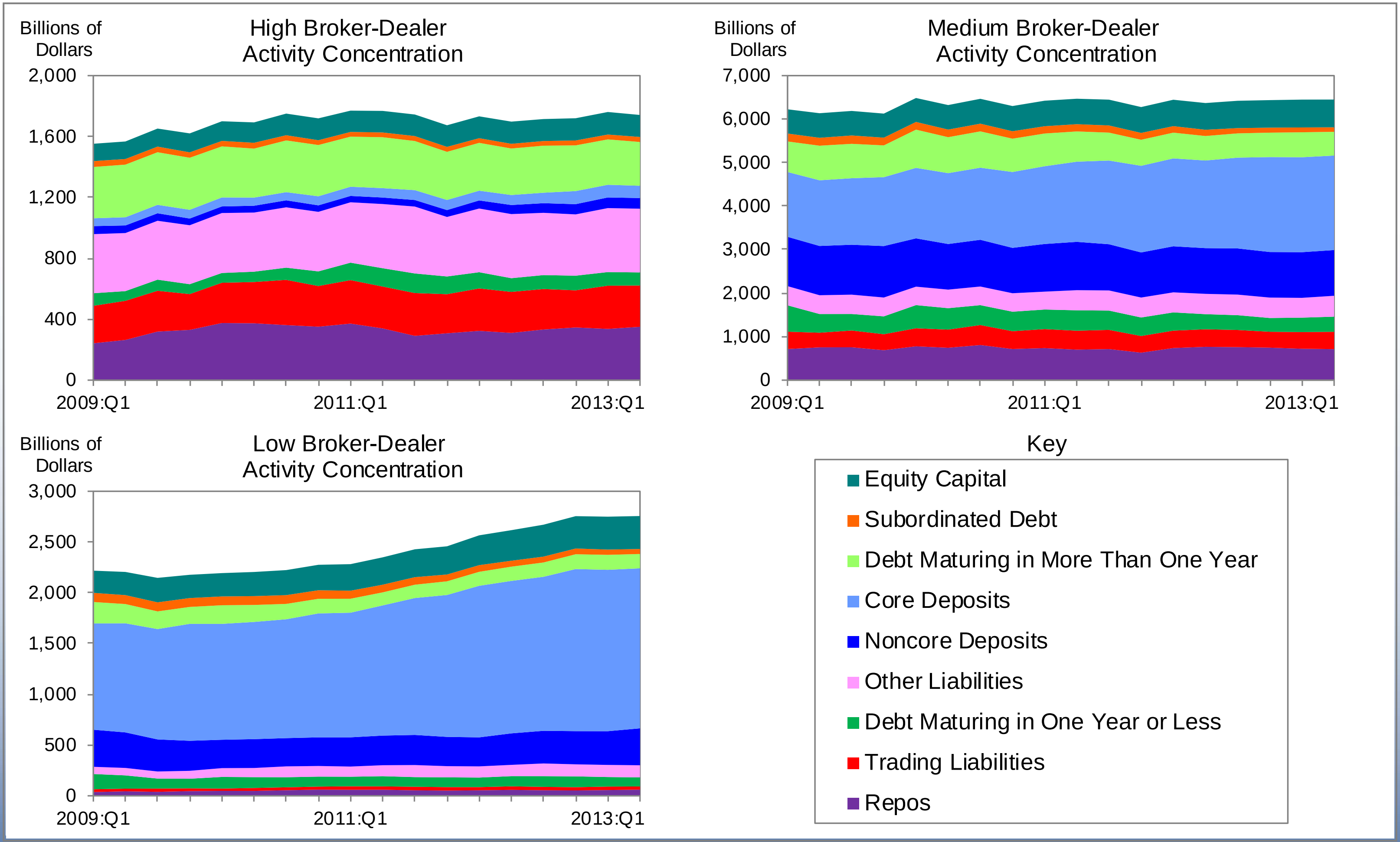
Source: Consolidated Financial Statements for Bank Holding Companies (FR Y-9C).

