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An Essential Post-Crisis Reform Should Not Be Weakened:

The Enhanced Supplementary Leverage Capital Ratio

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Introduction

I would like to thank the Peterson Institute for inviting me to speak this morning.

A central lesson of the financial crisis of 2008 was that the buildup of leverage—in other words, reliance on debt—at the largest financial institutions in the United States increased the vulnerability of the financial system and was a critical contributor to the crisis.

The enhanced supplementary leverage capital ratio, which is an unweighted measure of equity as a percentage of an institution’s exposures designed to constrain reliance on debt, was, in my view, the key post-crisis reform that addressed this issue. This capital requirement, which the federal banking agencies—the Federal Reserve Board, the Office of the Comptroller of the Currency (OCC), and the FDIC—established after the financial crisis for the eight U.S. global systemically important banking organizations, or G-SIBs, is the issue I would like to address today.

On April 11 of this year, the Federal Reserve Board and the OCC released a joint notice of proposed rulemaking, or NPR, to make changes to the enhanced supplementary leverage ratio capital requirement applied to the eight U.S. G-SIBs and their federally insured bank subsidiaries. The changes would have the effect of reducing the capital requirement. They are not technical fixes. They would significantly weaken constraints on financial leverage in systemically important banks put in place in response to the crisis.

According to the NPR, the proposed changes would reduce capital requirements at the lead federally insured banks of the eight G-SIBs by $121 billion. This roughly 20 percent reduction in capital would benefit the affiliates, parent companies, and shareholders of these institutions. It would, however, make the banks themselves more vulnerable to disruption and failure.

In my remarks, I will briefly address why the banking agencies initially implemented the enhanced supplementary leverage ratio and the strong performance of the banks that have been subject to it. I will summarize the changes that have been proposed and their immediate and

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potential effects on the capital requirements of these institutions. I will also discuss the case that has been made for the proposed changes and my serious concerns with the proposal.

The Enhanced Supplementary Leverage Ratio

Runs by financial counterparties during the crisis highlighted doubts among market participants about the capital adequacy of many large financial institutions, and their ability to meet their obligations and absorb losses. The loss of market confidence prompted the Federal Reserve, the FDIC, and the U.S. Treasury to implement liquidity programs and guarantee bank liabilities, which mitigated the need for institutions to sell assets at fire-sale prices.

Collectively, the eight U.S. G-SIBs and their affiliated entities had $434 billion of their debt obligations guaranteed by the FDIC during the crisis. In addition, the eight lead banks of these institutions utilized a separate FDIC guarantee of their large non-interest-bearing transaction accounts, with $436 billion of such accounts guaranteed by the FDIC as of year-end 2008. In addition to these $870 billion in FDIC guarantees, these G-SIBs also benefitted from an emergency U.S. Treasury guarantee of their affiliated money market mutual funds, received large capital injections from the U.S. Treasury, and borrowed heavily under various Federal Reserve liquidity programs.

The need for this unprecedented public assistance made it clear that the pre-crisis regulatory framework had allowed large institutions to operate with insufficient capital and liquidity.

In response to the crisis, the federal banking agencies adopted the Basel III capital rule, which for the largest institutions became effective in 2014. The rule strengthened the quality of bank capital and the level of risk-based capital requirements. It also required that large, internationally active banks must, starting in 2018, implement a new supplementary leverage

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2 These were FDIC programs of general availability undertaken pursuant to a systemic risk determination. A list of debt issuances guaranteed by the FDIC during the crisis pursuant to the Temporary Liquidity Guarantee Program can be found at [https://www.fdic.gov/regulations/resources/tlgp/total_debt.html](https://www.fdic.gov/regulations/resources/tlgp/total_debt.html). The amount of non-interest bearing transaction accounts guaranteed by the FDIC for the institutions that opted-in to the Transaction Account Guarantee program can be found on Call Report schedule RC-O, memorandum item 4.
capital ratio consisting of tier 1 capital\(^3\) of at least 3 percent of balance sheet assets and certain off-balance sheet assets.\(^4\)

In the U.S., the increase in capital requirements under Basel III was largely attributable to the higher risk-based capital requirements. The 3 percent supplementary leverage ratio was a significant development for banks in the many Basel member countries that did not have leverage capital requirements of any kind. In the U.S., where banks had been subject to leverage requirements for many years, it was not nearly as significant a change.

