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Let's Move Forward:  
The Case for Timely Implementation of Revised Capital Rules

Remarks by

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at

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Good morning and thank you to the Ohio Department of Commerce Division of Financial Institutions (DFI) for the invitation to come to Columbus to share some thoughts with you on Ohio Bankers Day.

In my remarks this morning, I want to describe some features of an appropriate regulatory capital framework for banks--focusing on community banks--and I'll cut to the chase by setting out what I believe to be two imperatives in finalizing this framework. Each of these imperatives has, at its core, the inherent goals of minimizing uncertainty and promoting safety and soundness. These imperatives are timeliness and simplicity.<sup>1</sup>

To explain why timeliness--by which I mean timely implementation of final capital rules in the United States--and simplicity are imperative, it helps to set the stage. And to do that, I have to go back in time. Way back, in fact, to when I was a child growing up in a small town in Illinois, just minutes away from the Indiana border. There was no bank in our town, but there was one in the next town over, which was where my family and our neighbors would do their banking. The bank probably had no more than \$30 million in assets. On Saturday mornings, my mother (who essentially was the CFO of the family financial unit) would toss me in the back seat of the car and drive over to deposit my parents' paychecks, which, in those days before ATMs, meant visiting a teller. If there were no checks to deposit, Saturday morning would be when my mother would go to withdraw cash for the week. "Get in this line," my mother would order. "We want Shirley."

Sometimes, we would end with a visit to the vault. To my seven-year-old self, going to the vault was deadly serious, a ritual that began by signing in with a stern-looking man who held the keys. It felt like entering a cave and looking at gold, although in retrospect I suspect my mother was only checking on insurance policies or her passbook savings. After the vault, back

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<sup>1</sup> The views in these remarks are my own and not necessarily those of my colleagues on the Federal Reserve Board.

in the lobby there were donuts with sprinkles and coffee, and the donuts came from the bakery next to the bank, which meant they were exceedingly special.

Years later, I learned that this bank was swallowed up by a larger competitor. But what was important about this bank, and why it remains so vivid in my memory, is that it was part of the fabric of our community. Our bank not only bought the local donuts, it sponsored the local Little League team, had a table at the summer sidewalk sale, made the hand fans for the Fourth of July parade, gave money to the local hospital's candy strippers, and surely did hundreds of other things invisible to me but nonetheless sewn into the tapestry of the lives of our community.

### **Community Banking Today**

Lest this sound only like nostalgia for small-town America, let's remember that the vast majority of American banks today are still very much like this one in scale, and have deep roots in their communities.<sup>2</sup> For the most part, these banks did not engage in subprime lending, nor did they otherwise contribute to the financial crisis. These banks provide their towns with sustainable and affordable credit, and have employees on hand to provide families with good advice about how to save for cars, houses, new businesses, and education.

This large segment of financial institutions is a necessary and critical part of our country's financial landscape. And it is returning to strength. While revenue is not fully back to pre-crisis levels, the community banking sector is solidly profitable. Asset quality has improved and appears to have stabilized and capital ratios have been strengthened and remain, on average, higher than those of larger banks.

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<sup>2</sup> According to Call Report data, as of March 31, 2013, 98 percent of the 6,017 insured commercial banks in the United States had total assets of \$10 billion or less, which is the threshold that the Federal Reserve typically uses to define community banks. And the vast majority of these (91 percent of all insured commercial banks) are much smaller as of that date, with less than \$1 billion in total assets.

I do not need to trumpet the benefits that community banks provide right now. But I will highlight that post-crisis research regarding these banks is moving front and center and shows that these banks provided public benefits in the crisis and in the recovery stage after the crisis.<sup>3</sup> For example, data show that community banks played an important cushioning role in the aftermath of the collapse of the market for jumbo mortgages. When the market for private-label, mortgage-backed securities collapsed in 2007, so too did jumbo mortgage lending as liquidity dried up.<sup>4</sup> In the immediate aftermath, despite a substantial reduction in jumbo lending as a share of the overall mortgage market, the data indicate that the share of community bank jumbo mortgage lending held steady. Such lending actually increased at community banks that were not dependent on correspondent banking and at those that were sufficiently well capitalized and more profitable. And, by their sheer numbers and their central role in local communities, these banks are vital and competitive players in a highly diverse landscape for financial services. They often provide competitive options where none would otherwise exist, thereby lower borrowing costs for businesses and consumers.

Whether we single them out for special advantage is a question for legitimate debate. What I do know is that what we most certainly should not do is hinder them from engaging in a fair fight.

### **The Post-Crisis Regulatory Landscape**

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<sup>3</sup> To highlight the importance of such research, the Federal Reserve System and the Conference of State Bank Supervisors will host a conference on “Community Banking in the 21<sup>st</sup> Century” at the Federal Reserve Bank of St. Louis on October 2-3, 2013. More information is available at: <http://www.stlouisfed.org/banking/community-banking-conference/>.