Complexity Continued

- A third form of complexity emerges from the complications involved in risk-weighting assets for risk-based capital calculations
- A fourth form of complexity stems from the use of both risk-based capital ratios and leverage ratios. But the need for both capital ratios reflects in part the complexity of the activities of banking organizations

Figure 3
Liabilities and Capital Composition of Largest U.S. Bank Holding Companies by Broker-Dealer Activity Concentration

2009:Q1 - 2013:Q2



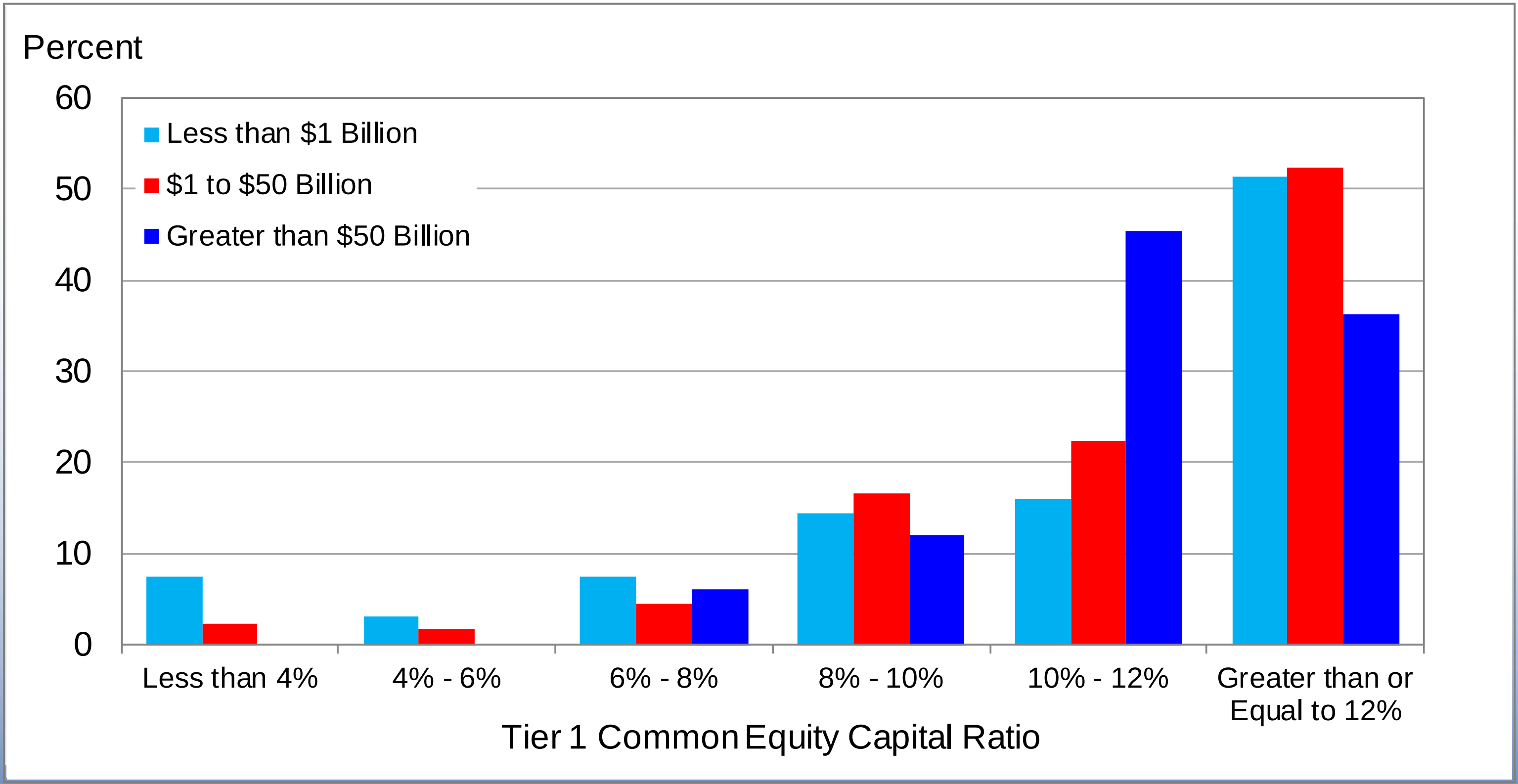
Note: The Largest BHCs include the 10 largest domestically owned U.S. bank holding companies. Source: FR Y-9C

The Leverage Ratio and Broker-Dealer Activities

- Broker-dealers – Investment banking activities and buying and selling securities
- The riskiness of their assets is significantly compounded by the riskiness of their funding model
- Short-term financing might dry up with a financial shock and not be available to finance their longer-term securities portfolio
  - Could be forced to sell securities at fire-sale prices, causing solvency and liquidity concerns