It was this disparity between the substantial strengthening of risk-based capital requirements in the U.S. under the Basel III rule and the relatively more modest change in leverage capital requirements that led the banking agencies to consider adopting an enhanced supplementary leverage ratio for the eight U.S. G-SIBs.

The agencies noted in the preamble to the enhanced supplementary leverage ratio proposed rule in 2013 that a 3 percent supplementary leverage ratio would not have placed a significant constraint on the pre-crisis buildup of leverage at the largest U.S. institutions. The agencies also noted that this disparity could allow institutions to benefit from active management of their risk-weighted assets before they breached the leverage requirements.\(^5\)

Based on these considerations and the systemic importance of the eight U.S. G-SIBs, the agencies implemented an enhanced supplementary leverage ratio requirement for them. Rather than 3 percent, the enhanced supplementary leverage ratio was to be 5 percent at G-SIB holding companies and 6 percent at FDIC-insured G-SIB banks.\(^6\) While the enhanced supplementary leverage ratio capital requirement had an effective date of January 1, 2018, all eight G-SIBs have effectively been in compliance with it since early 2016.

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\(^3\) Tier 1 capital is, essentially, equity capital minus certain deductions (consisting mostly of goodwill and most other intangible assets, certain deferred tax assets, and certain investments in the capital instruments of other financial institutions) plus non-cumulative perpetual preferred stock. See 12 CFR § 324.2.

\(^4\) The new supplementary leverage ratio includes both on and off balance sheet assets, while the pre-existing U.S. leverage ratio included only on balance sheet assets.

\(^5\) See 78 FR 51105 (August 20, 2013).

\(^6\) As the agencies noted in the NPR, the difference between the 5 percent holding company and 6 percent bank requirements is structurally similar to the difference between the 4 percent and 5 percent U.S. leverage requirements that exist for holding companies and banks.
In calibrating the enhanced supplementary leverage ratio at 5 percent and 6 percent, respectively, the banking agencies described their approach as designed to achieve a comparable increase in the stringency of leverage requirements and risk-based requirements at U.S. G-SIBs. They noted that from a safety-and-soundness perspective, each type of capital requirement offsets potential weaknesses of the other. The risk-based requirements, while risk-sensitive, use risk-measures that have at times dramatically underestimated risk and are subject to management. The leverage framework, while relatively simple, does not differentiate assets by risk and ensures banks hold a base of capital proportional to their exposures. The two frameworks in that sense are complementary and work together to provide a stronger capital foundation than either would in isolation.

It is worth noting that risk-based capital requirements are the binding tier 1 capital requirements at the bank holding company level for the four universal banking organizations—Bank of America Corporation, Citigroup Inc., JPMorgan Chase & Co. and Wells Fargo & Company—whiches assets comprise 78 percent of the assets of the eight organizations. The binding capital requirement is the requirement that calls for the highest amount of capital when compared to other capital standards. The enhanced supplementary leverage ratio is the binding tier 1 capital requirement for the holding companies of the two investment banks—Goldman Sachs Group, Inc. and Morgan Stanley—and the two custody banks—Bank of New York Mellon Corporation and State Street Corporation.

For the lead federally insured banks of the eight G-SIBs, the U.S. leverage ratio was binding before the adoption of Basel III, and similarly, the enhanced supplementary leverage ratio is binding for the eight banks today. Thus a binding leverage ratio was not new to the banking system. During the crisis, market participants gave credence to leverage capital and lost confidence in risk-based capital. In light of that experience, the question to ask is why should this straightforward capital measure that limits excessive leverage be reduced now?

Banking Organization Performance Under Strengthened Capital Standards

As of March 31, 2018, the holding companies of the eight U.S. G-SIBs held about $923 billion in tier 1 capital, comfortably exceeding their aggregate tier 1 risk-based capital requirement of $767 billion and their aggregate enhanced supplementary leverage ratio
requirement of $689 billion. Collectively, the largest U.S. banking organizations hold roughly twice the capital and more than twice the liquid assets relative to their size than they held entering the crisis. This makes them significantly stronger financial institutions that are less likely to experience liquidity problems or fail during a period of financial stress.

How then, has compliance with the strengthened risk-based and enhanced supplementary leverage capital standards affected their performance and their ability to support U.S. economic growth?

