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Client Alert

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Bubble, Bubble Toil and Trouble:

The Fed Breathes Life into the Countercyclical Capital Buffer

Widespread problems in the banking system are often associated with sharp declines in asset prices, or the economy more broadly. When these declines result in loan defaults, bank capital can erode, leading to more stringent underwriting standards, tighter credit and further declines in economic activity. In theory, a capital cushion that can be reduced in times of stress while still maintaining adequate capital levels in banking institutions might be used to mitigate this cycle. Capital could be increased during times of irrational exuberance and then reduced as the bubble bursts and losses accrue. This theory was incorporated into section 616 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, which provides that

> [i]n establishing capital regulations pursuant to [the Bank Holding Company Act of 1956], the [Federal Reserve Board] shall seek to make such requirements countercyclical, so that the amount of capital required to be maintained by a company increases in times of economic expansion and decreases in times of economic contraction, consistent with the safety and soundness of the company.[1]

In practice, the idea of countercyclical capital raises issues of correctly identifying market conditions that are likely to lead to eventual contractions and communicating those determinations in a way that do not make them self-fulfilling prophecies. Accordingly, implementing countercyclical capital will entail a lot of hard work in monitoring economic activity and a certain amount of risk.

With these issues in mind, on December 21, 2015, the Board of Governors of the Federal Reserve System (the "Federal Reserve"), in consultation with the Federal Deposit Insurance Corporation (the "FDIC") and the Office of the Comptroller of the Currency (the "OCC" and, together with the Federal Reserve and FDIC, the "Banking Agencies"), announced that it was seeking public comment on a proposed policy statement (the "Policy Statement") that details the framework that the Federal Reserve will follow in establishing the U.S. Basel III countercyclical capital buffer ("CCyB") for large, internationally active banking organizations that are subject to the advanced approaches capital rules (referred to herein as "Advanced Approaches Institutions"). Such banking organizations generally include (1) all financial institutions with greater than $250 billion in total assets or $10 billion in on-balance-sheet foreign exposure, and (2) any depository institution subsidiary of such a banking organization.[2]

The CCyB is intended to be a macroprudential tool that the Federal Reserve may use to strengthen the financial system by raising capital requirements when there is an elevated risk of above-normal losses. The CCyB functions as an extension of the Capital Conservation Buffer and, from a regulatory standpoint, is already provided for in the

[1] The Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, Sec. 616 (July 21, 2010). Similar provisions apply to savings and loan holding companies and insured depository institutions.
[2] *See* 12 C.F.R. § 217.100(b)(1).

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regulatory capital rules ("Regulation Q") issued in June 2013 by the Federal Reserve, in coordination with the FDIC and OCC.[3] While the capital rules detail the mechanics of applying the CCyB, the Policy Statement focuses on when the CCyB will be invoked.

The Policy Statement, which is described in greater detail below, consists of six sections that together enunciate the framework that the Federal Reserve will follow in determining the appropriate CCyB for U.S.-based credit exposure.[4]

In addition to issuing the Policy Statement for comment, the Federal Reserve also voted to affirm the CCyB amount at the level of zero percent. Once fully phased in, the CCyB, which is calculated based on private-sector credit exposures located in the United States, will range anywhere from zero percent of risk-weighted assets (indicating moderate financial-system vulnerabilities) to a maximum of 2.5 percent (denoting significantly elevated financial-system vulnerabilities). If the Federal Reserve decides to increase the CCyB amount, Advanced Approaches Institutions would have 12 months to comply with the increased CCyB amount before it becomes effective (unless the Federal Reserve expressly establishes an earlier effective date). The Federal Reserve has set a deadline for comments to the Policy Statement on or before February 19, 2016.

Section 1. <u>General Background of the Policy Statement</u>. As described in Section 1 of the Policy Statement, the CCyB is a flexible macroprudential policy tool that the Federal Reserve can increase during times of stress on the financial system and reduce when vulnerabilities of the stability of the financial system subside. The primary goal of the CCyB is to augment the resiliency of large banking organizations when there is an elevated risk of above-normal losses, which, in turn, should serve to enhance the strength of the financial system generally. Above-normal losses frequently follow periods of rapid asset price appreciation or credit growth that are not well supported by underlying economic fundamentals.

Section 1 further explains that the Federal Reserve, working jointly with the OCC and FDIC, will set the CCyB moving forward by taking into account the macrofinancial environment in which banking organizations function and the degree to which that environment impacts the resilience of the group of Advanced Approaches Institutions. However, in practice, the CCyB will fluctuate for each Advanced Approaches Institution, given that the CCyB is weighted based on a banking organization's particular composition of private-sector credit exposures across national jurisdictions.