Figure 4
Tier 1 Common Equity Capital Ratio Distribution of U.S. Bank Holding Companies by Asset Size

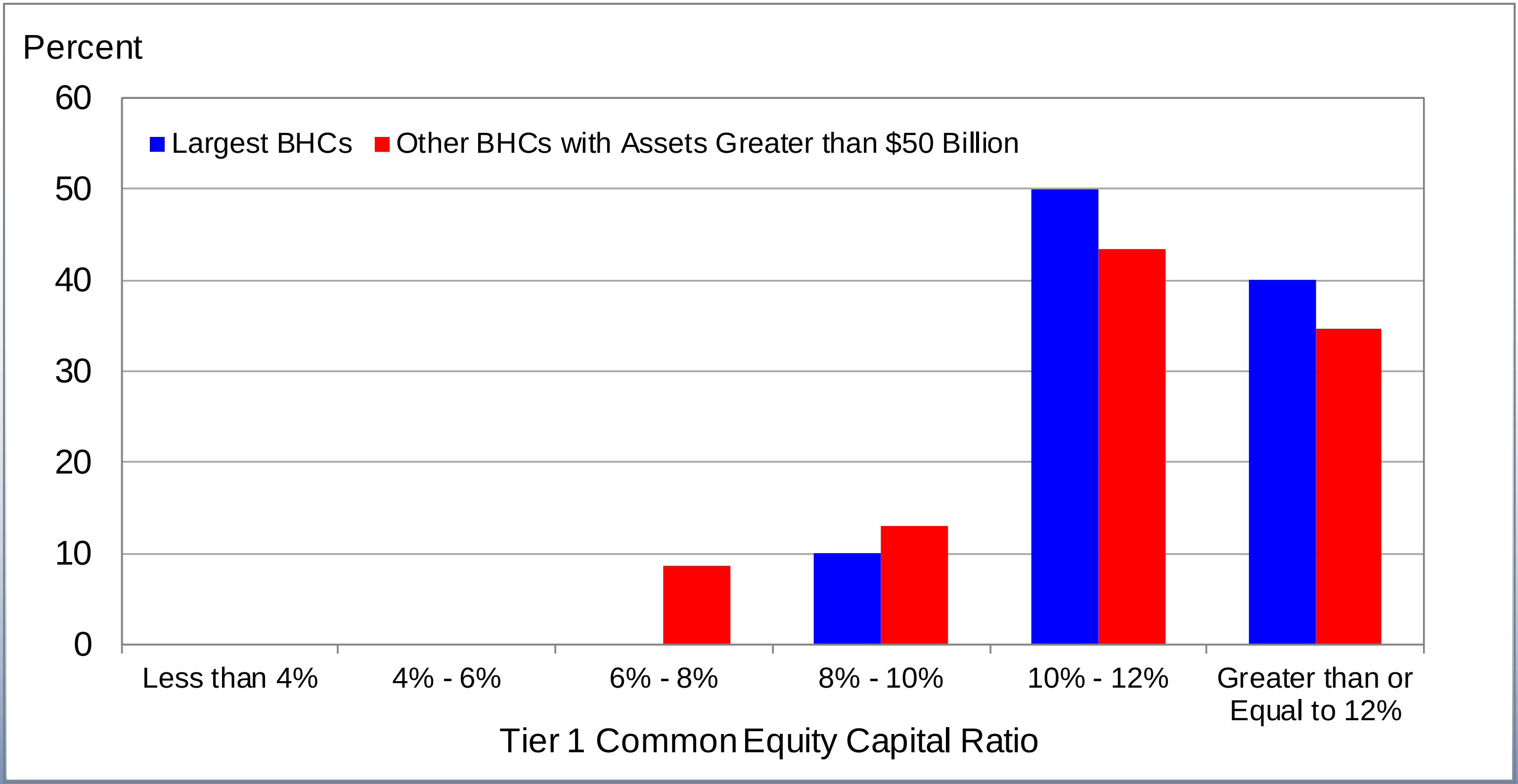
as of June 30, 2013



Source: Consolidated Financial Statements for Bank Holding Companies (FR Y-9C).