Since mid-2014 after the Basel III capital rule became effective and when these institutions first knew they would be subject to the enhanced supplementary leverage ratio, their financial performance and their support to U.S. economic activity has been notable. Between mid-2014 and year-end 2017, total loans outstanding at the eight U.S. G-SIBs grew faster than nominal GDP. The cumulative increase in nominal GDP during this time was about 13 percent. In comparison, the cumulative percentage growth in total loans outstanding at the eight G-SIB lead banks, where almost all of the lending in the consolidated organizations takes place, was about 18 percent. This comparison suggests that on balance, the lending activities of G-SIBs are supporting economic growth.

The activities of investment banking subsidiaries of the eight G-SIBs also have strongly supported economic activity. The bond underwriting activities of these institutions have fueled a record-setting pace of credit provision to the corporate sector during this expansion. Bid-ask spreads on bond trades, a standard measure of the cost of trading to market participants, have been at or near historic lows. The top five investment banks in the world by fee income have, for several years, been the investment banking subsidiaries of five U.S. G-SIBs.

Through their Futures Commission Merchant subsidiaries (which often are also regulated broker-dealers), the eight G-SIBs have been actively engaged in derivatives clearing activities. As reported by the Commodity Futures Trading Commission, the volume of segregated funds for cleared swap customer accounts reported by the Future Commission Merchant subsidiaries of the eight G-SIBs roughly tripled between mid-2014 and year-end 2017. The market share in clearing swaps for customers of these Future Commission Merchants, whose parent companies
all are subject to the enhanced supplementary leverage ratio, increased from about 50 percent to about 80 percent during the same period.

Another measure of financial performance is bank earnings. The eight U.S. G-SIB holding companies earned $345 billion during the four years from 2014 to 2017, with $295 billion of those earnings, or over 85 percent, attributable to the eight lead insured banks. Comparisons to the earnings of other U.S. corporations provide some context for evaluating G-SIBs’ earnings. Measured by dollars of net income, in the first quarter of 2018, all four universal banking organizations ranked among the top ten earning firms in the S&P 500 companies. The aggregate earnings performance of the lead insured banks of the other four G-SIBs (the custody and investment banking organizations) also was noteworthy. Their aggregate earnings grew steadily throughout the four years. Combined earnings at these four banks in 2017 were 61 percent higher than in 2013, despite the large one-time tax-related write-downs that affected many banks in 2017.

In short, large U.S. financial institutions, whose vulnerability necessitated extraordinary public assistance during the crisis, are now among the strongest in the world. Their loan growth, bond underwriting volumes, bid-ask spreads on bond trades, volume and market share of derivatives clearing, and commercial and investment bank earnings all reflect their strong support to the U.S. economy.

The Effect of the Fed/OCC NPR on G-SIB Insured Bank Capital Requirements

In their April 11 NPR, the Federal Reserve and OCC proposed to change the required 6 percent enhanced supplementary leverage ratio at the insured banks of the U.S. G-SIBs to a range of lower ratios, from 3.75 percent to 4.75 percent. The specific value within this range would vary by bank, with the percentage point amount above 3 percent equal to half of each bank’s holding company risk-based capital ratio surcharge. Unlike the current enhanced Tier 1 risk-based capital requirements for the 8 G-SIB bank holding companies consist of a minimum of 6 percent of risk-weighted assets, plus a “capital conservation buffer” of 2 ½ percent of risk-weighted assets, plus a G-SIB surcharge, currently varying in amount between 1.5 percent of risk-weighted assets and 3.5 percent of risk-weighted assets depending on the company (see 80 FR 49082-49116 (August 14, 2015), Regulatory Capital Rules: Implementation of Risk-Based Capital Surcharges for Global Systemically Important Bank Holding Companies). One half of the G-SIB surcharge thus varies between 0.75 percent and 1.75 percent of RWA, and in the NPR the enhanced supplementary leverage ratio is proposed to exceed the minimum 3 percent SLR by these percentage point amounts: thus the range from 3.75 percent to 4.75 percent.

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supplementary leverage ratio, there would be no difference between the bank and holding company requirements.

