Simplicity and Complexity in Capital Regulation

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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
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.
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).
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).
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.
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.