Figure 5
Tier 1 Common Equity Capital Ratio Distribution of U.S. Bank Holding Companies with Assets Over $50 Billion

as of June 30, 2013

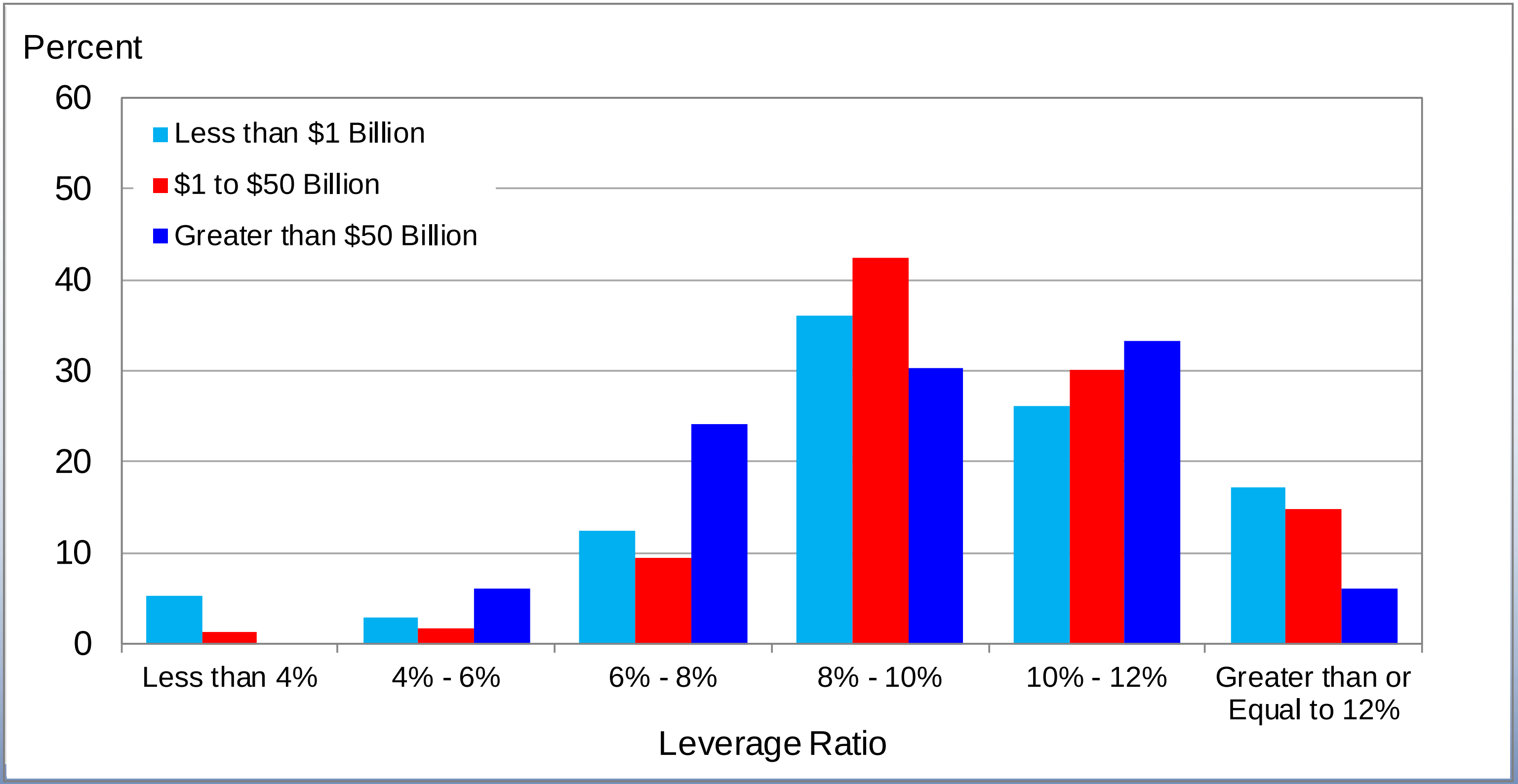


Note: The Largest BHCs include the 10 largest domestically owned U.S. bank holding companies.

Source: Consolidated Financial Statements for Bank Holding Companies (FR Y-9C).

