“Tailoring” Financial Regulations

Diana Hancock

Senior Associate Director, Research and Statistics Division, Federal Reserve Board

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Road Map

1. Why “Tailor” Regulations?
2. Alternative Classifications: The Key to the Tailored Approach
3. Prudential Requirements in the U.S. Vary Across Companies; The size or systemic importance of an entity matters
4. Foreign Banking Organizations and Nonbanks Operating in the US; A Tailored Approach

What’s Next?

1. Why "Tailor" Financial Regulations?

- Financial institutions differ across a multitude of characteristics (e.g., size, services provided, and funding sources)
  - These differences affect an organization's risk of failure and whether its failure could pose risks to the overall financial system
  - Policymakers generally agree that certain financial regulations should be "tailored" to account for such differences
    - "The additional complexity of Basel III has triggered discussions on the principle of "proportionality", ie on how best to tailor regulatory requirements to non-internationally active banks, especially smaller and less complex ones." (Financial Stability Institute, August 2017)
    - "The character of our regulation should match the character of the risk at the institution." (Randall Quarles, January 19, 2018)
    - "The Fed will continue to focus on reducing the regulatory burden for community banks, and without losing any safety and soundness, try to make sure that our regulation is no more burdensome than it needs to be." (Jerome Powell, February 27, 2018)
- The amount of realized benefits and costs of a regulation for any individual entity, or group of entities, are likely to depend in part on certain characteristics of that entity or group (e.g., willingness to take risk, systemic importance)
  - Potential benefits (e.g., better managed risks, increased consumer protection, greater systemic stability) justify potential costs of regulation (e.g., reduced credit availability for certain consumers or businesses, slower economic growth over some period of time)

2. Alternative Classifications

The key to tailored approach

Existing Financial Institution Characterizations in the U.S. Are Often Size-Based Thresholds

- Proponents of this classification system argue that simple “bright line” rules create certainty and transparency and that asset size is an adequate measurement to identify which institutions should or should not be subject to certain regulations.
- Critics argue that (1) using size thresholds too narrowly focuses on one aspect of a financial institution, and therefore, may needlessly subject certain entities to inappropriate regulation, and (2) additional criteria based on other criteria (e.g., the business activities the entity engages in, and complexity) should be implemented.

Source: D.W. Perkins (2017) “Tailoring Bank Regulations: Differences in Bank Size, Activities, and Capital Levels,” Congressional Research Service, December 21.

Size and Selected Activities of the BHCs in the U.S. Using Federal Reserve Y-9C Data (June 30, 2017)

B U S I N E S S M O D E L S D I F F E R

BHC	Total Assets ($billions)	Loans as % of Assets	Deposits as % of Liabilities	Trading Assets as % of Assets	Trading Liab. as % of Liabs.
JPMC	2,563	36.2	62.5	15.9	5.8
BAC	2,256	42.6	63.7	12.0	5.6
WFC	1,931	50.6	75.7	5.0	1.6
Citigroup	1,864	35.5	58.8	13.9	8.4
GS	907	11.0	15.3	34.4	14.7
MS	841	15.8	19.0	31.5	14.9
US Bancorp	464	60.4	83.7	0.7	0.5
PNC	372	59.1	79.5	1.3	0.8
BONY	355	17.4	75.0	1.6	1.3
Capital One	351	69.8	79.5	0.2	0.1
TD Group	349	42.3	79.1	4.4	2.9
HSBC	308	22.4	40.7	11.4	4.4
State Street	238	10.2	83.9	1.9	2.7
Average for BHCs with > $1B Total Assets	32	68.5	87.0	0.5	0.2

Note: Two different business models are highlighted in green and yellow above.

