FEDERAL RESERVE BANK OF BOSTON™

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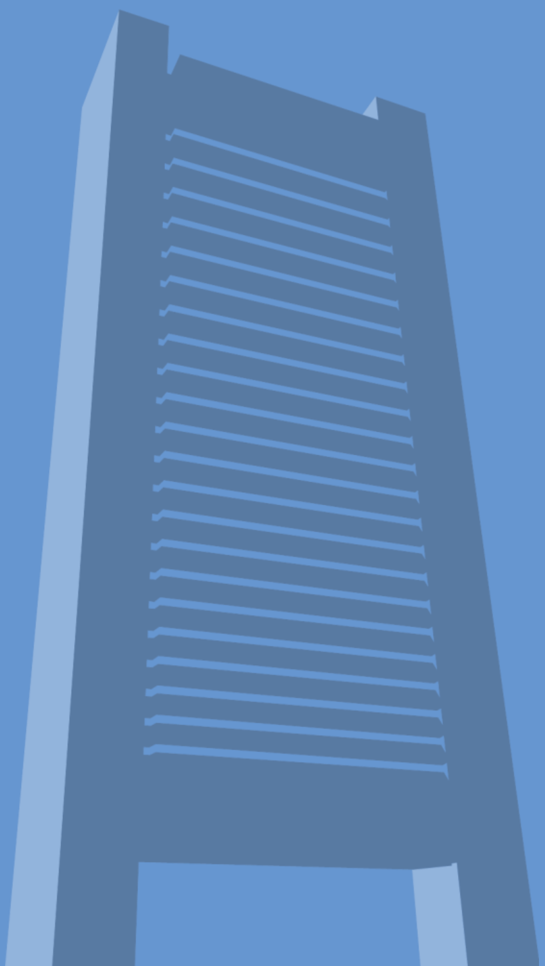
Observations on Defining the Objectives and Goals of Supervision



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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…"*

Intent of Supervision and Regulation

- Avoiding future bailouts is a critical lesson from the financial crisis and Dodd-Frank
- But also, well-functioning financial intermediaries are important to public welfare, as essentially the lubricant for the real economy:
  - A car engine without oil will seize up; countries with failed financial intermediaries can find their economies seizing up
  - It is no coincidence that the two worst economic cycles in the U.S. over the past 100 years have coincided with the widespread failure of financial institutions

Importance of Financial Intermediaries

- Supervision has several objectives beyond avoiding taxpayer losses
  - Financial institutions need to be resilient to effectively channel funds from savers to borrowers
  - Prevent problems at financial intermediaries from damaging the real economy in downturns
  - Major conduit through which monetary policy affects the real economy

Stress Tests Critical to Supervision

- Stress testing – a proactive supervisory approach introduced after the crisis
- If properly implemented, should make systematic failures quite unlikely
- Restrict dividends or share buybacks unless the supervisor is confident that systemic institutions are resilient to even severe stress
- Financial institutions should be able to effectively intermediate throughout the cycle

If an Intermediary is Impaired: Trade-Offs

- Capital regulation provides an example of the trade-offs inherent in supervisory and regulatory policymaking
- A bank that falls below its regulatory capital-to-assets ratio can take one of two paths:
  - Raise new capital (by raising new equity or retaining earnings)
  - Or shrink assets (by selling assets or reducing lending, because loans are assets for financial institutions)

Supervisory Trade-Offs: the Numerator

- Choosing to increase capital by suspending dividends or not repurchasing shares
  - Less of an impact on borrowers seeking credit
  - Likely to increase capital only very gradually
- Issuing new equity
  - Can be done relatively quickly
  - Dilutes existing shareholders, but if done proactively it can stave off severe financial stress on the institution

Supervisory Trade-Offs: the Denominator

- Reduce lending
  - Takes time – primarily affects new, not existing, loans
  - Impacts credit for individuals and firms
- Sell assets
  - Accomplished relatively quickly
  - The sales may have to occur at deeply discounted or even “fire sale” prices – which can impact capital