Figure 6
Leverage Ratio Distribution of U.S. Bank Holding Companies by Asset Size

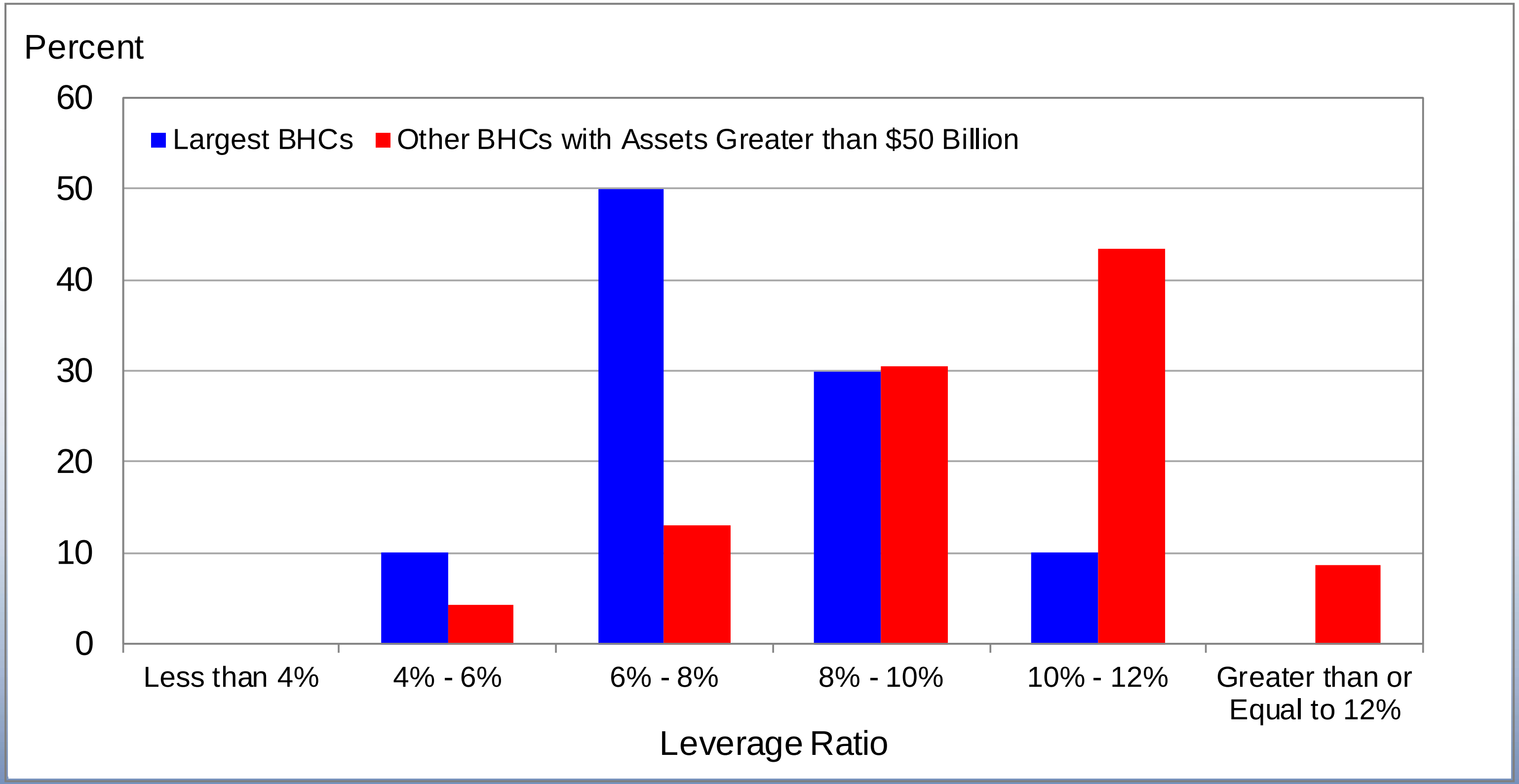
as of June 30, 2013



Source: Consolidated Financial Statements for Bank Holding Companies (FR Y-9C).

