National Association of County Collectors, Treasurers, and Finance Officers

Regulating banks in a global economy

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Overview

- What is bank regulation?
- Who cares?
- Modern banking regulation
- Really modern banking regulation
- How should we regulate banks? You decide
- Basel III
  - ...and public sector entity deposits
  - ...and public sector entity borrowing
- The reform agenda

What is bank regulation?

- Deposit insurance and resolution
- Prudential supervision
- Consumer protection

CSBS

Consumer Financial Protection Bureau

CSBS: Conference of State Bank Supervisors, c.1902
NCUSIF: National Credit Union Share Insurance Fund created in 1970
CFBP: created 2010 under Dodd-Frank
OCC - dates to 1863
Board of Governors of the Federal Reserve: oversight of large bank holding companies and some state-chartered banks
FRS - powers expanded 1935
FDIC – 1933
FDIC insures about 2/3 of the 6,000 insured depository institutions
NCUA oversees about 6,000 credit unions

Bank regulation? Who cares?

- Financial crisis is a major public policy challenge
  - bank runs
  - spillovers or contagion across firms and borders
  - massive economic dislocation

Image credit: Run on the Bowery Savings Bank, 1934 (Library of Congress)

The 2008 financial crisis: What role did banks play?

- Implicated in the crisis:
  - AIG Financial Products
  - Fannie Mae & Freddie Mac
  - Lehman Bros. & Bear Stearns

- But also failing:
  - Washington Mutual
  - IndyMac
  - 150 banks failed in 2009 and 2010
  - About ½ of these were state-chartered and supervised by the FDIC

AIGFP located in London – a component of AIG, an insurance company regulated by the State of New York
Fannie and Freddie: government-sponsored housing finance enterprises
Lehman Bros. & Bear Stearns: stand-alone investment banks regulated by the SEC
Washington Mutual and IndyMac: regulated by the OTS but insured by the FDIC. IndyMac closed and sold to OneWest, subsequently purchased by CIT group. Washington Mutual was purchased by JPMorganChase. Total costs of IndyMac resolution was $8 billion. Washington Mutual: $0 (but major losses borne by shareholders).

Modern bank regulation

- 1933
- 1935
- "Boring Banking" era

1933: FDIC created and Glass-Steagall wall created
1935: FDIC made permanent and Federal Reserve reorganized
Image credit: 1935 signing ceremony with Glass and Steagall (Library of Congress).
http://www.loc.gov/pictures/item/hec2013015488/
For a description of the "Boring banking" era, see 13 Bankers (James Kwak and Simon Johnson, 2010).

Evaluating individual banks

- Capital adequacy
- Assets
- Management
- Earnings
- Liquidity
- Sensitivity to market risk

Banking agencies have relied on the CAMELS framework for nearly 40 years. The criteria were developed by the Federal Financial Institutions Examination Council (FFIEC) in 1979 as the Uniform Financial Institutions Rating System. The Sensitivity component was added later (1996).

Capital adequacy – incorporates broad evaluation of riskiness of assets
Asset quality – focuses on credit risk
Management – board/executive supervision of internal controls, compliance and operations
Earnings – are earnings sustainable and can the bank monitor and project earnings
Liquidity – access to short-term funds
Sensitivity to market risk – is the bank resilient to changes in equity, bond, commodity, foreign exchange markets

Image credit: Bank examiner. Still image from It's a Wonderful Life (1947).

The push to deregulate

- Globalization of banking
- Economies of scale
- Financial engineering

For details about financial engineering, see 13 Bankers

Image: Gramm-Leach-Bliley signing, 2000 (William J. Clinton Presidential Library)

Really modern bank regulation

- Basel Committee on Bank Supervision
- Cross border risks (1970s)
- Level playing field (1980s)
- International conventions vs. domestic law

"Regrettably, instead of performing their own rigorous analysis, they chose to outsource it to the Basel Committee."
Senator Richard Shelby (June 7, 2016)

Image credit: BIS "Tower" building (Bank of International Settlements)
BCBS activity dates to 1974 failure of Bankhaus Herstatt and Franklin National Bank

How should we regulate banks?

- Limits on products: consumer protection
- Limits on size: too big to fail
- Exempting small institutions
- Limits on trading and market activity
- Separating retail and investment banking
- Taxpayer money and bank bailouts
- New competitors? Postal Savings Banks

US Postal Savings System (1911-1967)

Capital and liquidity requirements

- What is Basel III?
- What are the new rules?
- What is the impact on municipal debt and deposits?