<sup>4</sup> See Paul Calem, Francisco Covas, and Jason Wu (2011), “The Impact of a Liquidity Shock on Bank Lending: The Case of the 2007 Collapse of the Private-Label RMBS Market,” (Washington: Board of Governors of the Federal Reserve System, August 15), [www.federalreserve.gov/events/conferences/2011/rsr/papers/CalemCovasWu.pdf](http://www.federalreserve.gov/events/conferences/2011/rsr/papers/CalemCovasWu.pdf). Publication is also forthcoming in the *Journal of Money, Credit and Banking*. This paper did not specifically address community bank lending, but the authors conducted subsequent analysis of community bank data using the methodology set forth in the paper.

This brings me to regulatory policy. One of the questions I am most frequently asked when I speak to audiences like this one is, “What on earth is going on in Washington these days?”

Well, there certainly is a lot going on. Right now, among some other things, federal regulators are working to build out hundreds of requirements laid out by Congress in the Dodd-Frank Wall Street Reform and Consumer Protection Act. And, in the midst of this complicated rule-writing effort, there is a renewed debate over whether these requirements are sufficient to end too-big-to-fail. Regulators are also continuing to oversee improvements to the operational problems in the massive numbers of foreclosures in the wake of the financial crisis and exploring the risks to financial stability that may persist in the differentially regulated parts of our financial system. This is all necessary work, and it is appropriately getting significant attention from officials at the highest levels in multiple agencies.

But just as important is what, unfortunately, is not yet getting as much attention in Washington. What is not happening--what in fact may be difficult to achieve until this post-crisis work is near completion and the overarching goal of financial stability has been addressed--is a more proactive inquiry and articulation of a positive vision of what kind of financial system we want to foster or preserve. While we focus on the difficult task of implementing a wide range of rules, a number of questions about the industry remain, questions that we must shift our full focus to once the post-crisis work is near completion.

For example, is diversity in both the size and type of financial institutions critical to the goals of stability and access to credit? Should new technologies that permit mobile payments and mobile banking be fostered through federal policy? To what extent should we be concerned about cyber threats, and are there features of a financial system that can mitigate or thwart such

threats? After a crisis caused in part by opaque financial engineering, how do we prevent such excesses without stifling innovation that might benefit customers and the public and foster economic growth? Should financial inclusion and financial literacy be regulatory goals, as some have suggested, and what responsibility should banks bear in achieving such ends? What do we do to re-calibrate a multi-layered regulatory response that was partly dictated by the exigencies of a crisis rather than by calculated principles of best design?

We have to address these and other questions if we hope to envision a post-crisis financial regulatory system that supports a strong, dynamic, and diverse financial system. This, to me, is the strongest motivation for moving ahead as expeditiously as possible on implementing statutory requirements and international agreements to raise capital standards so that we can begin lifting our vision beyond a crisis response. Moreover, as we implement these requirements and agreements, one of the things that the agencies have been considering is how we can do so in a way that does not differentially harm those financial institutions whose actions were not, by and large, responsible for the need to develop a policy response to the crisis.

### *Timeliness*

Let's talk about the importance of timely implementation of rules based on one set of international agreements--the Basel III framework. The proposed rule, together with the capital-related provisions in the Dodd-Frank Act, is intended to raise both the quality and quantity of capital at banking organizations in the United States. I fully support this goal, because the financial crisis demonstrated, among other things, the need for robust capital at banks of all sizes. The issue, of course, is that the framework has not been finalized, and I am concerned that significant, further delays could add to uncertainty and could detract from the maintenance of strong capital levels.

There are some good reasons why the capital rules have not yet been finalized--in particular, the need to carefully consider the thousands of comment letters on the proposed rules, many of which came from community banks. Meanwhile, since Basel III sets a final deadline for implementation of 2019, one might ask why it is so imperative to act sooner.

First, while it is important to get it right, this goal must be balanced with the costs imposed by delay. Lending decisions and funding plans today are shaped by perceptions of business conditions in the future, and those conditions include the details of the final regulatory capital framework. It seems obvious to me that uncertainty over that framework is weighing on the balance sheets of banks that will be affected by the rules.

Second, while Basel III calls for full implementation by 2019, it also envisions a transition that must start years earlier. Since the transition to the new rules will be gradual, with some elements of the rules proposed to come into effect earlier, the sooner that regulators finalize the rules, the sooner banks will be able to incorporate those rules into their capital planning efforts.

Now that banking agencies, including the Federal Reserve, have completed much of the analytical work in response to public comments on the proposed rules on Basel III, we must continue to work together to get on with the finalization of a regulatory capital framework. So let me add my voice to those who believe that this work must be completed soon. At a moment when the economy finally seems to be gaining some traction, I believe that finalizing a capital rule will minimize uncertainty related to capital requirements as well as promote safer and sounder banks.

