Financial Services Management

U.S. Counter-Cyclical Capital Buffer

Cite

Federal Reserve Board; Regulatory Capital Rules: The Federal Reserve Board's Framework for Implementing the U.S. Basel III Countercyclical Capital Buffer

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Impact Assessment

- The manner in which the FRB actually deploys the CCyB will determine the extent to which it is vulnerable to legal challenge. The final statement includes new procedures to limit risk, but does not eliminate it for the FRB.
- Due to remaining FRB discretion and current market conditions, larger banks may feel compelled to add at least minimum counter-cyclical capital to their minimum-capital thresholds absent a wide enough CCAR margin of error to permit catch up upon CCyB deployment.
- The U.S. CCyB will not include sector-specific requirements (e.g., mortgage LTV limits). All covered banks, not just those active in targeted sectors, will thus bear its cost.
- The CCyB does not reach non-banks (the FRB has no authority to do so), meaning asymmetric results and uncertain impact on procyclicality and stability.

Overview

Moving forward with its efforts to implement the Basel III Accord, the Federal Reserve has finalized the U.S. version of the counter-cyclical capital buffer (CCyB). Although global regulators agreed in 2010 to a CCyB and several nations have since actually mandated one to address asset-price spikes, the U.S. takes a different approach. In it, the FRB has retained considerable discretion as to when, how, and why it would institute a CCyB requirement, although the final policy statement now makes it clearer than

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the proposal[1] that the Board will not use asset- or sector-specific charges and will generally seek comment (possibly after the fact) on any CCyBs it decides to mandate. The Board has also made more clear its intention of lifting CCyBs when conditions warrant rather than using them as surcharges for larger BHCs over an extended period of time. However, the near-term prospect is only for CCyB imposition given current market conditions and the lack of any current buffer. The FRB plans to impose any CCyB gradually, but it has also retained discretion to go up to the full 2.5 percent buffer at once should it determine this to be necessary.

Impact

As with the global CCyB,[2] the FRB's buffer is intended as a macroprudential tool – that is, it is to apply horizontally across all large banking organizations to address identified macroeconomic or financial-stability risks. As detailed in a recent FedFin paper,[3] even the FRB is divided over whether the CCyB should be focused principally on overall procyclicality (e.g., spikes in asset growth vis-a-vis GDP targeted in Basel's CCyB), at financial-stability risks (e.g., overheating credit sectors), or at some combination of these and other goals. Nothing in the FRB's final policy statement clarifies why it would use the CCyB, thus making it harder to predict when it might do so or forecast the likelihood of success. This ambiguity also leaves the FRB considerable discretion to use the CCyB for monetary-policy purposes or in other ways that may or may not be clarified when a CCyB is implemented.

The policy statement is also premised on another assumption about which the FRB and others (e.g., the Office of Financial Research) are uncertain: that making large banks more resilient will insulate the financial sector from systemic risk. The FedFin paper noted above also addresses this question in depth based on research demonstrating that higher capital requirements for large banks or other sanctions often do not appear to reduce credit supply in asset-price bubbles in the U.S. due to the very large role played by non-bank credit providers and the corporate-bond market. Recognizing this issue, the FRB indicates now that it will consider any such "shadow" risk when deciding to impose a CCyB, but the discussion also implies that this consideration may not be undertaken until well after a CCyB is in place.

As noted, the CCyB will not be sector-specific – the final policy statement expressly rejects doing so on grounds that microprudential rules best capture specific asset or activity risk. It is also possible that a CCyB imposed without asset-sector specificity could lead large banks to accelerate yield-chasing to protect return on equity – a counter-productive consequence of a counter-cyclical buffer. This could result because higher capital

[1] See **CAPITAL210**, *Financial Services Management*, December 28, 2015.

[2] See **CAPITAL173**, *Financial Services Management*, January 7, 2011.

[3] See FedFin Paper *Square Pegs and Round Holes: The Effectiveness of Monetary Policy and Macroprudential Regulation in the Post-Crisis Regulatory Regime*, May 18, 2016.

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requirements across the board – especially for banks already subject to surcharges and stress tests – could lead to further risk arbitraging.

Although the CCyB is based on risk-based assets, its total cost atop all the other risk-based rules and requirements will strain bank profitability and alter portfolio incentives. Combined with the cost of the leverage requirement, larger holdings of higher-risk assets could well result. The FRB signals here that other tools (e.g., microprudential, sector-specific standards) will be considered in concert with CCyB imposition, but assessing the cumulative impact of a CCyB on its own or in concert with any such standards will be challenging, especially in advance.

Perhaps reflecting these lingering doubts, the FRB has left itself considerable CCyB discretion. The policy statement now indicates that the buffer would be triggered only when systemic vulnerabilities are "meaningfully above normal." This is a departure from the "somewhat above normal" criterion in the proposal, but the FRB has still left itself considerable flexibility. This flexibility not only applies to the risk threshold at which a CCyB would be imposed, but also by the various ways the FRB could choose to measure risk.