Image credit: Federalreserve on Flickr
For details: see the last slide (www.bis.org/bcbs/basel3/b3summarytable.pdf)

What are the new rules?

- Basel III includes more than a dozen categories of rules
  - New and revised capital requirements
  - New liquidity requirements
  - More scrutiny of large globally active banks
  - Implemented in the US by the OCC, Federal Reserve, and FDIC

Daniel Tarullo
Board of Governors
Chair, Committee on Bank Supervision
Federal Reserve System

Revised : risk-weighted capital requirements
New: leverage ratio and countercyclical capital buffer
New: Liquidity Coverage Ratio and Net Stable Funding Ratio
New: additional capital for Globally Systemically Important Financial Institutions (25 largest global banks)

Image credit: Board of Governors, Federal Reserve System

Capital requirements and municipal borrowing

- "Well-capitalized" banks must hold total capital equivalent to 10% of risk-weighted assets (Tier 1, 6%)
- Proposed risk weights were 20% for general obligation and 50% for revenue bonds (higher risk)
- ICMA advocated 20% for all Investment-Grade Municipal Bonds

10% total capital requirement is based on U.S. CAMELS ratings. The Basel requirement is 8%.

Risk-weighting rules start with Basel framework, but there is discretion for individual countries/regulators

50% risk weight is equivalent to BBB sovereign debt
20% risk weight is equivalent to A+/A- sovereign debt
0% risk weight for AAA to AA-

Partial list of the associations joining ICMA in opposing the new rules:
American Public Gas Association
American Public Power Association
Council of Infrastructure Financing Authorities
Education Finance Council
Government Finance Officers Association
International Municipal Lawyers Association
Large Public Power Council
National Association of Counties
National Assosiation of Local Housing Finance Agencies
National League of Cities
U.S. Conference of Mayors

Liquidity requirements and municipal borrowing

- Liquidity Coverage Ratio: Large banks must hold High Quality Liquid Assets equivalent to 30 day cash outflow in a period of severe distress
- HQLA cannot include municipal securities (only federal and state), unless a set of restrictions are satisfied
- There are proposals to compel the banking agencies to include municipal securities in HQLA

Large banks means banks with assets of $50 billion or more – and these institutions hold something like ½ of all municipal deposits

The Federal Reserve System is the only banking agency that has ruled to treat municipal securities as HQLA – but many of the large banks are supervised by the OCC.

Other implications: some HQLA might be tied to collateralized municipal deposits – so those deposits can't be used to support lending.

Volcker rule: What about Tender Option Bonds: TOBs involve a trust that holds long-term municipal debt, but divides participation into two classes – a short-term less risky part (suitable for money market mutual funds) and a long-term more risky part (suitable for life insurance companies)
Bank of American came up with a joint ownership structure that makes this work c. 2014. TOBs are a $75 billion niche in the municipal security market

Liquidity requirements and municipal deposits

- What percentage of deposits are likely to "run off" in a period of stress?
- Municipal deposits are considered to be vulnerable to run off (Retail, 3%; Municipal non-operational; 40%, Interbank, 100%)
- Large banks would have an incentive to reduce municipal deposits
- These decisions will be revisited as long-term liquidity rules are finalized (Net Stable Funding Ratio)

Census data on state and local finances indicates state/local governments hold about $2 trillion in cash and securities.
If deposits are non-operational and over insured limits, then runoff is a real concern.
Community banks have opportunities to pick up this municipal deposit business

Who is involved in reform?

- Senator Elizabeth Warren (D-MA)
- The banking agencies, especially the Board of Governors of the Federal Reserve System (Daniel Tarullo)
- House of Representatives, Financial Services Committee (Rep. Jeb Hensarling, R-TX)
- U.S. Senate, Banking Committee (Sen. Richard Shelby, R-AL)
- FDIC Vice Chair Thomas Hoenig
- Basel Committee (William Coen, former Federal Reserve and OCC bank examiner)

Elizabeth Warren is probably the most vocal proponent of breaking up the largest banks

FDIC Vice Chair Hoenig is an advocate of higher capital requirements (see "A Capital Conflict" – Remarks by FDIC Vice Chairman Hoenig to the National Association for Business Economics (NABE) and the Organization for Economic Cooperation and Development (OECD) Global Economic Symposium, Paris, France)

What is on the agenda?

