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Shadow Financial Regulatory Committee Statement on
**The Federal Reserve Board Proposal for Enhanced Prudential
Standards and Early Remediation Requirements**

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On December 20, 2011 the Federal Reserve Board (FRB) issued a Notice of Proposed Rulemaking to implement the heightened supervisory standards and early remediation requirements that are intended to play a crucial role in achieving the aims of the Dodd-Frank Act. These rules will apply to all U.S. banks with more than \$50 billion in assets and to any non-bank financial institutions identified by the Financial Stability Oversight Council (FSOC) as presenting a potential systemic threat to financial stability. To date no non-bank financial institutions have been designated by FSOC, but it is convenient to refer to the included institutions as Systemically Important Financial Institutions (SIFIs).

The intent of the proposal is to prevent SIFIs from becoming a threat to the stability of the financial system and, if they should nonetheless experience distress, intervene to rehabilitate them. Failing this, a non-bank financial institution can be turned over to the bankruptcy courts. Alternatively, the Secretary of the Treasury can issue a written determination to initiate a process whereby the institution will be handed over to the FDIC for resolution under Title II of the Dodd-Frank Act.

This very complex notice of proposed rule-making encompasses 173 pages and poses 95 specific questions. The proposed rules cover capital and leverage requirements, liquidity requirements, limits on single-counterparty exposures, standards for risk management, requirements for stress testing and a description of Early Remediation Requirements. Given the length and complexity of the proposal, the Shadow Financial Regulatory Committee can comment on only a few aspects of the proposal at this time.

The Committee is encouraged that at several points the FRB has included some forward-looking indicators of the financial health of a SIFI. For example, the requirement that the bank hold a Tier 1

common equity risk-based capital ratio of 5 percent under both specified base and adverse stress scenarios ensures that traditional capital (whose measures have virtually always lagged the actual economic condition of the financial institution) will be scaled relative to a forward-looking measure of risk.

The Committee is pleased to see that some forward-looking indicators are included as triggers for early remediation intervention. These include deficiencies in the capital ratio, stress test results and liquidity deficiencies based on liquidity exposures and contingent funding strategies. The FRB has also taken the bold move of proposing a direct market indicator: the implied volatility of the equity price of the covered company. While we are sympathetic to the inclusion of a direct market indicator, Goodhart's Law warns that once a measure is used as a policy indicator it is likely to lose some of its value because the firm and market participants will tend to manipulate it.

The Committee would recommend an alternative measure that is less easy to manipulate and did an excellent job of separating the banks that passed the Supervisory Capital Assessment Program (SCAP) from those that required capital infusions or were forced into mergers, or failed. This measure is also based on stock market prices, which are more liquid (and thus more informative) than the prices of subordinated debt or credit default swaps. But stock price movements are reliable only if they are sustained. To reduce the prospect of manipulation and to remove the substantial amount of volatility in daily stock prices, we advocate using a moving average of stock prices (such as, for example, 90 days). Under the assumption that the financial firm will repay its debts in full, one can add the face value of debt to the moving average of stock prices to estimate a proxy for the market value of assets. Then one can derive a quasi-market value of the capital-asset ratio by dividing the moving average of share prices by the proxy for the market value of assets. This measure has the virtue of being simple to compute. Moreover, some evidence indicates that a four percent quasi-market value of the capital asset ratio (based on a 90 day moving average) would have identified the troubled banks weeks before the regulators tried to improvise frantic resolutions over sleepless weekends.

Still the proposal ignores what is arguably the major lesson from the crisis: that under stress, the only capital that matters is instruments that can absorb loss without having to take the firm through bankruptcy. In light of this and the international agreement under Basel III to redefine Tier 1 capital using this standard, one wonders why the FRB exposure limits to single counterparties use a much looser concept, the "Consolidated Capital Stock". The Consolidated Capital Stock includes not only the obsolete Tier 1 and Tier 2 measures, but also factors in so-called "excess loan loss reserves" not permitted under the obsolete, but very lax Tier 2 concept. The rationale for this absurd capital concept is not given. One can only suppose that it makes the limits appear tougher than they really are. The permissible ratios could have been easily restated in terms of the newly-defined Basel III concept of Tier 1 capital. The proposed limit applies to all counterparties except the US Government (and entities guaranteed by the Federal Government so long as they remain in receivership or conservatorship), although it does apply to foreign, state, and local governments. How these concepts can possibly be applied to non-bank SIFIs remains an unanswered question.

The FRB has tried to measure net counterparty exposure very carefully and has even valued trading and available-for-sale debt securities at the greater of amortized purchase price or market value, whichever is higher. This is intended to reduce exposures when positions increase in value. This leaves open, however, the question of how to deal with entities that

are not owned or controlled by the SIFI, but which may represent a reputational risk nonetheless. Two examples from the recent crisis make the point clearly: most banks supported their special- purpose vehicles when they lost access to funding even though they had no legal obligation to do so. In addition, many banks that sponsored money market mutual funds provided substantial financial support to prevent them from breaking-the-buck. To some extent, these issues may be resolved by other means. For example, the Financial Accounting Standards Board has already eliminated the category of qualified special purpose entities, bringing these exposures back onto the balance sheet. The International Accounting Standards Board has moved even further in this direction. The suggestions that the Committee makes for redesigning money market mutual funds (see Statement No. 325) could mitigate this problem as well. Until these reforms are adopted, however, it seems wise to regard entities that are reputationally linked to the SIFI to be part of its exposure.