3. Prudential Requirements in the U.S. Vary Across Companies

The size or systemic importance of an entity matters

Regulatory Tailoring in the U.S. Starts with the Dodd-Frank Act (DFA)

- DFA creates prudential requirements that vary with the size or systemic importance of banking organizations
  - It creates thresholds for various prudential regulations at asset sizes of $1 billion, $10 billion, and $50 billion
- Sec. 165 of DFA requires the Federal Reserve to establish enhanced prudential standards for Bank Holding Companies (BHCs) with total assets of $50 billion or more and other financial firms designated as systemically important by the Financial Stability Oversight Council (FSOC)
  - These standards include capital, liquidity, risk management, resolution planning and single-counterparty limits
  - These standards increase in stringency depending on the size, interconnectedness, role in credit intermediation, and other factors specified in the law
  - In addition, firms with greater than $50 billion in assets are subject to annual supervisory stress tests

Source: Davis Polk & Wardwell LLP, "US Bank Holding Companies: Overview of Dodd-Frank Enhanced Prudential Standards Final Rule" at http://usbasel3.com/EPS/

The Federal Reserve Created Three Categories within the Universe of Firms with Assets ≥ $50 Billion

- Firms with assets between $50 billion and $250 billion
  - are subject only to basic enhanced prudential standards

- Firms with at least $250 billion or $10 billion in on-balance-sheet foreign assets
  - are also subject to more stringent requirements, including advanced approaches for risk-based capital requirements, the supplementary leverage ratio, the countercyclical buffer, and the full-scope liquidity coverage ratio

- Eight US BHCs that have been designated as global systemically important banking organizations (G-SIBs)—JP Morgan Chase, Citigroup, Bank of America, Goldman Sachs, Morgan Stanley, Bank of New York Mellon, State Street, and Wells Fargo)— are subject to an additional set of regulatory requirements

Sources: D.T. Tarullo (March 19 2015) “Application of Enhanced Prudential Standards to Bank Holding Companies,” before Committee on Banking, Housing and Urban Affairs, US Senate; Davis Polk & Wardwell LLP “US Bank Holding Companies: Overview of Dodd-Frank Enhanced Prudential Standards Final Rule” at http://usbasel3.com/EPS/

Financial Stability Board, “2015 Update of List of Global Systemically Important Banks” at http://www.fsb.org/wp-content/uploads /2015-update-of-list-of-global-systemically-important-banks-G-SIBs.pdf

Number of Firms Meeting Selected Classification Groups (as of June 30, 2017)

Classification	Number of Bank Holding Companies
$0 - $1 billion	3,992
$1 billion - $10 billion	502
$10 billion - $50 billion	73
Over $50 billion (but not G-SIB or BHC with $250 billion in total assets or $10 billion in total foreign exposures)	27
BHC with $250 billion in total assets or $10 billion in total foreign exposures (but not a G-SIB)	7
G-SIBs	8
Total	4,539