*Simplicity*

There is significant justification for both higher levels, and higher quality, of capital. In particular, we have seen that highly capitalized banks are more likely to maintain their lending activity through good times and bad, as evidenced during the recent crisis, a trend that helps their customers and the overall economy.<sup>5</sup> A framework requiring higher quality and quantity of capital should be established post-haste. At the same time, however, for community banks in particular, more and better capital should be achieved without significantly increasing the complexity of capital calculations. It is not only possible and desirable, but also necessary, to ensure that our capital requirements for community banks remain relatively simple and effective. Otherwise, we risk drowning banks in a capital adequacy system that is so complex that it both misses the mark of addressing meaningful emerging risks and piles regulatory costs on banks with no public benefit. I should note here that the proposed Basel III rules include complex models-based approaches for internationally-active banks and for banks with significant trading activities. These models-based approaches are clearly inappropriate for, and will not apply to, community banks.

### **Risk-Weighted Assets**

To step back, the first framework for risk-based capital was implemented in the United States in 1989 and entailed assigning assets to one of four defined risk-weighting categories: zero percent, 20 percent, 50 percent, and 100 percent, with a higher percentage signifying higher inherent risk.<sup>6</sup> This had the advantage of making the framework more risk-sensitive than the simpler, one-size-fits-all, leverage-based approach that I will discuss later. As a result, a Treasury security and an unsecured loan to a start-up business were no longer treated identically

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<sup>5</sup> See R. Alton Gilbert, Andrew P. Meyer, and James W. Fuchs (2013), "The Future of Community Banks: Lessons From Banks That Thrived During the Recent Financial Crisis," *Federal Reserve Bank of St. Louis Review* (March/April), pp. 115-144, at <http://research.stlouisfed.org/publications/review/13/03/gilbert.pdf>.

<sup>6</sup> Note that the number of risk weight buckets would increase under the Basel III notices of proposed rulemaking (77 Fed. Reg. 52791 and 77 Fed. Reg. 52887), but would still remain relatively small.

for purposes of regulatory capital. This not only made intuitive sense, but was also more consistent with how banks managed their own balance sheets and measured their risk-based performance.

But the approach of risk-weighting assets by placing them in defined buckets is not precise. While it might have the virtue of providing some capital sensitivity to the quality of different asset classes, a granular system of risk-weighting raises issues of its own.

For example, the riskiness associated with each asset class can be flat-out wrong. Errors are going to occur in part because risks can change over time and in part because no one has perfect knowledge about the nature of risks associated with every single asset class. To note one prominent example, risk exposures to the sovereign debt of countries that are members of the Organisation for Economic Co-operation and Development currently receive a zero percent risk weight. That is, for regulatory capital purposes, their debt is considered to be risk-free. But if there is one thing we have learned in recent years, sovereign debt can indeed be risky even if, in good times, it appears to be perfectly safe.

In addition, I believe you can make a case that risk weights for securitization exposures understated the risks and losses that were actually incurred in these exposures. In fairness, losses during the financial crisis far exceeded prior historical losses on securitization exposures. But that's just the point: The risk profile of a particular financial instrument can change significantly over time, which can be very difficult to capture in a regulatory capital regime based on crude risk buckets that do not evolve over time. Accordingly, the amount of capital held can be inappropriate relative to the actual risk.

One problem this can lead to is that it can create incentives that skew lending decisions and credit allocation more broadly. To be clear, I don't want to give the impression that banks'

lending decisions are driven solely, or even primarily, by regulatory capital requirements. Bank lending is influenced by a variety of factors--capital requirements are just one. But at the margin, we shouldn't be surprised to see banks in aggregate making lending and investment decisions that have favorable risk-based capital treatment or that generate higher returns on a given amount of regulatory capital. So, for example, in Europe a number of banks had significant sovereign holdings going into the financial crisis, not only because capital requirements were so low, but also because high credit spreads made these particularly attractive investments. Likewise, here in the United States, banks piled into mortgage lending in the early-to mid-2000s not only because it offered generous returns, but also because regulatory capital requirements did not adequately capture the risks in this lending, particularly for subprime exposures.

### **Leverage Ratio**

One of the ways that supervisors, particularly here in the United States, have addressed shortcomings in the risk-based capital regime has been to also impose a simple capital-to-assets requirement, or leverage ratio, to supplement the risk-based measures. A leverage ratio has a number of things that make it intuitively appealing, if it can be set correctly. First and foremost, it has the virtue of simplicity. Not only is it easy to calculate and easy for market participants and the public to understand, it also provides a single benchmark by which to easily compare and calibrate institutions' capital positions. In addition, a leverage ratio provides a relatively straightforward gauge of how close an institution is to insolvency. In simple terms--and I should caution that reality is seldom this simple--if an institution has a leverage ratio of 3 percent, a decline in value of assets on the balance sheet of greater than 3 percent is likely to render the institution insolvent.