Figure 7
Leverage Ratio Distribution of U.S. Bank Holding Companies with Assets over $50 Billion

as of June 30, 2013

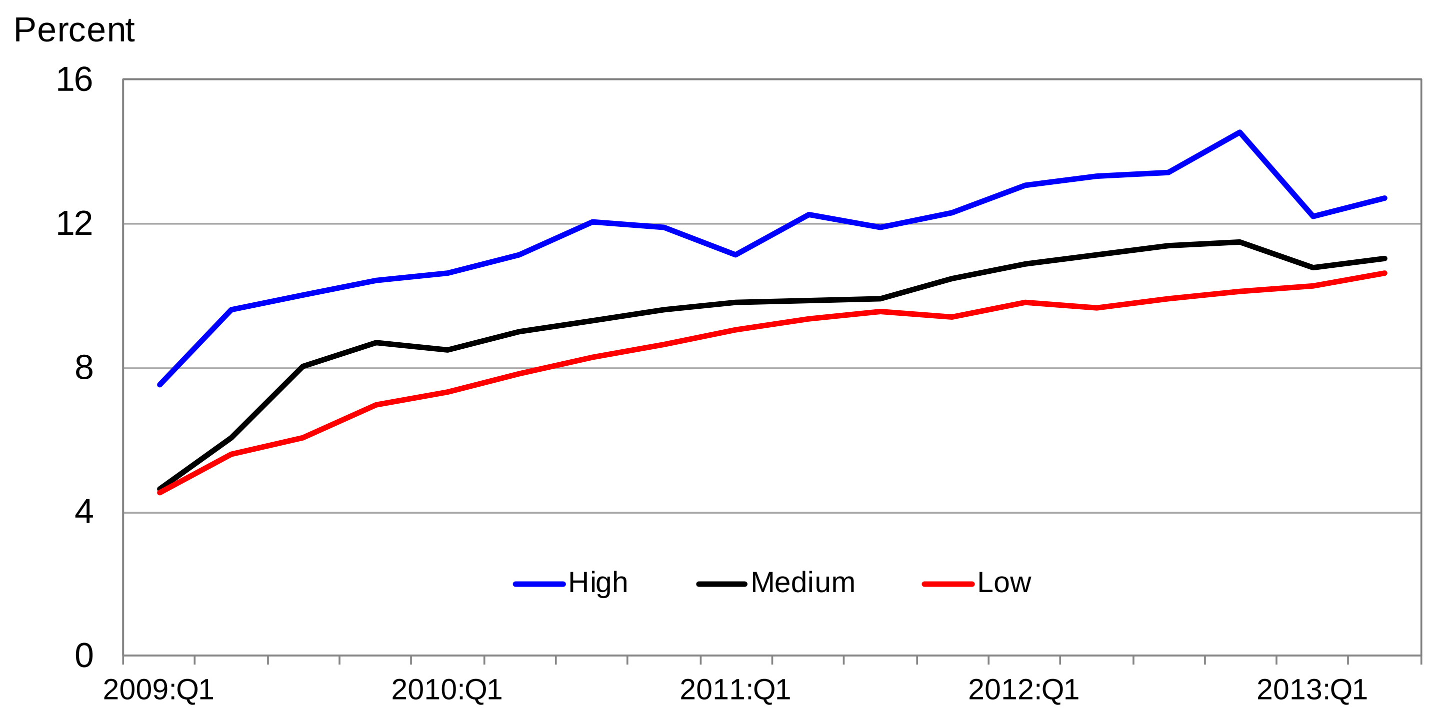


Note: The Largest BHCs include the 10 largest domestically owned U.S. bank holding companies.

Source: Consolidated Financial Statements for Bank Holding Companies (FR Y-9C).

Figure 8
Tier 1 Common Equity Capital Ratio of Largest U.S. Bank Holding Companies by Broker-Dealer Activity Concentration