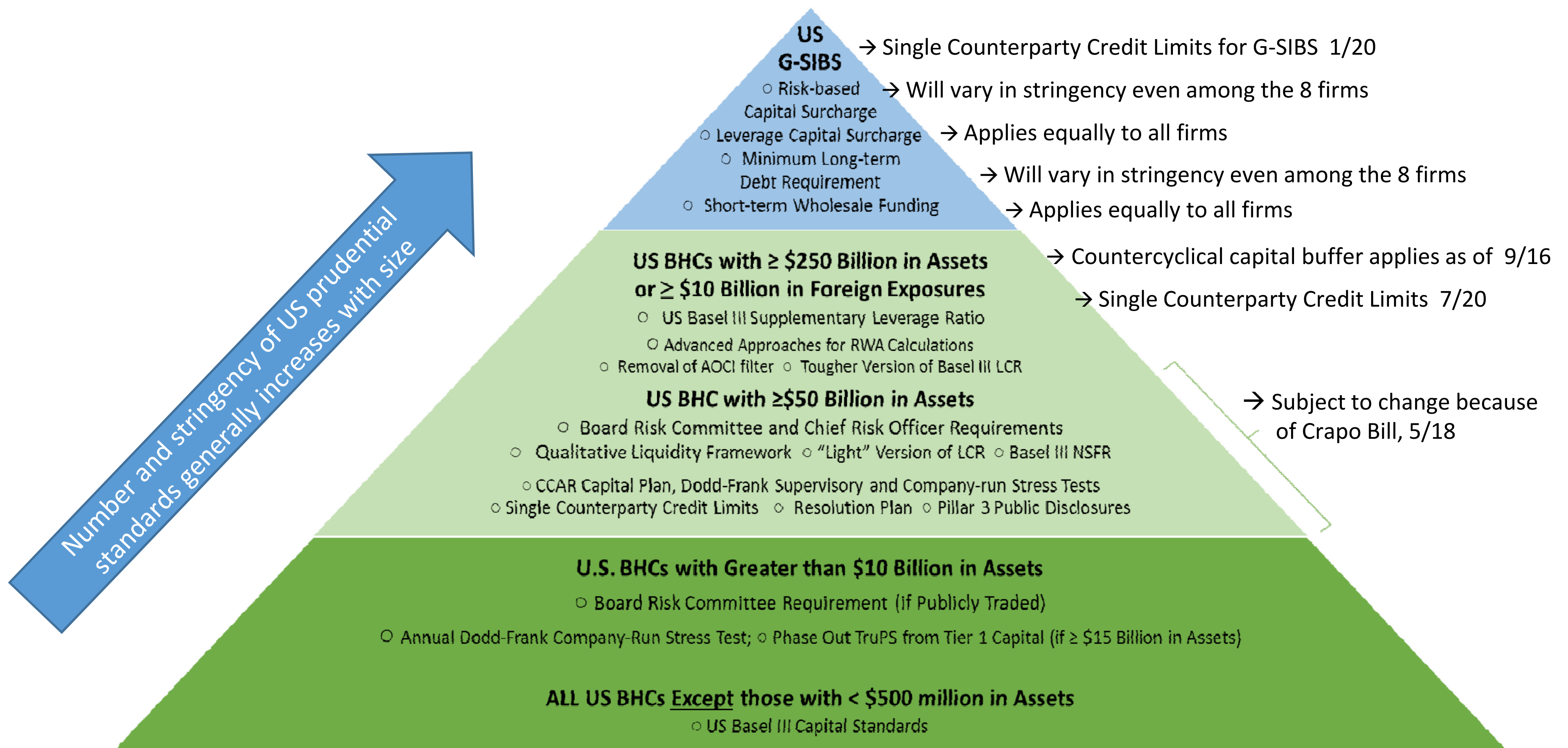
Source: Congressional Research Service (CRS) calculations using Federal Reserve Y-9C and Y-9SP data.
Note: These counts include savings and loan holding companies that are not subject to the same regulations facing bank holding companies. All of the classifications except the G-SIB designations are based on size measures (largely based on total assets). See D.W. Perkins (2017) at https://fas.org/sgp/crs/misc/R45051.pdf

BHCs Over $1 Billion: Averages by Selected Classifications (as of June 30, 2017)

Classification	Loans / Assets (in %)	Deposits / Liabilities (in %)	Trading Assets / Assets (in %)	Derivatives ($bns)	Tier 1 Capital Ratio (in %)
$1 billion - $10 billion	70.4	89.5	0.1	0.2	14.0
$10 billion - $50 billion	67.2	82.6	0.9	71.8	13.4
Over $50 billion (but not G-SIB or BHC with $250 billion in total assets or $10 billion in total foreign exposures)	53.2	66.0	4.2	144.8	15.2
BHC with $250 billion in total assets or $10 billion in total foreign exposures (but not a G-SIB)	50.1	70.6	2.7	817.6	13.9
G-SIBs	27.4	56.7	14.5	28,566.5	15.1

Source: Federal Reserve Y-9C data.

The Prudential Landscape for U.S. BHCs is Multifaceted



Source: Davis Polk & Wardwell LLP, "US Bank Holding Companies: Overview of Dodd-Frank Enhanced Prudential Standards Final Rule" at http://usbasel3.com/EPS/

Regulatory Tailoring in the U.S. was Recently Changed with Passage of the Crapo Bill (CB) in May 2018

- CB amended the Financial Stability Act of 2010, with respect to nonbank financial companies supervised by the Federal Reserve and certain Bank Holding Companies, to:
  - Increase the asset threshold at which certain enhanced prudential standards shall apply, from $50 billion to $250 billion, while allowing the Federal Reserve Board discretion in determining whether a financial institution with assets greater than $100 billion must be subject to such standards
  - Increase the asset threshold at which company run stress tests are required from $10 billion to $250 billion, and
  - Increase the asset threshold for mandatory risk committees from $10 billion to $50 billion.
- It also made modifications to provide regulatory relief and protect access to credit, more specifically
  - Federal banking agencies must develop a specified Community Bank Leverage Ratio for banks with assets of less than $10 billion. Such banks that exceed this ratio shall be deemed to be in compliance with all other capital and leverage requirements. Federal banking agencies may consider a company's risk profile when evaluating whether it qualifies as a community bank for purposes of the ratio requirement.
  - The bill amends the Bank Holding Company Act of 1956 to exempt from the "Volcker Rule" banks with: (1) total assets valued at less than $10 billion, and (2) trading assets and liabilities comprising not more than 5% of total assets.