Moreover, we know not only from the fundamentals of finance theory but also from hard experience, that while leverage can boost earnings when times are good, leverage can also amplify losses. There is a reason why, despite the evolution of risk-based capital frameworks over the years, the leverage ratio has remained a key part of the banking supervision toolbox. This was recognized by the U.S. Congress when it passed the Federal Deposit Insurance Corporation Improvement Act (FDICIA) in 1991. FDICIA made the leverage ratio one of the key elements of the prompt corrective action framework for assigning capital categories to banks and taking supervisory action as appropriate and required by law. As a matter of fact, U.S. supervisors felt that a leverage ratio was such an important factor in assessing capital adequacy that U.S. negotiators worked to make sure a leverage ratio was included in the Basel III framework for global banks, many of which were not subject to explicit leverage requirements.

For all its strengths, however, a leverage ratio also has significant shortcomings if not set appropriately. While its simplicity may be one of its greatest virtues, simplicity is also one of its biggest drawbacks. Notably, leverage ratios typically only apply to assets held on the balance sheet. This may be fine for institutions that primarily engage in on-balance-sheet deposit-taking and lending--like most community banks--but it can fail to capture the risks of banks' off-balance-sheet activities, which have grown exponentially over the past several decades. I mentioned previously that leverage tends to amplify losses, and I would suggest that many of the losses during the recent financial crisis, particularly at the largest firms, were a result of off-balance-sheet leverage.

So, given the various features of a simple leverage-based approach and a more complex and imperfect system of risk weighting, what is the right approach for community banks? The right approach should not significantly increase the complexity of capital. The risk-based capital

ratios should provide a rough baseline benchmark for ensuring that sufficient capital is held relative to a bank's risk profile, and the leverage ratio--which has certainly stood the test of time--serves as an effective backstop to reduce the risk that a bank would allow its balance sheet to become overleveraged.

### **Supervisory Assessments of Capital Adequacy**

Indeed, there is another side to appropriate regulation. And that is supervision and the supervisory process. At least as, if not more important as the regulatory ratios for banks is an effective supervisory assessment of capital adequacy. Regulatory capital ratios certainly provide valuable input into a bank's capital adequacy, but it is important to understand that these ratios are rough and imperfect estimates. As supervisors, we expect banks to hold capital that captures the full range of risks associated with the bank's activities, which, based on a bank's expertise in managing the risks, may very well dictate capital levels that differ from these minimum ratios.

I'm not talking about anything new here: If you look at the criteria for rating capital adequacy under the banking agencies' CAMELS rating system for banks<sup>7</sup>, and under the Federal Reserve's RFI rating system for bank holding companies, you will actually see very few references to minimum regulatory capital.<sup>8</sup> Instead, the focus is on maintaining capital that is commensurate with the overall risk profile of the bank, not just credit risk. This requires both management and the supervisor to have an effective understanding of the banking organization's risk profile, which is central to our supervisory program. This supervisory feature sometimes gets lost in the public debate about the value of well-constructed regulatory capital ratios, but I

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<sup>7</sup> The interagency CAMELS rating system for banks is described in Supervisory and Regulatory (SR) letter 96-38, "Uniform Financial Institutions Rating System." The main components of the CAMELS rating system are capital adequacy (C), asset quality (A), management (M), earnings (E), liquidity (L), and sensitivity to market risk (S), as well as an overall composite rating.

<sup>8</sup> The Federal Reserve's RFI rating system for bank holding companies is set forth in SR letter 04-18, "Bank Holding Company Rating System." The main components of the RFI rating system are risk management (R), financial condition (F), and potential impact (I).

believe that effective supervisory assessments of risk and capital adequacy as part of the community bank examination process are absolutely critical.

### **Conclusion**

In sum, let me conclude by saying that time is of the essence here in moving forward with the Basel III final rules. The proposed rules were not perfect and I expect there to be meaningful modifications. At the same time, while we attempt to craft a risk-based system that makes sense from the perspective of safety and soundness, we have to resist the temptation to believe we can create a perfectly sensitive risk-based regime that gives the illusion of safety. Such a regime would not be a meaningful surrogate for effective on-site supervision, and the effort to try to create an ever-more refined system would distract us from some of the important policy questions that lie ahead for our financial system. Finally, there are costs to complexity that should not be ignored. We shouldn't be lulled into thinking that these unnecessary costs should be allocated to community banks, which are a segment of our financial system that provides meaningful benefits to many Americans.

Thank you very much for your time this morning.