Statement by FDIC Board Member Martin J. Gruenberg

Meeting of the FDIC Board of Directors

Notice of Proposed Rulemaking on Changes to Applicability Thresholds for Regulatory Capital and Liquidity Requirements

November 20, 2018

I would like to begin by thanking the staff for their work on this Notice of Proposed Rulemaking (NPR) before the FDIC Board today. Since I intend to vote against this NPR, I would like to take this opportunity to explain the reasons for my vote.

As staff indicated, this Notice of Proposed Rulemaking would establish a revised framework for the application of regulatory capital and liquidity requirements for large U.S. banking organizations with total assets of $100 billion or more. A consequence of the revised framework would be to reduce significantly the liquidity requirements for banking organizations with assets between $100 billion and $700 billion. This would, in my view, unnecessarily weaken a central post-crisis prudential protection for the financial system and place the Deposit Insurance Fund at greater risk.

My comments today will focus on the changes proposed to the liquidity coverage ratio (LCR), a short-term liquidity buffer. The NPR also proposes parallel changes to the net stable funding ratio (NSFR), a proposal that has yet to be finalized that would help ensure covered firms are supported by stable funding over a longer-term one-year horizon. In addition, the NPR would allow banks with assets between $250 billion and $700 billion to opt out of a requirement to account in their capital for unrealized gains and losses on securities – otherwise known as accumulated other comprehensive income (AOCI). The failure to account for unrealized losses on securities in bank capital during the crisis allowed banks to appear more strongly capitalized than they actually were. Removing this important post-crisis reform is also unwarranted. But as I indicated, my comments today will focus on the liquidity coverage ratio.

In November 2013, the Federal Reserve, the OCC, and the FDIC issued a Notice of Proposed Rulemaking to implement for the first time a quantitative liquidity requirement known as the liquidity coverage ratio for large banking organizations in the United States.[1] The LCR was designed to improve the ability of the banking sector and individual banking organizations to absorb liquidity shocks arising from financial or economic stress, without reliance on government support, thus reducing the risk that financing stress in the banking sector would spill over and damage the broader economy.

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[1] 78 Fed. Reg. 71817 (Nov. 29, 2013)

As the 2013 NPR pointed out, the financial crisis demonstrated significant weaknesses in the liquidity positions of large banking organizations in the United States, many of which experienced difficulty meeting their obligations due to a breakdown of funding markets.[2] In response to the breakdown, the Federal Reserve and the FDIC established various temporary liquidity facilities during the crisis to provide extraordinary funding support for those institutions.

The 2013 NPR also indicated that these events came in the wake of a period characterized by ample liquidity in the financial system. The rapid reversal in market conditions combined with an equally rapid decline in the availability of liquidity during the financial crisis "illustrated both the speed with which liquidity can evaporate and the potential for protracted illiquidity during and following these types of market events. In addition, the financial crisis highlighted the pervasive detrimental effect of a liquidity crisis on the banking sector, the financial system, and the economy as a whole."[3]

In October 2014, the three banking agencies adopted a final rule implementing a quantitative liquidity coverage ratio.[4] A company subject to the rule is required to maintain an amount of high quality liquid assets that is no less than 100 percent of its total net cash outflows over a prospective 30-calendar day period. The rule applies to bank holding companies and insured depository institutions with $250 billion or more in total assets or $10 billion or more in on-balance sheet foreign exposure. The Federal Reserve also adopted its own modified liquidity coverage ratio standard that is based on a 21-calendar day stress scenario that applies to bank holding companies with total consolidated assets between $100 billion and $250 billion. The LCR and the modified LCR were intended to be quantitative measures of liquidity to complement existing supervisory guidance and the more qualitative and internal stress test requirements of the Federal Reserve.[5]

The Notice of Proposed Rulemaking before the Board today would reduce the liquidity coverage ratio requirements to between 70 and 85 percent of the full LCR for banking organizations with assets between $250 billion and $700 billion, and less than $75 billion in weighted short-term wholesale funding. The NPR would remove the current modified LCR requirement for banking organizations with assets below $250 billion.

