Progress on Addressing “Too Big To Fail”

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bostonfed.org
Dodd-Frank Act

“To promote the financial stability of the United States by improving accountability and transparency in the financial system, to end ‘too big to fail,’ to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices, and for other purposes…”

- Congressional intent is clear
- Regulations to carry out intent are extensive; still being finalized or phased in
Two Areas of Focus – and Substantial Progress

- Reducing the *probability* of failures
  - Comprehensive Capital Analysis and Review (CCAR)
  - Global Systemically Important Bank Holding Company (GSIB) capital surcharge
  - Both significantly increased capital buffers

- Reducing the *cost* of failures (reduced likelihood a large institution’s failure would be systemically destabilizing)
  - Hold sufficient debt to avoid necessity of taxpayer funds in the event of a resolution
  - Resolution plans ("living wills")
Other Important Initiatives Relevant to ‘Too Big to Fail’

- Derivatives clearing
  - More derivatives are centrally cleared
  - Increased margin requirements on derivatives contracts not centrally cleared
- Non-bank financial institutions can be designated systemically important
- Intermediate holding companies for foreign banking organizations
- New liquidity requirements – Liquidity Coverage Ratio (LCR), Net Stable Funding Ratio (NSFR), Comprehensive Liquidity Analysis and Review (CLAR)
Figure 1: Assets of U.S. Global Systemically Important Bank Holding Companies (GSIBs)

Source: Consolidated Financial Statements for Bank Holding Companies (FR Y-9C)
Figure 2: U.S. GSIB Share of Banking Industry Assets
2010:Q1 - 2015:Q3

Note: Commercial and savings bank assets only. Does not include the assets of former OTS-regulated institutions or branches and agencies of foreign banking organizations.

Source: Quarterly Bank Call Reports
Important Caveats

- Many regulations are new, some are proposals
- Full implementation is several years in the future
- Too soon to assess bank reaction
- Significant progress in reducing probability and cost of a GSIB failure
CCAR

- Examines the ability of large bank holding companies to withstand stressful economic and financial conditions
- Stress test used to determine whether the Fed will object to capital distributions
  - Payment of dividends
  - Stock repurchases
- Both quantitative and qualitative risk assessments
- Flexible – stress reflects biggest concerns
- Stress changes – banks need to hold a sufficient capital cushion for a variety of stress situations
Figure 3: U.S. GSIB Actual Tier 1 Leverage Ratio in 2014:Q3 and Projected Minimum in the Severely Adverse CCAR Scenario

Source: Federal Reserve Board, Comprehensive Capital Analysis and Review (CCAR), March 2015
Capital Surcharge on U.S. GSIBs

- Significant other capital requirements added since the financial crisis
- Focus on additional capital required for GSIBs given the greater threat their size and complexity pose to the financial stability of the U.S.
- Surcharge calculated two ways, with the higher of two outcomes applied as the actual surcharge
  - Method 1 (based on BCBS framework) considers size, interconnectedness, cross-jurisdictional activity, substitutability, and complexity
  - Method 2 uses similar inputs, is calibrated to yield higher surcharges, and replaces substitutability with a measure of reliance on short-term wholesale funding

GSIB Surcharge

- Estimated surcharges for the GSIBs, at the time of adoption, ranged from 1.0 to 4.5 percent
  - Estimates do not necessarily reflect the surcharges that would apply when the rule becomes effective, because the rule relies on individual firm data which changes over time
  - As Janet Yellen noted: “…they must either hold substantially more capital, reducing the likelihood that they will fail, or else they must shrink their systemic footprint, reducing the harm that their failure would do to our financial system.”
Figure 4: Common Equity Tier 1 Risk-Based Capital Ratio for U.S. Domestic Bank Holding Companies

Note: Includes firms with assets over $1 billion throughout the period. Several sharp declines in the ratios can partly be attributed to the implementation of new Basel capital rules.

Source: Consolidated Financial Statements for Bank Holding Companies (FR Y-9C)
Figure 5: Tier 1 Leverage Ratio for U.S. Domestic Bank Holding Companies

2010:Q1 - 2015:Q3

Note: Includes firms with assets over $1 billion throughout the period as the reporting size increased with the March 31, 2015 report, from $500 million to $1 billion in assets.

Source: Consolidated Financial Statements for Bank Holding Companies (FR Y-9C)
Capital Regulation Not Fully Phased In

- Complete phase in occurs in several years
- Counter-cyclical capital buffer is currently zero
- Not yet decided by the Fed’s Board of Governors whether GSIB institutions will be required to include all or part of the surcharge in the capital required by CCAR
- If they were required to, or if post-stress CCAR minimums were increased by other means, the stress tests would be even more binding on GSIB institutions
- I would be in favor of such changes. My view is that GSIB institutions should be required to increase post-stress minimums, through one means or another
Proposed Rule for Long-Term Debt and Total Loss-Absorbing Capacity (TLAC) Requirements

- Domestic GSIBs would be required to hold at a minimum:
  - A long-term debt amount of the greater of 6 percent plus its GSIB surcharge of risk-weighted assets and 4.5 percent of total leverage exposure; and
  - A TLAC amount of the greater of 18 percent of risk-weighted assets and 9.5 percent of total leverage exposure

- Enough long-term debt so that if a GSIB fails and needs to be resolved, the debt could be converted to equity and negate the need for support from taxpayers

Source: Federal Reserve Board Press Release, October 30, 2015
Figure 6: Depiction of Proposed Long-Term Debt Requirement and Fully Phased-in Tier 1 Risk-Based Capital Requirements

Chart illustrates the minimum level of loss-absorbing capacity that a U.S. GSIB would have as a result of the proposed rule, if the GSIB meets the fully phased-in capital requirements and capital buffers under the board’s existing capital rules.

External LTD Requirement: (RWA Approach – 6.0% + GSIB surcharge)
GSIB Surcharge:¹ Additional CET1 Capital
Tier 1 Capital: 2.5% Capital Conservation Buffer plus 1.5% Additional Tier 1 plus 4.5% Common Equity Tier 1 (CET1) Minimum

¹GSIB surcharge is based on estimates disclosed with the final rule in July 2015.

Note: Chart does not depict (i) the amount of external TLAC that would be required under the proposed rulemaking or (ii) any higher amount of LTD that could be required if calibrated under the proposed external LTD requirement’s leverage approach.

Source: Federal Reserve Board Press Release, October 30, 2015
Resolution Plans ("Living Wills")

- Both FDIC and Federal Reserve must agree to the resolution plan
- Evaluation of plans is continuing
- Additional protection for taxpayer resources
- S&P downgraded non-operating holding companies of the domestic GSIBs, reflecting the enhanced possibility that there will not be U.S. government support
Concluding Observations

- Significant progress made in eliminating TBTF
- However, significant work remains
  - Proposals need to be finalized
  - More work needed on resolution plans
  - Full phase in of regulations
- Nonetheless,
  - Capital ratios increasing, with goal of reducing chances of a GSIB failing
  - Potential cost to taxpayer of such a failure reduced by TLAC and resolution plans