Section 2. <u>Overview and Scope</u>. Section 2 sets forth the scope of the Policy Statement. Specifically, the Policy Statement provides the Federal Reserve with a framework to set the amount of the CCyB for U.S.-based credit exposures. This framework: (i) provides a set of principles for translating assessments of threats to the stability of the financial system into the appropriate level of the CCyB; and (ii) assesses whether the CCyB is the most appropriate policy instrument to address particular financial-system vulnerabilities.

Section 3. <u>Objectives of the CCyB</u>. Section 3 outlines the objectives of the CCyB: (i) strengthening of banking organizations' resiliency against the build-up of systemic vulnerabilities; and (ii) reduction of fluctuations in the supply of credit. While prior rules implemented by the Banking Agencies, such as the minimum capital requirements, the capital conservation buffer and the capital surcharge (imposed on global systemically important banking organizations, or "G-SIBs"), have sought to provide greater market resiliency to unexpected losses and financial distress, banking organizations are still susceptible to undercapitalization during periods of financial excesses, as reflected by bouts of rapid asset appreciation or credit growth not well supported by underlying economic fundamentals, followed by above-normal losses.

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[3] *See* Regulatory Capital Rules, 78 Fed. Reg. 62018 (Oct. 11, 2013) (Federal Reserve and OCC); Regulatory Capital Rules, 79 Fed. Reg. 20754 (Apr. 14, 2014) (FDIC). Regulation Q applies generally to all bank holding companies with greater than $1 billion in total consolidated assets and savings and loan holding companies with more than $1 billion in total consolidated assets that are not substantially engaged in commercial or insurance underwriting activities. *See* 12 C.F.R. § 217.1(c)(1).
[4] The CCyB is subject to a phase-in arrangement between 2016 and 2019. *See* 12 C.F.R. § 217.300(a)(2).

Accordingly, the Federal Reserve expects that the CCyB will help to achieve greater market resiliency for Advanced Approaches Institutions, as well as the financial market at large, in the following two ways. First, Advanced Approaches Institutions will likely hold more capital to avoid limitations on capital distributions and discretionary bonus payments resulting from the implementation of the CCyB. Second, the CCyB will help promote a more sustainable supply of credit over the economic cycle. If Advanced Approaches Institutions are better capitalized, they will likely have continued access to funding and be less likely to take actions that create broader financial-sector distress and associated macroeconomic costs. Accordingly, as a result of the CCyB being put into place during a period of rapid credit creation, such Advanced Approaches Institutions will likely be better positioned to continue their important intermediary functions even during a subsequent market downturn. Furthermore, Advanced Approaches Institutions might react to an increase in the CCyB by tightening lending standards, increasing capital, or both. Such actions will only further reduce the likelihood that Advanced Approaches Institutions with insufficient capital would need to engage in imprudent risk taking.

Section 4. <u>The Framework for Setting the U.S. CCyB</u>. Section 4 lists the factors that the Federal Reserve intends to consider when determining the appropriate size of the U.S. CCyB, including: (a) financial-system vulnerabilities; (b) financial and macroeconomic quantitative indicators; and (c) relevant empirical models.

First, the Federal Reserve will evaluate financial-system vulnerabilities, including, but not limited to: (i) asset valuation pressures and risk appetites; (ii) leverage in the nonfinancial sector; (iii) leverage in the financial sector; and (iv) maturity and liquidity transformation in the financial sector. Any decision regarding the appropriateness of the U.S. CCyB will reflect the implications of the assessment of the aforementioned financial-system vulnerabilities, as well as any concerns related to certain classes of vulnerabilities.

Second, the Federal Reserve will monitor a wide range of financial and macroeconomic quantitative indicators, including, but not limited to: (i) measures of relative credit and liquidity expansion or contraction; (ii) a variety of asset prices; (iii) funding spreads; (iv) credit condition surveys; (v) indices based on credit default swap spreads; (vi) options implied volatility; and (vii) measures of systemic risk.[5]

Third, the Federal Reserve will also take into consideration empirical models that translate a manageable set of quantitative indicators of financial and economic performance into potential settings for the CCyB. Such models may include: (i) those that rely on small sets of indicators (*e.g.*, credit-to-GDP ratio, its growth rate and a combination of the credit-to-GDP ratio with trends in the prices of residential and commercial real estate); and (ii) those that consider larger sets of indicators, which have the advantage of representing conditions in all key sectors of the economy (such as those specific to risk-taking, performance and the financial condition of larger banks).

When setting the CCyB, the Federal Reserve will nevertheless consult with the OCC and FDIC on their analyses of what constitutes financial-system vulnerabilities and the extent to which banking organizations are exposed to or contributing to such vulnerabilities.