2009:Q1 - 2013:Q2

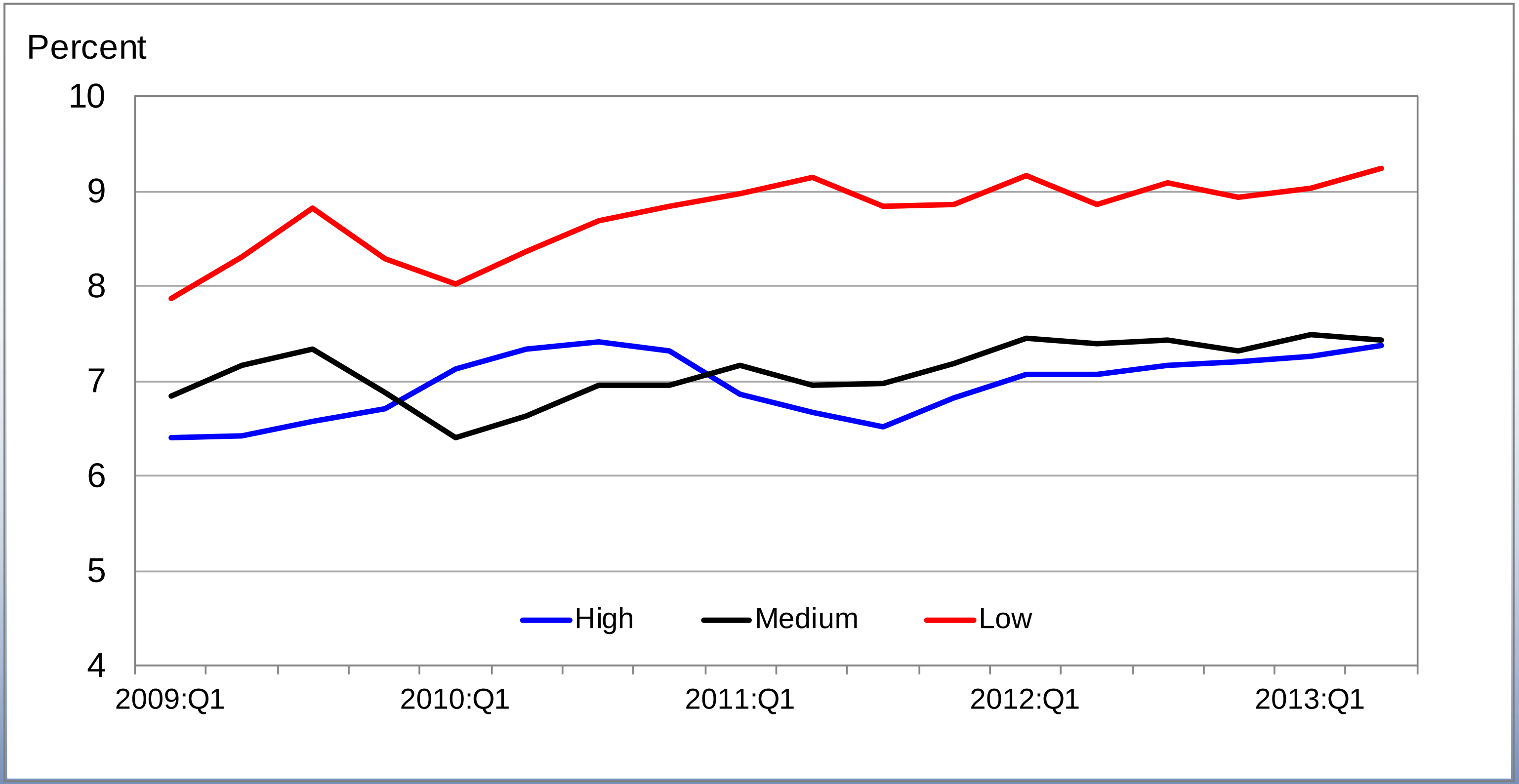


Note: Tier 1 Common Equity Capital Relative to Basel I Risk-Weighted Assets

Note: The Largest BHCs include the 10 largest domestically owned U.S. bank holding companies.
Source: Consolidated Financial Statements for Bank Holding Companies (FR Y-9C).

Figure 9
Leverage Ratio of Largest U.S. Bank Holding Companies by Broker-Dealer Activity Concentration

2009:Q1 - 2013:Q2



Note: The Largest BHCs include the 10 largest domestically owned U.S. bank holding companies.
Source: Consolidated Financial Statements for Bank Holding Companies (FR Y-9C).

Capital at Banking Organizations with Broker-Dealers

- Business models of some bank holding companies span diverse activities, particularly among the largest organizations – reason for leverage ratio use as an important supplement
- Broker-dealer operations carry high risk-weighted capital ratios because they hold low-risk assets – but they are still highly leveraged
- Consider a capital charge for reliance on wholesale funding

Concluding Observations

- Banking organizations have responded to more regulatory and supervisory scrutiny of capital by raising their capital ratios
- There is the potential that the complexity could weaken the third pillar of Basel III market discipline
- The leverage ratio is a particularly important supplemental tool for global banks that are heavily reliant on wholesale funding

Concluding Observations Continued

- Many of these very large organizations have lower leverage capital ratios than are observed at more traditional large bank lenders
- Global banking organizations with significant investment banking and broker-dealer activities pose significant potential risk to the financial system and should be among the best capitalized