By comparison with the current flat 6 percent requirement, under the proposal the enhanced supplementary leverage ratio requirements at the insured banks would be reduced substantially. The effective change in capital requirements depends on the extent that other capital requirements, such as risk-based capital, would constrain each bank’s ability to reduce its capital.8

The NPR states that as of September 30, 2017, the amount of capital that the lead banks of the eight U.S. G-SIBs need to be considered well-capitalized would be reduced by $121 billion.9 Applying the methodology described in the NPR, the effective capital requirements in aggregate at the eight U.S. G-SIB lead banks would be reduced under the proposal from $588 billion to $467 billion, a roughly 20 percent reduction.10, 11

The Effect of the Fed NPR on G-SIB Bank Holding Company Capital Requirements

By comparison with the current flat 5 percent requirement, the enhanced supplementary leverage ratio requirement at the holding companies would be reduced under the NPR to the same lower range as that for the banks, between 3.75 percent and 4.75 percent depending on the G-SIB surcharge for the company.12

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8 The eight U.S. GSIB insured banks, in addition to the enhanced supplementary leverage ratio, are required to hold tier 1 capital of at least 8½ percent of risk-weighted assets. Since the early 1990s, they and all other insured banks have been required to meet a separate U.S. leverage requirement, namely that tier 1 capital must be at least 5 percent of balance-sheet assets. These banks are not subject to G-SIB risk-based capital surcharges, or the Federal Reserve’s Comprehensive Capital Analysis and Review or capital plan rule.

9 83 FR 17321 (April 19, 2018). The preamble to the NPR indicated that the effective reduction in tier 1 capital requirements across the 8 GSIB IDIs would total $121 billion, based on data as of the third quarter of 2017.

10 83 FR 17321 (April 19, 2018), footnote 29.

11 These estimates consider only the NPR, without factoring in the recent statutory change adopted by Congress. In May of this year, Section 402 of the Economic Growth, Regulatory Relief and Consumer Protection Act was enacted, requiring the federal banking agencies to make changes to the enhanced supplementary leverage requirements for the G-SIB custody banks. That change requires the agencies to revise their regulations to remove central bank deposits of custody banks from the denominator of the supplementary leverage ratio calculation, subject to certain conditions. This may have the effect of further reducing the capital of these institutions, but we will have to see how the provision is implemented.

12 Identifying the change in effective capital requirements is more complex for G-SIB holding companies than for their bank subsidiaries. Currently, GSIB bank holding companies’ tier 1 capital must satisfy the 5 percent enhanced supplementary leverage ratio, a generally applicable 4 percent U.S. leverage ratio, and a risk based capital requirement ranging from 10 percent to 12 percent of risk-weighted assets, depending on the company. The eight GSIB holding companies also are subject to
The NPR stated that the aggregate estimated reduction in effective tier 1 capital requirements across the eight holding companies is about $9 billion, or approximately a 1 percent reduction on average. The small aggregate reduction reflects that risk-based capital requirements are binding at the four large universal banking organizations, which means that the change in the leverage capital requirement does not have an effect for them. However, for the holding companies of the two investment banks and two custody banks where the enhanced supplementary leverage ratio is binding, the reductions in capital are more meaningful.

The Federal Reserve estimated in the NPR that after taking into account the effect of its Comprehensive Capital Analysis and Review program, or CCAR, and its capital plan rule, the aggregate reduction in capital requirements would be only $400 million at the holding company level. The CCAR program is the Federal Reserve’s annual evaluation of the capital adequacy of the largest U.S. bank holding companies, using a stress testing analysis of the effect of assumed severe economic scenarios. Under its capital plan rule, the Federal Reserve may object or not object to planned capital actions by the covered companies, such as dividend payments or share buybacks. In effect, the Federal Reserve estimated in the NPR that it would exercise its discretionary authority pursuant to these processes to prevent most capital reductions at the holding company level that would have been permitted under the regulations.

Concerns About Financial Stability and Safety and Soundness

The most notable immediate effect of the proposed rule would be its $121 billion reduction in the aggregate effective capital requirements at the lead banks of the eight U.S. G-SIBs.

Two types of arguments have been made in support of these changes. One is an incentive argument based on the benefits of risk-based capital. The other asserts that whatever concerns one may have about lower capital requirements at the federally insured bank, holding company capital requirements and/or the CCAR process should allay those concerns.

