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Statement on Proposals to Modify Enhanced Prudential Standards
for Large Banking Organizations
by Governor Lael Brainard

I appreciate the work that has gone into the two proposals we are considering today. I have consulted closely with my colleagues in the hope that I could support a proposal for revising the enhanced prudential standards applicable to noncomplex domestic banking organizations between $100 and $250 billion in assets, consistent with the provisions of the Economic Growth, Regulatory Relief, and Consumer Protection Act (S. 2155).

Unfortunately, the proposals under consideration go beyond the provisions of S. 2155 by relaxing regulatory requirements for domestic banking institutions that have assets in the $250 to $700 billion range and weaken the buffers that are core to the resilience of our system. This raises the risk that American taxpayers again will be on the hook. The proposed reduction in core resiliency comes at a time when large banks have comfortably achieved the required buffers and are providing ample credit to the economy and enjoying robust profitability. In short, I see little benefit to the institutions or the system from the proposed reduction in core resilience that could justify the increased risk to financial stability and the taxpayer.

S. 2155 amends the Dodd-Frank Act by raising the threshold for automatic application of enhanced prudential standards to banking institutions of $250 billion or more in assets and provides the Board with discretion to apply any of these standards to domestic banking organizations holding between $100 and $250 billion in assets. I am concerned that the proposals go beyond the statutory mandate. While not mandated by Congress, they would reduce regulatory safeguards for institutions in the size range of $250 to $700 billion by reducing the liquidity coverage ratio by as much as 30 percent and removing an important requirement to ensure that regulatory capital is credibly loss absorbing. These institutions as a group represent a significant part of the banking system, holding total assets of $1.5 trillion. The proposal also would eliminate the liquidity coverage ratio entirely for institutions with assets of $100 to $250 billion, which is of concern.

We voted to finalize the liquidity coverage ratio only four years ago, and I see no change in the financial environment or provision in S. 2155 that would require us to substantially weaken a rule that was backed by strong analysis and informed by extensive public comment. Large banking institutions have accumulated liquidity buffers in excess of their requirements and are providing ample credit and earning ample profits. The liquidity coverage ratio was designed as a baseline requirement that would be appropriate for all large banking firms. It is by design tailored to the size and business model of the institutions to which it applies and appropriately reflects the differential quality and stickiness of different funding sources. Moreover, the compliance burden of the liquidity coverage ratio is relatively low.

The crisis demonstrated clearly that robust liquidity buffers are critical to provide defenses against the distress and failure of large banking firms and to protect US taxpayers. We saw in the crisis that the distress of even noncomplex large banking organizations generally manifests first in liquidity stresses and quickly transmits contagion to other vulnerable financial institutions. During the crisis, there were two large domestic banking institutions in the $100 to $250 billion size range whose liquidity stress necessitated distress acquisitions and another large banking organization with roughly $300 billion in assets whose closure due to insufficient liquid resources triggered substantial systemic spillovers. These episodes would have led to rapid depletion of the deposit insurance fund had the institutions not been acquired in distress.

Who can doubt that the liquidity insolvency of a large banking institution with $250 to $700 billion in assets would pose substantial risk of loss to the deposit insurance fund or that the need to monetize a large amount of assets associated with a balance sheet of that size in a time of market stress would generate large spillovers? It is worth highlighting that a distressed acquisition of a large banking institution by one of the largest domestic banking institutions is a less likely option today than previously. The alternative is the use of taxpayer resources--precisely the outcome that the core resiliency reforms seek to avoid.

The proposed changes would not only reduce by up to a third the liquidity requirement for institutions in the $250 to $700 billion range, but would also--presumably as a consequence--eliminate the current 70 percent liquidity requirement for domestic banking institutions in the $100 to $250 billion range. Staff analysis indicates that the reduced requirements would lead to an estimated reduction in high quality liquid assets at the affected firms of as much as $70 billion overall and a reduction of 15 percent in their liquidity buffers. The proposed reduction in liquidity buffers would lead to a very small positive effect on net interest margins at these banks, at the expense of an economically meaningful increase in the probability of stress at the affected institutions.

For firms with between $250 and $700 billion in assets, the rulemakings under consideration propose to weaken not only liquidity requirements, but also a capital requirement. Here too, I see nothing in S. 2155 that would direct us to make this proposed change.

We learned in the crisis that investors tend to discount the loss absorbency of capital that is subject to large mark-to-market value changes. During the crisis, banks faced losses and write-downs that translated into unrealized gains and losses on securities, and directly reduced the retained earnings component of common equity. Market participants lost confidence in the regulatory capital measure as a reflection of solvency and instead focused on measures such as tangible common equity. In response, the banking agencies finalized a rule in 2013 to ensure regulatory capital more accurately reflects the actual solvency of large financial institutions. The inclusion of unrealized gains and losses through accumulated other comprehensive income, known as AOCI, in the calculation is intended to ensure regulatory capital accurately reflects the amount that is fully available to absorb both realized and unrealized losses.

Today's proposal would reverse that progress by allowing institutions between $250 and $700 billion in assets to opt out of the requirement. Staff analysis suggests the proposed elimination of this requirement for institutions between $250 and $700 billion would result in an upward adjustment to their reported capital of $5 billion, making their core risk-adjusted capital ratio look roughly 50 basis points stronger, with no change in their actual capacity to absorb losses.[1]

[1] The impact could vary under different economic and market conditions.