Source: Economic Growth , Regulatory Relief, and Consumer Protection Act, Summary: S.2155.

4. Foreign Banking Organizations and Nonbanks Operating in the U.S.

A tailored approach

Regulation of Foreign Banking Organizations (FBOs)

- Sections 165 and 166 of DFA instruct the Federal Reserve to implement enhanced prudential standards for large foreign banks, it
  - bolsters capital requirements for financial holding Companies (FHCs), including foreign FHCs, by extending the well-capitalized and well-managed requirements beyond U.S. bank subsidiaries to the top-tier holding company
  - removes an exemption from BHC capital requirements that had been granted by the Federal Reserve's Supervision and Regulation Letter 01-01

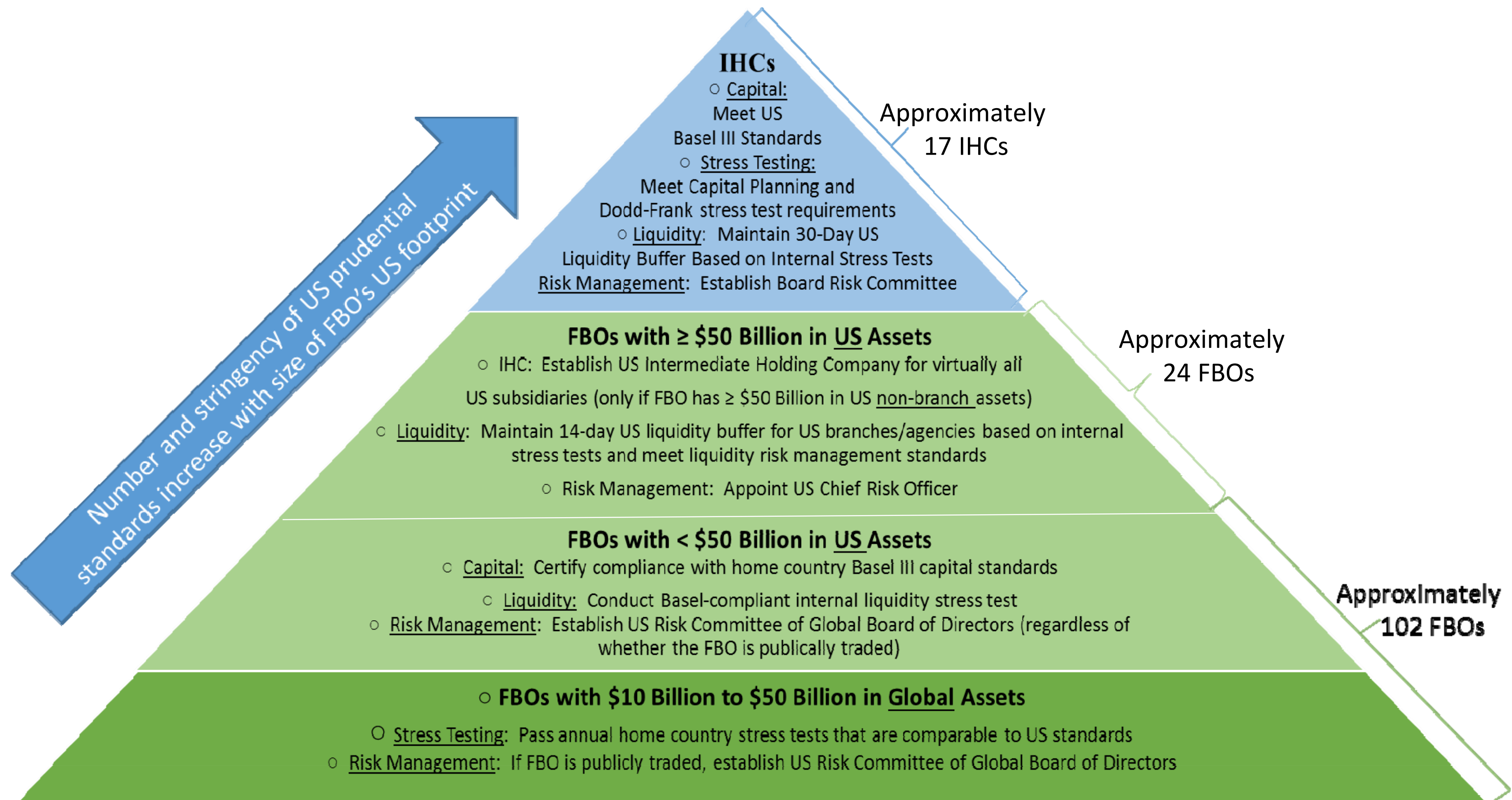
- A new approach was designed to
  - address vulnerabilities that were created by a shift in foreign banking activities toward often complex capital market activities and a significant reliance on short-term funding, which is associated with run risk
  - maintain the principle of national treatment and allow foreign banks to continue to operate in the US on an equal competitive footing
  - reduce the ability of large foreign banks to restructure their U.S. operations to minimize the impact of US regulatory changes