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13 Statutory supervisory stress tests and the Federal Reserve's Comprehensive Capital Analysis and Review program and capital plan rule.

14 83 FR 17321 (April 19, 2018).
The incentive argument made in the NPR is that a binding leverage ratio discourages low risk activities such as clearing derivatives for clients, secured repo lending, and taking custody deposits because the leverage ratio doesn’t distinguish between high risk and low risk activities. The argument is that to avoid discouraging such activities, the enhanced supplementary leverage ratio should be reduced so that it would no longer be the binding constraint. It is argued that lowering the enhanced supplementary leverage ratio requirement will make banks safer by making risk-based capital, with its incentive effects, the binding constraint.

There are three points to be made in response to this argument.

The first and most fundamental point is that a bank’s risk of failure depends not only on the risk profile of its assets, but on the amount of capital it holds. The question is whether the assumed risk-reducing improvement in incentives would offset the risk-increasing effect of operating with less capital? Evidence suggests the answer is no. Research on bank failures typically concludes that more capital reduces the risk of bank failure and vice versa. Reducing the G-SIB lead banks’ capital by $121 billion would be expected to make them more likely to fail under stressful conditions, not less.

Second, it is worth noting that the incentive effects of risk-based capital can also be problematic. When the risk-based capital ratios are binding, banks may tend to expand activities where the risk is underestimated by risk-based capital. Low risk weights may have encouraged the growth of highly-rated securitizations of alternative mortgage products and related credit derivatives before the financial crisis.

Third, as noted previously, the eight U.S. G-SIBS have effectively been in compliance with the enhanced supplementary leverage ratio since early 2016. Judging by the firms’ overall financial performance and market share in activities such as central clearing and custodial services, the evidence is not clear the extent to which the enhanced supplementary leverage ratio

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has impacted their participation in these activities. These activities were concentrated in the eight U.S. G-SIBs before the crisis and remain so today.

This brings me to the second type of argument for the enhanced supplementary leverage ratio proposal. That is, we should not worry about capital at the bank level because holding company capital requirements and CCAR will essentially trap the capital at the holding company.

First, regardless of holding company requirements, these are large reductions in capital requirements at the lead federally insured banks. If the capital reduction at the bank is paid to the parent in dividends or otherwise transferred to nonbank affiliates, it may become unavailable to absorb losses at the bank. Just as a bank’s capital is not available to absorb losses at affiliates, an affiliate’s capital is generally not available to a bank. Parent companies have long been expected to serve as a source of strength to federally insured banks, which reflects the importance of safeguarding their subsidiary insured banks. I do not believe that anyone has previously envisioned the source of strength by the parent company being bolstered by lowering the capital requirement at the bank. In effect what is being proposed here is to significantly reduce the capital of the bank in order to serve the interests of the parent company and its affiliates.

Finally, we should examine closely the premise that the capital released from the bank will be trapped in the holding company through the CCAR process. Notwithstanding the good intentions with which CCAR is applied, it is a discretionary process that does not provide the same certainty as does a numerical capital requirement. Large banking organizations typically do not hold what they view as excess capital voluntarily, and can be counted on to avail themselves of any flexibility afforded by the CCAR process. Given the discretion provided in the CCAR process, and the eagerness of institutions to make distributions to shareholders through dividends and stock repurchases, close scrutiny will be needed going forward.

Conclusion

In conclusion, the proposed reduction in capital requirements at these systemically important insured banks is, in my view, a serious weakening of the post-crisis reforms.
It is reasonable to assume that substantially lowering leverage capital requirements at G-SIB insured banks would cause them to become substantially more leveraged than they are today. Significantly reducing G-SIB bank capital requirements will increase the risk of financial counterparty runs, reduce their ability to absorb losses, make them less able to lend in an economic downturn, increase their likelihood of failure, and increase risk to the Deposit Insurance Fund.

We are now in the ninth year of this economic recovery, the second longest on record. We know that recoveries don’t last forever. It seems to me that the first lesson of the recent financial crisis for the federal banking agencies is to ensure that our systemically important banks are positioned to manage the next downturn, whenever it occurs, without disruption to the institutions or the financial system. Ideally they should be able to sustain their lending activity to support the economy. Reducing the capital of these insured banks by $121 billion would be a failure to learn that lesson. I would hope therefore that serious reconsideration is given to this proposal.