Examples

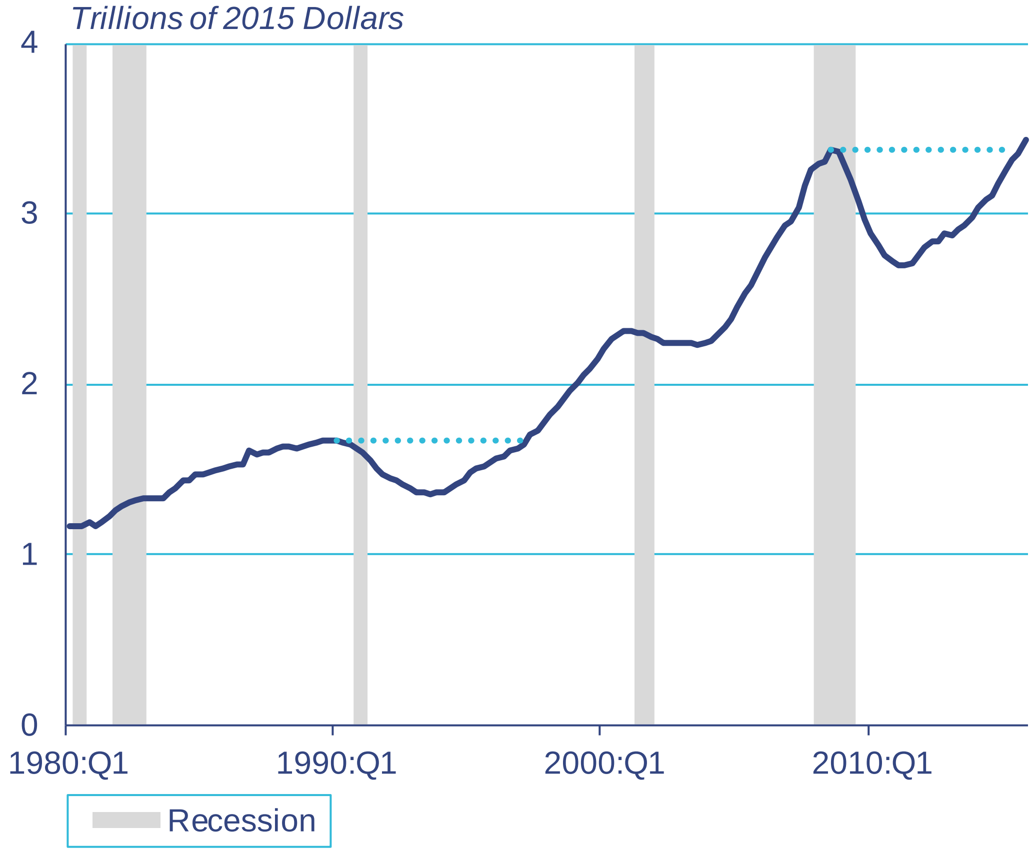
- In the United States, the recession in the early 1990s was exacerbated by binding capital requirements
- The first supervisory “stress test” exercise in 2009 required that recapitalization not be accomplished by shrinking assets, i.e., reducing lending
- Following the Japanese banking problems of the 1990s, the authorities counted on bank earnings to recapitalize the banking sector – but this was handicapped by continued declines in stock and real estate prices in Japan’s economy

My View

- Supervisors can help prevent systemic events with sufficiently high capital standards and rigorous stress tests
- Achieve sufficient resilience so shocks would not badly impair financial intermediaries over the business cycle
- Use stress tests to ensure banks are resilient before approval to pay out earnings (depleting capital)
  - Before introduction of the post-crisis stress tests, banks were allowed to continue to pay dividends in 2007 and 2008, resulting in a much greater need to recapitalize
- However, if a shock occurs and banks prove insufficiently resilient, proactively recapitalize the sector as quickly as possible *while at the same time avoiding collateral damage from tighter credit standards*

Figure 1: Real Business Loans Outstanding at Commercial Banks

1980:Q1 - 2015:Q4



Note: Real Business Loans include Commercial and Industrial and Commercial Real Estate Loans. Real Business Loans Outstanding are adjusted for inflation using the GDP deflator.