→ Require a top-tier U.S. intermediate holding company (IHC) over all U.S. bank and nonbank subsidiaries (IHC) for the largest U.S. operations of foreign banks

→ Require liquidity standards for large U.S. operations of foreign banks

Sources: D.K. Tarullo (November 28, 2012) "Regulation of Foreign Banking Organizations" at Yale School of Management Leaders Forum; Davis Polk & Wardwell LLP, "Foreign Banks: Overview of Dodd-Frank Enhanced Prudential Standards Final Rule" at http://usbasel3.com/EPS/

U.S. Regulatory Landscape for FBOs



Sources: D.K. Tarullo (November 28, 2012) "Regulation of Foreign Banking Organizations" at Yale School of Management Leaders Forum;

Davis Polk & Wardwell LLP, "Foreign Banks: Overview of Dodd-Frank Enhanced Prudential Standards Final Rule" at http://usbasel3.com/EPS/

Heighted Prudential Standards for Some Nonbanking Organizations

- The final rule that strengthened prudential standards for U.S. BHCs and FBOs (issued on February 18, 2014) does not apply to nonbank financial companies that are designated by the FSOC for Federal Reserve supervision
- Instead, the Federal Reserve Board said "it will apply enhanced prudential standards to these institutions through a subsequently issued order or rule following an evaluation of the business model, capital structure, and risk profile of <u>each</u> designated nonbank financial company"