The final statement also stipulates that a process designed to ensure transparency will generally be followed before a triggering action. The final statement describes this largely as a clarification of the proposed policy statement, but it is in fact a significant change from the initial approach which would have given the FRB free rein to impose or eliminate the CCyB for any reason at any time in any amount up to 2.5 percent. The Board emphasizes that its notice-and-comment process ensures CCyB actions comply with applicable administrative-procedure law, but it has left itself considerable flexibility – for example through after-the-fact requests for comment – and thus could remain open to challenge depending on the manner in which a CCyB is imposed and how well it is seen to comport with the specifics provided in the policy statement. Given the broad authority the Board has retained in areas like possible triggers (see below), challenges could still advance.

What's Next

The CCyB final statement was released on September 8. It is effective as of October 14, meaning that the Board could take action under it at any time thereafter. The CCyB will be phased in, with the likely maximum potential amount of the CCyB for U.S.- based credit exposures at 0.625 percentage points in 2016, 1.25 percentage points in 2017, 1.875 percentage points in 2018, and 2.5 percentage points in 2019 and thereafter. In general, a CCyB would not apply until twelve months after an announcement imposing it, but the Board retains the right to mandate one more quickly. The CCyB would return to zero in twelve months unless the

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Board decides to alter or maintain it. Importantly, imposition/removal rates could vary based on the FRB's determination of applicable risk conditions.

An outstanding issue is how the FRB would calculate the CCyB because the risk weightings it plans to use (see below) do not align with current regulatory reports. The Board intends to address this at some future point, but apparently could nonetheless impose a CCyB ahead of such reporting should it decide to rely upon bank calculations.

Analysis

A. CCyB Structure

The CCyB is an expansion of the Capital Conservation Buffer (CCB) which is designed to ensure adequate risk-based capital under ordinary stress and is applicable to banking organizations subject to the advanced Basel rules (i.e., those with assets above $250 billion or that meet other conditions). To avoid limits on capital distributions and certain discretionary bonus payments, the CCB requires a buffer of common equity tier 1 capital at least 2.5 percent of the risk-weighted assets in addition to the minimum risk-based capital ratios. The CCB is divided into quartiles, each associated with increasingly stringent limitations on capital distributions and certain discretionary bonus payments as risk-based capital ratios approach regulatory minimums. The CCyB is an additional, countercyclical buffer with the same limitations on dividends and capital distributions as the CCB.

The applicable CCyB amount is equal to the weighted average of CCyB amounts established by the Board for the national jurisdictions where the bank has private-sector credit exposures weighted by jurisdiction according to risk-weighted private-sector credit exposures for a specific jurisdiction as a percentage of total risk-weighted private-sector credit exposures. This approach does not address the treatment of any CCyBs imposed by foreign regulators; the FRB will do so at some later date although the final statement does not make it clear if this would be done by rule or on a case-by-case basis.

B. Application

1. Triggers

"Meaningfully above normal" risk warranting the CCyB would result when the Board concludes that financial-system vulnerabilities are already above "normal" and are either at or could build to levels at which material unexpected losses could occur upon an "unfavorable" event in the economy or financial markets. "Vulnerabilities" could include, but not be limited to:

- asset-valuation pressures;

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- risk appetite;
- leverage in the non-financial and financial sectors; and
- maturity and liquidity transformation only in the financial sector.

The measures of this risk provided in the policy statement do not constrain the FRB, which could use others at any time it determined that they signaled meaningful concern. The credit-growth to GDP indicator on which Basel relies might be used by the FRB, but not in isolation. Other vulnerability measures could include:

- measures of credit and liquidity expansion or contraction;
- a variety of asset prices, funding spreads, credit-condition surveys, and indices based on CDS spreads;
- option implied volatility;
- measures (unspecified in the statement) of systemic risk; and
- certain empirical models used in concert with a "comprehensive judgmental assessment." The policy statement describes possible approaches.

2. Requirements

The FRB intends to consult with the OCC and FDIC in imposing or lifting the CCyB, which would mean that the buffer is applied in the same percentages to BHCs and their subsidiary insured depositories. However, the FRB cannot assure that the other agencies would concur, meaning that disparities could occur in both CCyB imposition and reduction. The FRB's charge would essentially override any decision by another agency not to impose the CCyB since the Board imposes capital at the consolidated level based on BHC assets, but it would have significant implications were the Board to lift the CCyB and another regulator keep it in place.

3. Process

The Board will generally either issue a proposal for comment or an order following which comment is requested before triggering the CCyB. Notice-and-comment periods would generally be at least thirty days long.

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4. Communications

The Board would at least annually consider the status of the CCyB, but could adjust the buffer more frequently. The semi-annual reports to Congress on monetary policy would continue to include the FRB's assessment of financial stability, updating the public on the FRB's systemic-risk opinions and presumably providing early warning about CCyB changes.

5. Monitoring

Reflecting the newness of the CCyB and the issues outlined above, the FRB pledges to monitor it.

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