- 2016 CHOICE Act [Hensarling]
  - Advocates less prudential supervision for banks that satisfy higher capital requirements
  - But also strips away key provisions of Dodd Frank
- Notice and comment period for the Net Stable Funding Ratio

2016 Choice Act: Uses a simple leverage ratio, rather than complex risk weights
Eliminates CFPB, FSOC, Volcker rule, and reduces the number of institutions subject to Basel III

Comments on the NSFR are posted here:
https://www.regulations.gov/docket?D=OCC-2014-0029

So far, so good

- Worries:
  - Risk weights
  - HQLA
  - Volcker rule
- Reality:
  - In the low rate environment, banks have dramatically increased exposure to municipal debt (doubling from $250 billion to $500 billion, 2007 to 2015)

Source: SIFMA

Thank you!

Questions?

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Basel Committee on Banking Supervision reforms - Basel III

Strengthens microprudential regulation and supervision, and adds a macroprudential overlay that includes capital buffers.

	Capital				
	Pillar 1			Pillar 2	Pillar 3
	Capital	Risk coverage	Containing leverage	Risk management and supervision	Market discipline
All Banks	**Quality and level of capital** Greater focus on common equity. The minimum will be raised to 4.5% of risk-weighted assets, after deductions. **Capital loss absorption at the point of non-viability** Contractual terms of capital instruments will include a clause that allows – at the discretion of the relevant authority – write-off or conversion to common shares if the bank is judged to be non-viable. This principle increases the contribution of the private sector to resolving future banking crises and thereby reduces moral hazard. **Capital conservation buffer** Comprising common equity of 2.5% of risk-weighted assets, bringing the total common equity standard to 7%. Constraint on a bank's discretionary distributions will be imposed when banks fall into the buffer range. **Countercyclical buffer** Imposed within a range of 0-2.5% comprising common equity, when authorities judge credit growth is resulting in an unacceptable build up of systematic risk.	**Securitisations** Strengthens the capital treatment for certain complex securitisations. Requires banks to conduct more rigorous credit analyses of externally rated securitisation exposures. **Trading book** Significantly higher capital for trading and derivatives activities, as well as complex securitisations held in the trading book. Introduction of a stressed value-at-risk framework to help mitigate procyclicality. A capital charge for incremental risk that estimates the default and migration risks of unsecuritised credit products and takes liquidity into account. **Counterparty credit risk** Substantial strengthening of the counterparty credit risk framework. Includes: more stringent requirements for measuring exposure; capital incentives for banks to use central counterparties for derivatives; and higher capital for inter-financial sector exposures. **Bank exposures to central counterparties (CCPs)** The Committee has proposed that trade exposures to a qualifying CCP will receive a 2% risk weight and default fund exposures to a qualifying CCP will be capitalised according to a risk-based method that consistently and simply estimates risk arising from such default fund.	**Leverage ratio** A non-risk-based leverage ratio that includes off-balance sheet exposures will serve as a backstop to the risk-based capital requirement. Also helps contain system wide build up of leverage.	**Supplemental Pillar 2 requirements.** Address firm-wide governance and risk management; capturing the risk of off-balance sheet exposures and securitisation activities; managing risk concentrations; providing incentives for banks to better manage risk and returns over the long term; sound compensation practices; valuation practices; stress testing; accounting standards for financial instruments; corporate governance; and supervisory colleges.	**Revised Pillar 3 disclosures requirements** The requirements introduced relate to securitisation exposures and sponsorship of off-balance sheet vehicles. Enhanced disclosures on the detail of the components of regulatory capital and their reconciliation to the reported accounts will be required, including a comprehensive explanation of how a bank calculates its regulatory capital ratios.
SIFIs	In addition to meeting the Basel III requirements, global systemically important financial institutions (SIFIs) must have higher loss absorbency capacity to reflect the greater risks that they pose to the financial system. The Committee has developed a methodology that includes both quantitative indicators and qualitative elements to identify global systemically important banks (SIBs). The additional loss absorbency requirements are to be met with a progressive Common Equity Tier 1 (CET1) capital requirement ranging from 1% to 2.5%, depending on a bank's systemic importance. For banks facing the highest SIB surcharge, an additional loss absorbency of 1% could be applied as a disincentive to increase materially their global systemic importance in the future. A consultative document was published in cooperation with the Financial Stability Board, which is coordinating the overall set of measures to reduce the moral hazard posed by global SIFIs.				