→ Tailor regulations to each nonbank's systemic importance

Source: http://www.federalreserve.gov/newsevents/press/bcreg/20140218a.htm

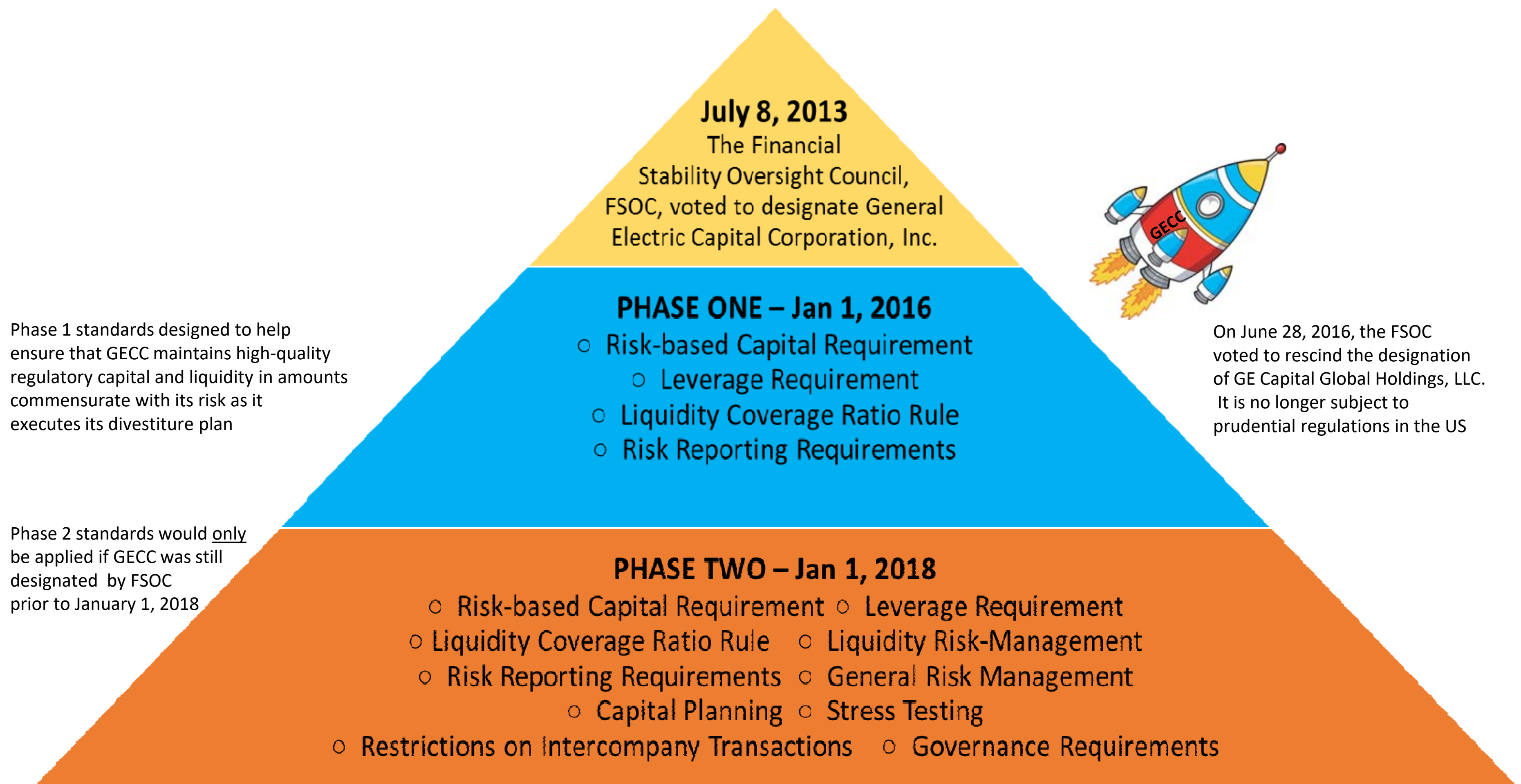
For Example, Enhanced Prudential Regulations were Applied to GE Capital on July 20, 2015

- Because of the substantial similarity of GECC's current activities and risk profile to that of a large BHC, the enhanced prudential standards that would be applied to GECC are similar to those that apply to large BHCs, but are tailored to reflect the unique characteristics of GECC

- In light of the plan that had been announced and that was in the process of execution by General Electric (GE), parent company of GECC, to substantially shrink GECC's systemic footprint and retain only those business lines that support GE's core industrial businesses, the final order provided for the application of enhanced prudential standards in two distinct phases

Source: Federal Register Notice at https://www.federalregister.gov/articles/2015/07/24/2015-18124/application-of-enhanced-prudential-standards-and-reporting-requirements-to-general-electric-capital

GE Capital: Enhanced Prudential Regulations



On June 3, 2016, the Federal Reserve Proposed Tailored Regulatory Capital Frameworks for Supervised Insurers

- "Building Block" Approach
  - Starting point, existing state and foreign risk-based capital requirements for insurance company subsidiaries and the Federal Reserve's risk-based capital standards for banking, non-insurance and unregulated subsidiaries
    - A firm's aggregate capital requirement would equal "the sum of the capital requirements at each subsidiary, with adjustments to address items such as differences in accounting and to eliminate inter-company transactions, and scalars to reflect other cross-jurisdictional differences such as differing supervisory objectives and valuation approaches
  - The second capital framework, referred to as the "consolidated approach" and intended for the Designated Insurer SIFIs, would "categorize an entire insurance firm's assets and insurance liabilities into risk segments, apply appropriate risk factors to each segment at the consolidated level, and then set a minimum ratio of required capital"
    - Specific risk weights, risk segments and capital adequacy ratios to be used under the consolidated approach, the specific scalars to be used in the building block approach, and the definition and potential tiering of qualifying capital under both proposed frameworks were not specified