Source: Commercial Bank Quarterly Call Reports, BEA, NBER, Haver Analytics

Figure 2: GSIB Minimum Basel III Leverage Ratio Required by Region/Country

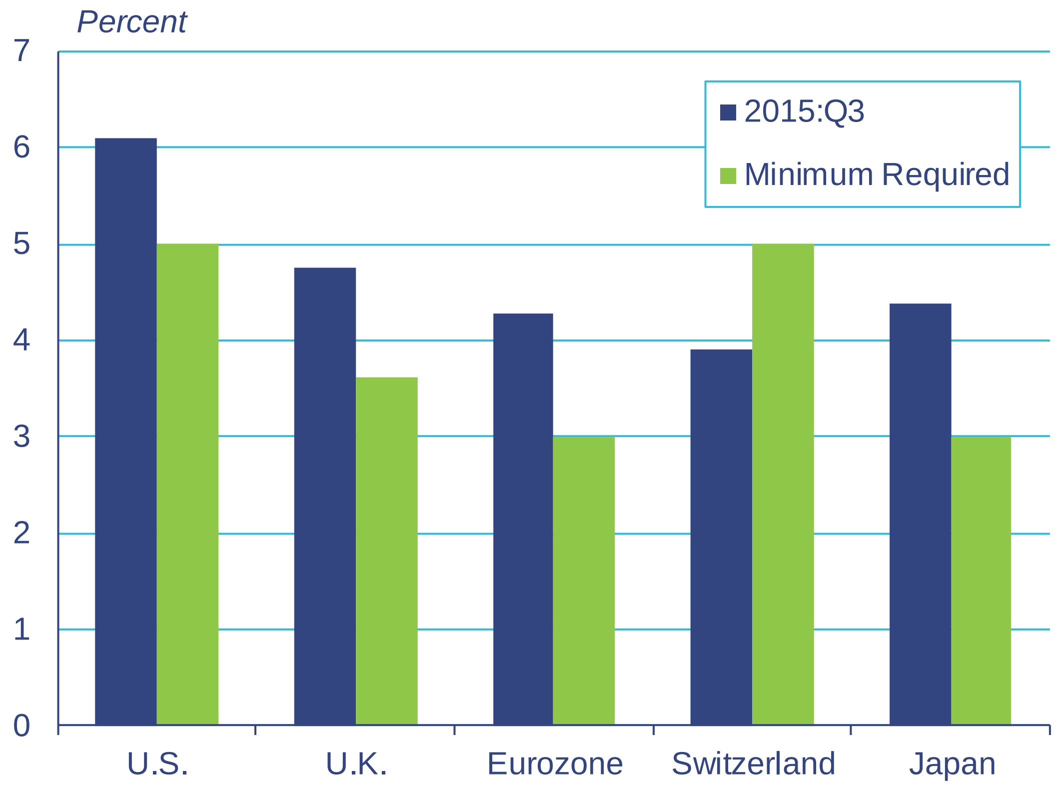
Region/Country	Banking Organizations	Minimum	Additional Detail
U.S.	GSIBs	5%	2 percentage points above the 3% minimum to avoid restrictions on capital distributions and discretionary bonus payments
U.K.	GSIBs	3.35%-3.875% plus CCLB	Additional Leverage Ratio Buffer: 35% of corresponding risk-weighted systemic buffer rates (0.35% - 0.875% for current GSIBs) Countercyclical Leverage Ratio Buffer (CCLB): 35% of a bank's institution-specific countercyclical capital buffer rate
Eurozone	GSIBs	3%	
Switzerland	GSIBs	5%	
Japan	GSIBs	3%	

Note: Additional requirements for GSIBs are under discussion by the Basel Committee's Group of Central Bank Governors and Heads of Supervision (GHOS)

Source: Federal Reserve Board, Bank of England, BCBS, FNMA

Figure 3: Basel III Fully Phased-In Leverage Ratio: Average of GSIBs and Minimum Required by Region/Country