Based on its analysis of these factors, the Federal Reserve will then set the CCyB on a sliding scale, ranging from zero percent to 2.5 percent. A zero percent U.S. CCyB amount would indicate the Federal Reserve's view that U.S. economic and financial conditions are generally consistent with a financial system in which levels of system-wide vulnerabilities are not "somewhat above normal." Conversely, increasing the CCyB to 2.5 percent for U.S.-based credit exposures would reflect the Federal Reserve's determination that the U.S. financial sector is undergoing a period of significantly elevated or rapidly increasing system-wide market vulnerabilities. As a macroprudential tool, the CCyB will be adjusted based on the developments and trends in the U.S. financial system as a whole, as opposed to the "micro" activities of any individual banking organization. Therefore, when certain market vulnerabilities causing the increase of the CCyB have diminished, the Federal Reserve will remove or reduce the CCyB in a timely manner. However, the pace at which the CCyB will be raised or lowered will greatly depend on

[5] *See* 12 C.F.R. § 217.11(b)(2)(iv).

the financial sector's underlying conditions, the general economy and desired effects of the proposed changes in the CCyB.

While the Federal Reserve notes in Section 4 that it will consider the aforementioned indicators and models when determining the appropriate level of the CCyB for U.S.-based credit exposures, it cautions that no single indicator or fixed set of indicators can comprehensively capture all the key vulnerabilities in the U.S. economy and financial system. The Federal Reserve further states that tightly linking adjustments in the CCyB to a specific model or set of models would be imprecise due to the relatively short period that some indicators are available, the limited number of past crises against which the models can be calibrated and the Federal Reserve's limited experience with the CCyB as a macroprudential tool. Accordingly, the indicators and models used to determine the appropriate level of the CCyB will not be static, but instead constantly evolving based on research and as the Federal Reserve becomes more comfortable using and evaluating the CCyB tool.

Finally, as explained in Section 4, it is also possible that the CCyB will be an inappropriate policy instrument to utilize at times, depending on the type of financial-system vulnerability. For example, structural vulnerabilities are likely better addressed through targeted reforms or permanent increases in financial system resiliency, as opposed to the CCyB, which is intended to address cyclical vulnerabilities.

The criteria laid out in Section 4 provide for wide discretion in invoking the CCyB and enable the Federal Reserve to consider other macroprudential tools, which may include more conventional monetary policy tools.

Section 5. Communication of the U.S. CCyB with the Public. Section 5 of the Policy Statement sets forth the frequency with which the Federal Reserve plans to evaluate the appropriate level of the U.S. CCyB, as well as the ways in which the Federal Reserve intends to communicate its assessment of the financial stability of the U.S. markets to the public.

The Federal Reserve notes in Section 5 that it will review financial conditions regularly throughout the year, and expects to consider the applicable level of the U.S. CCyB at least annually. However, the Federal Reserve may adjust the CCyB depending on the results of its monitoring activities.

Furthermore, the Federal Reserve will communicate regularly with the public regarding its assessment of U.S. financial stability, including financial-system vulnerabilities. The Federal Reserve will continue to provide an update on developments pertaining to the stability of the U.S. financial system in its biannual Monetary Policy Report to the U.S. Congress. Specifically, the Federal Reserve will utilize the Monetary Policy Report to update the public on how the Federal Reserve's current assessment of financial-system vulnerabilities bears on the setting of the level of the CCyB.

Section 6. Monitoring of the Effects of the U.S. CCyB. As the Federal Reserve outlines in Section 6 of the Policy Statement, the effects of the U.S. CCyB on the broader financial system will largely depend upon a complex set of interactions between required capital levels at the largest banking organizations, and the economy and financial markets. It is also possible that secondary economic effects could result if the financial markets associate changes to the CCyB value with subsequent actions that the Federal Reserve plans to take.

In order to gain a better understanding of the direct and indirect effects associated with the U.S. CCyB, the Federal Reserve intends to monitor and analyze adjustments by banking organizations and other financial institutions to the CCyB. The results of these monitoring efforts could cause the Federal Reserve to favor either a higher or a lower value of the CCyB.

As provided in Section 6, the Federal Reserve will monitor for several potential consequences resulting from changes to the CCyB, including, but not limited to:

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- Whether changes in the CCyB result in changes to risk-based capital ratios at Advanced Approaches Institutions, and whether such changes are achieved passively through retained earnings, or actively through changes in capital distributions or in risk-weighted assets;

- The extent to which loan growth and spreads on loans issued by Advanced Approaches Institutions change relative to loan growth and loan spreads at banking organizations not subject to the CCyB; and

- The extent to which adjustments by Advanced Approaches Institutions to higher capital buffers lead to the migration of credit market activity outside of those banking organizations, such as to the non banking financial sector.

The Federal Reserve further notes that it will also consider the levels of and changes in the CCyB in other countries in order to garner a greater understanding of the effects of changes in the CCyB. The Federal Reserve will evaluate the data maintained and made publicly available on the Basel Committee on Banking Supervision website, as well as other supervisory and publicly available data sets.

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