Sources: Federal Register Notice at https://www.gpo.gov/fdsys/pkg/FR-2016-06-14/pdf/2016-14004.pdf; Sullivan & Cromwell, "Federal Reserve Proposes Regulatory Capital Frameworks for Supervised Insurers and Enhanced Prudential Standards for Insurers Designated as Systemically Important," June 7, 2016

At the Same Time, the Federal Reserve Proposed Tailored Prudential Standards for Insurers Designated as Systemically Important

- For example, the proposed rule would require designated insurer SIFIs to
  - create and maintain an enterprise-wide risk management framework and implement related policies and procedures
    - Establish and maintain a risk committee of the board of directors responsible for the company's risk management policies and framework, and to appoint a chief risk officer and chief actuary
  - focus on liquidity
    - produce and regularly update comprehensive enterprise-wide cash-flow projections over short- and long-term horizons
    - establish, maintain, and periodically test a contingency funding plan for responding to a liquidity crisis, including performing quantitative assessments to identify liquidity stress events and available funding sources
    - establish and maintain procedures for monitoring collateral, legal entity liquidity risk, and intraday liquidity risk
    - conduct "rigorous and regular" liquidity stress testing and scenario analysis under normal and adverse conditions over four stress-testing time horizons: 7 days, 30 days, 90 days and one year; and
    - maintain a liquidity buffer, comprised of highly liquid, unencumbered assets, sufficient to meet net cash outflows over a 90-day period

Sources: Federal Register Notice at https://www.gpo.gov/fdsys/pkg/FR-2016-06-14/pdf/2016-14005.pdf; Sullivan & Cromwell, "Federal Reserve Proposes Regulatory Capital Frameworks for Supervised Insurers and Enhanced Prudential Standards for Insurers Designated as Systemically Important," June 7, 2016

What is Next? Bank Holding Companies

- Federal Reserve (and other U.S. federal banking agencies) are currently implementing the Crapo Bill (CB)
  - In June 2018, the Federal Reserve announced that to be consistent with the recently passed CB, bank holding companies with less than $100 billion in total consolidated assets are no longer subject to supervisory stress testing, including both the Dodd-Frank Act stress tests and CCAR
  - Other key provisions of CB are targeted tailoring measures to reduce the regulatory burden on community banks
    - To provide clarity to the public, the Board and the federal banking agencies in July 2018 issued public statements on the regulations and associated reporting requirements that CB immediately affected, indicating that they would give immediate effect to those provisions even before the formal regulatory changes were fully implemented
    - In August 2018, the Federal Reserve implemented several interim rules
      - For example, CB requires the Board to revise its small BHC policy statement, raising a threshold from $1 billion to $3 billion, for entities allowed to incur higher debt levels and exempting smaller BHCs from minimum capital requirements at the holding company level
      - CB also expands eligibility for an Extended Exam Cycle; now, firms with up to $3 billion in assets are eligible
  - Work is currently underway on the tasks such as: (1) developing a community bank leverage ratio for companies with total consolidated assets less than $10 billion, (2) “Short-form” Call Reports for entities with assets of less than $5 billion, (3) issuing a proposed rule on tailoring enhanced prudential standards for banking firms with assets between $100 billion and $250 billion, and (4) a review of regulation and supervisory programs for firms with more that $250 billion in total assets, but below the G-SIB threshold.

Source: https://www.federalreserve.gov/newsevents/testimony/files/quarles20181002a.pdf

What is Next? Nonbanks

- In November 2017, the US Treasury released its report on FSOC Nonbank Designations. The US Treasury identified five goals that the Council's processes should be designed to achieve:
  - Leverage the expertise of primary financial regulatory agencies
  - Promote market discipline
  - Maintain a level playing field among firms
  - Appropriately tailor regulations to minimize burdens, and
  - Ensure the Council's designation analyses are rigorous, clear, and transparent
- This report also contained recommendations, such as:
  - Prioritize an activities-based or industry-wide approach to potential risks posed by nonbank financial companies
  - Increase the analytic rigor of determination analyses
  - Improve engagement and transparency in the determinations process
  - Provide a clear "off-ramp" for designated nonbank financial companies
  - Consider the costs and benefits of designations
- FSOC is currently working towards achieving these goals and implementing the recommendations

Source: https://www.treasury.gov/press-center/press-releases/Documents/PM-FSOC-Designations-Memo-11-17.pdf