The premise for these changes is stated in the NPR, "The proposal builds on the agencies' existing practice of tailoring capital and liquidity requirements based on the size, complexity, and overall risk profile of banking organizations."

There are five points I would make in regard to this proposal.

[2] 78 Fed. Reg. 71817, 71820
[3] 78 Fed. Reg. 71817, 71820
[4] 79 Fed. Reg. 61439 (Oct. 10, 2014)
[5] 79 Fed. Reg. 61439, 61444

First, the liquidity coverage ratio is already tailored to the size, complexity, and risk profile of the covered firms. The tailoring of liquidity requirements in the LCR currently in place was supported by careful analysis, and there have been no changes or developments since 2014 that would warrant a change to the LCR. Importantly, the current rule has yet to be tested through a full economic cycle.

Second, in my view, the current proposal significantly underestimates the liquidity risks posed by banking organizations with assets between $100 billion and $700 billion. The institutions in this asset range experienced significant liquidity stress during the financial crisis and had to make use of extraordinary liquidity support from the FDIC and the Federal Reserve, as well as capital support from the U.S. Treasury's Troubled Asset Relief Program. The institutions with assets between $100 billion and $700 billion collectively utilized over $125 billion in liquidity support from the FDIC's Temporary Liquidity Guarantee Program alone.

Third, the risks posed by the failure of banking organizations with assets between $100 billion and $700 billion are substantial and, in my view, also underappreciated.

Given the size of these banking organizations, the universe of healthy institutions that might be able to acquire one of them prior to or after failure is limited, particularly during a period of financial stress. If no acquiring institution were available, the FDIC itself would likely have to take over and manage the orderly wind down of the failed institution through the establishment of a bridge bank, or simply liquidate the institution. In that case depositors would be subject to the risk of loss on their uninsured deposits. Most of the institutions in the $100 billion to $700 billion asset class have tens of thousands of uninsured depositors. The risk of undermining public confidence and causing significant disruption to the financial system is substantial.

The NPR before us today points to the experience of Washington Mutual, a savings and loan holding company with approximately $300 billion in assets at the time of its failure during the financial crisis. In September 2008, Washington Mutual's primary regulator determined that the firm had insufficient liquidity to meet its obligations, closed the firm, and appointed the FDIC as the receiver. Washington Mutual was thereafter acquired by another firm at no cost to the Deposit Insurance Fund. The NPR states that the FDIC estimated that it would have cost $42 billion to liquidate Washington Mutual if there had been no acquirer, a sum that would have depleted the entire balance of the Deposit Insurance Fund at the time. It is worth noting that the most costly failure to the Deposit Insurance Fund during the crisis, and in the FDIC's history, was a $30 billion thrift institution for which there was no acquirer at the time of failure.

The Washington Mutual experience is pointed to in the NPR to justify retaining a reduced LCR requirement for institutions with assets between $250 billion to $700 billion. It seems to me the Washington Mutual case is a more compelling argument for not reducing the current requirement.

Fourth, as we learned during the crisis, the liquidity failure of a large banking organization can occur very quickly. High quality liquid assets sufficient to provide a 30-day runway before failure for institutions with assets over $250 billion, and a 21-day runway for institutions with assets between $100 billion and $250 billion, seem modest requirements given the risks associated with the failure of institutions of that size.

Finally, it is worth noting that, since the liquidity coverage ratio requirements took effect in January 2015, all of the covered firms have performed well. As the FDIC has documented in its Quarterly Banking Profiles, all of the firms subject to the LCR and the modified LCR have experienced strong growth in net income and loan balances.

In conclusion, the adoption of liquidity coverage ratio requirements in 2014 by the federal banking agencies for banking organizations with assets between $100 billion and $700 billion was a response to one of the most significant financial system vulnerabilities and risks to the Deposit Insurance Fund revealed by the crisis. The current requirements are tailored appropriately to the size, complexity, and risk profile of the institutions to which they apply. They provide a crucial prudential safeguard in the event of a rapid liquidity failure by one or more of these large institutions, they have not impeded the strong performance by these institutions since the requirements were adopted, and they have not yet even been tested through a full economic cycle.

I see no reason to weaken these requirements at this time.