2015:Q3

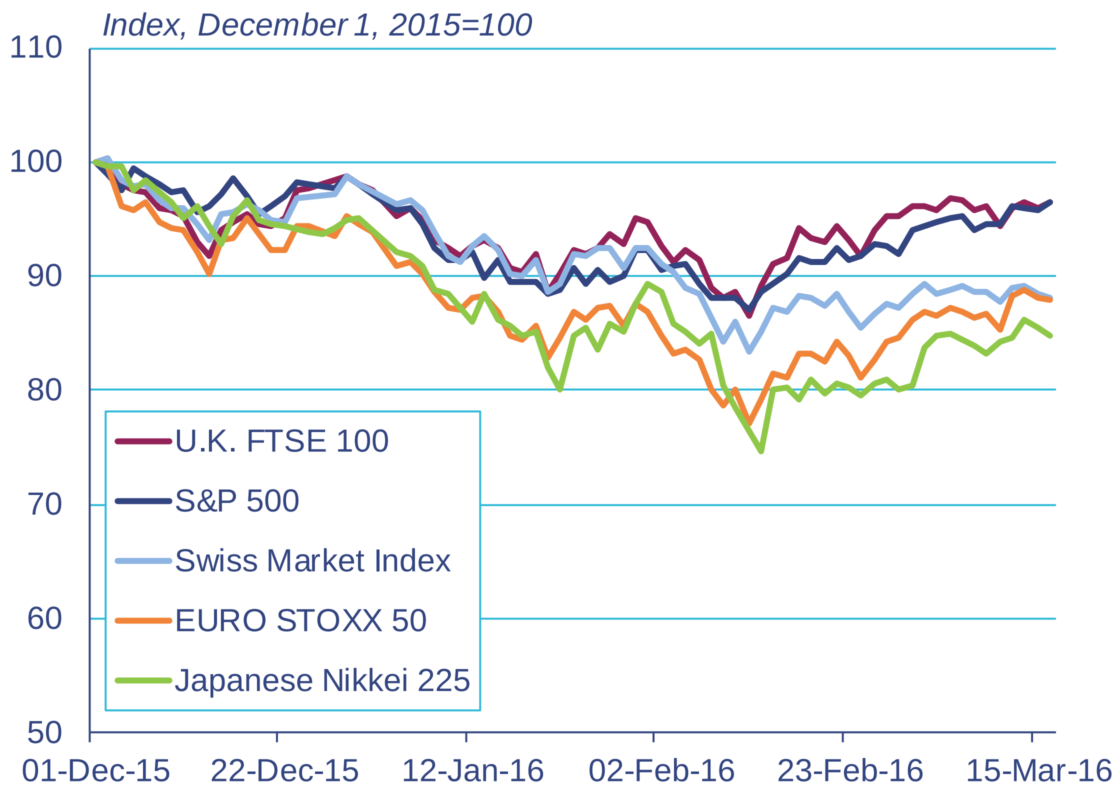


Note: Japan's average is based on leverage ratios calculated on a transitional basis. U.K. has individual minimums for GSIBs – the average of individual minimums (assuming CCLBs of 0%) is shown. Additional requirements for GSIBs are under discussion by the Basel Committee's Group of Central Bank Governors and Heads of Supervision (GHOS).

Source: Company Financials and Investor Presentation Materials

Figure 4: Global Stock Market Indices

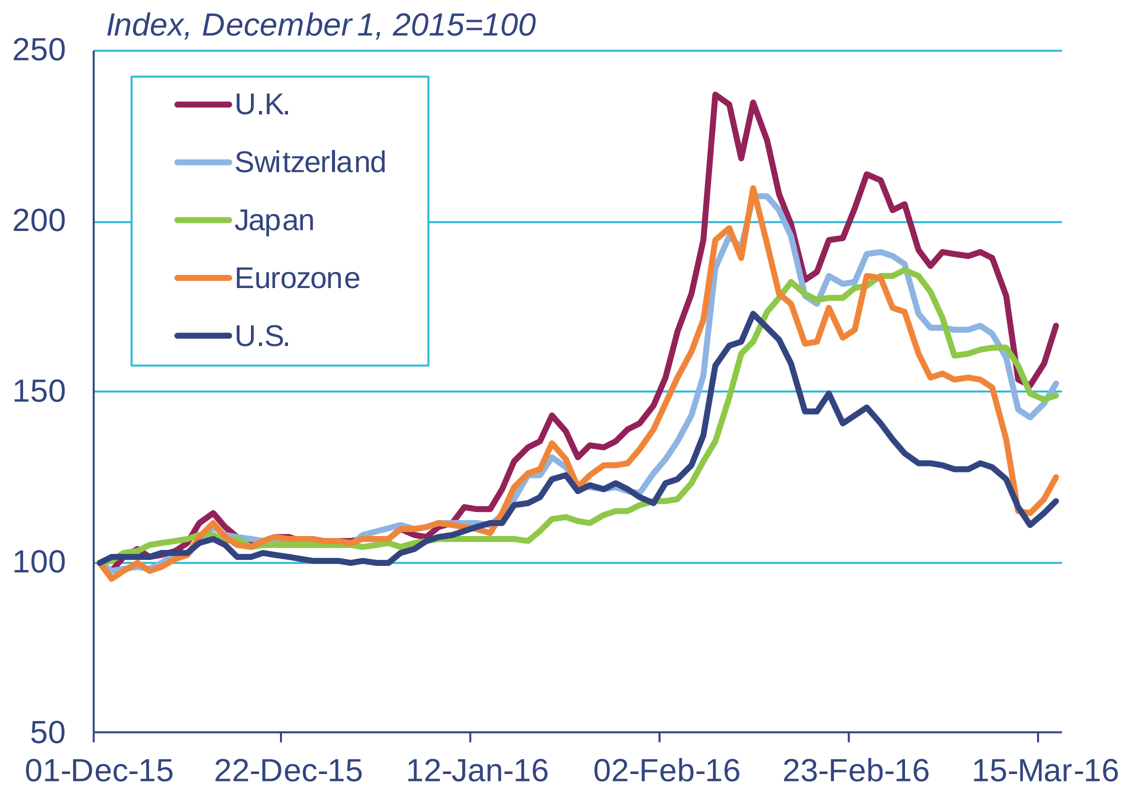
December 1, 2015 - March 16, 2016



Source: FT, S&P, STOXX Limited, SIX Swiss Exchange, WSJ, Haver Analytics

Figure 5: Average of CDS Spread Indices of GSIBs by Region/Country

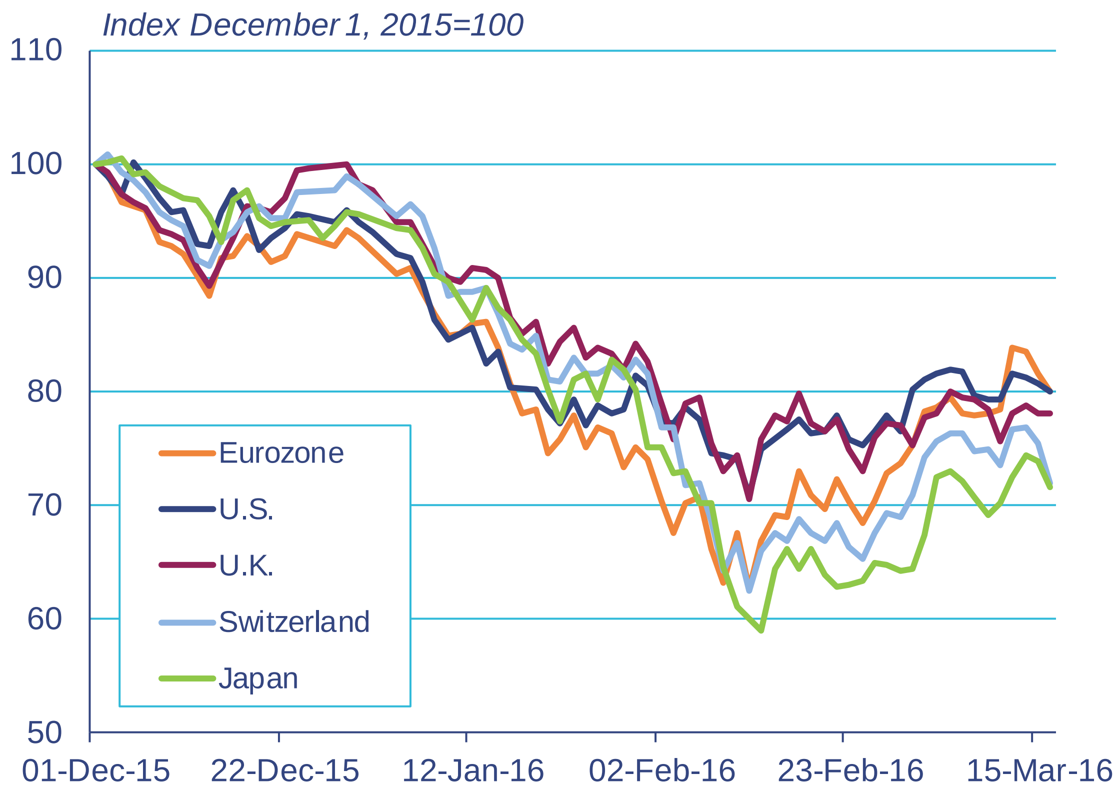
December 1, 2015 - March 16, 2016



Source: Bloomberg

Figure 6: Average of Stock Price Indices of GSIBs by Region/Country

December 1, 2015 - March 16, 2016



Source: Bloomberg

Concluding Observations

- The distribution of losses when financial institutions fail is very important
- The primary goal of supervision should be to ensure effective intermediaries that can support the broader economy throughout the business cycle including periods of stress
- Bank supervision helps insulate the largest financial institutions from adverse economic shocks that may emerge
- This should be done in ways that also encourage financial intermediaries to continue lending