FEDERAL RESERVE SYSTEM

12 CFR Part 217

[Docket No. R-1529]

RIN 7100 AE-43

Regulatory Capital Rules: The Federal Reserve Board's Framework for Implementing the U.S. Basel III Countercyclical Capital Buffer

AGENCY: Board of Governors of the Federal Reserve System

ACTION: Proposed policy statement with request for public comment.

SUMMARY: The Board is inviting public comment on a policy statement on the framework that the Board will follow in setting the amount of the U.S. countercyclical capital buffer for advanced approaches bank holding companies, savings and loan holding companies, and state member banks under the Board's Regulation Q (12 CFR part 217).

DATES: Comments must be received on or before March 21, 2016. Comments were originally due by February 19, 2016.

ADDRESSES: You may submit comments, identified by Docket No. R-1529 and RIN 7100 AE-43 by any of the following methods:

- **Agency Web site:** *http://www.federalreserve.gov*. Follow the instructions for submitting comments at *http://www.federalreserve.gov/generalinfo/foia/ProposedRegs.aspx*.
- **Federal eRulemaking Portal:** *http://www.regulations.gov*. Follow the instructions for submitting comments.

- **Email:** *regs.comments@federalreserve.gov*. Include the docket number and RIN number in the subject line of the message.
- **Fax:** (202) 452–3819 or (202) 452–3102.
- **Mail:** Robert V. Frierson, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue N.W., Washington, DC 20551.

All public comments will be made available on the Board's Web site at *http://www.federalreserve.gov/generalinfo/foia/ProposedRegs.aspx* as submitted, unless modified for technical reasons. Accordingly, your comments will not be edited to remove any identifying or contact information. Public comments may also be viewed electronically or in paper form in Room MP–500 of the Board's Martin Building (20th and C Streets N.W., Washington, DC 20551) between 9 a.m. and 5 p.m. on weekdays.

FOR FURTHER INFORMATION CONTACT: William Bassett, Deputy Associate Director, (202) 736-5644, or Rochelle Edge, Deputy Associate Director, (202) 452-2339, Office of Financial Stability Policy and Research; Sean Campbell, Associate Director, (202) 452-3760, Division of Banking Supervision and Regulation; Benjamin W. McDonough, Special Counsel, (202) 452-2036, Mark Buresh, Senior Attorney, (202) 452-5270, or Mary Watkins, Attorney, (202) 452-3722, Legal Division.

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I. Background

The Board of Governors of the Federal Reserve System (Board) issued in June 2013 a final regulatory capital rule (Regulation Q) in coordination with the Office of the Comptroller of the Currency (OCC) and the Federal Deposit Insurance Corporation (FDIC) to strengthen risk-based and leverage capital requirements applicable to insured depository institutions and certain depository institution holding companies (banking organizations).[1] Among the changes that Regulation Q introduced was the institution of a countercyclical capital buffer (CCyB) for large, internationally active banking organizations.[2]

The CCyB is a macroprudential policy tool that the Board can increase during periods of rising vulnerabilities in the financial system and reduce when vulnerabilities

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[1] See 78 FR 62018 (October 11, 2013) (Board and OCC); 79 FR 20754 (April 14, 2014) (FDIC). Regulation Q applies generally to bank holding companies with more than $1 billion in total consolidated assets and savings and loan holding companies with more than $1 billion in total consolidated assets that are not substantially engaged in commercial or insurance underwriting activities. See 12 CFR 217.1(c)(1).

[2] 12 CFR 217.11(b).

recede.[3] The CCyB supplements the minimum capital requirements and other capital buffers included in Regulation Q, which themselves are designed to provide substantial resilience to unexpected losses created by normal fluctuations in economic and financial conditions. The CCyB is designed to increase the resilience of large banking organizations when the Board sees an elevated risk of above-normal losses. Increasing the resilience of large banking organizations should, in turn, improve the resilience of the broader financial system. Above-normal losses often follow periods of rapid asset price appreciation or credit growth that are not well supported by underlying economic fundamentals. The circumstances in which the Board would most likely use the CCyB as a supplemental, macroprudential tool to augment minimum capital requirements and other capital buffers would be to address circumstances when potential systemic vulnerabilities are somewhat above normal. By requiring advanced approaches institutions to hold a larger capital buffer during periods of increased systemic risk and removing the buffer requirement when the vulnerabilities have diminished, the CCyB has the potential to moderate fluctuations in the supply of credit over time.

[3] Implementation of the CCyB also helps respond to the provision in the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) that the agencies "shall seek to make such [capital] requirements countercyclical, so that the amount of capital required to be maintained by a company increases in times of economic expansion and decreases in times of economic contraction, consistent with the safety and soundness of the company." See 12 U.S.C. 1467a; 12 U.S.C. 1844; 12 U.S.C. 3907 (as amended by section 616 of the Dodd-Frank Act).

The CCyB applies to banking organizations subject to the advanced approaches capital rules (advanced approaches institutions).[4] The advanced approaches capital rules generally apply to banking organizations with greater than $250 billion in total assets or $10 billion in on-balance-sheet foreign exposure and to any depository institution subsidiary of such banking organizations.[5]

The CCyB functions as an expansion of the Capital Conservation Buffer (CCB). The CCB requires that a banking organization hold a buffer of common equity tier 1 capital in excess of the minimum risk-based capital ratios greater than 2.5 percent of risk-weighted assets to avoid limits on capital distributions and certain discretionary bonus payments.[6] The CCB is divided into quartiles, each associated with increasingly stringent limitations on capital distributions and certain discretionary bonus payments as the firm's risk-based capital ratios approach regulatory minimums.[7]

As described in Regulation Q, the CCyB applies based on the location of exposures by national jurisdiction.[8] Specifically, the applicable CCyB amount for a banking organization is equal to the weighted average of CCyB amounts established by the Board for the national jurisdictions where the banking organization has private-sector

[4] An advanced approaches institution is subject to the CCyB regardless of whether it has completed the parallel run process and received notification from its primary Federal supervisor pursuant to § 217.121(d) of Regulation Q.

[5] 12 CFR 217.100(b)(1).

[6] 12 CFR 217.11(b)(1)(i).

[7] 12 CFR 217.11(a).

[8] 12 CFR 217.11(b)(1). The Board may adjust the CCyB amount to reflect decisions made by foreign jurisdictions. See 12 CFR 217.11(b)(3).

credit exposures.[9] The CCyB amount applicable to a banking organization is weighted by jurisdiction according to the firm's risk-weighted private-sector credit exposures for a specific jurisdiction as a percentage of the firm's overall risk-weighted private-sector credit exposures.[10]

Regulation Q established the initial CCyB amount with respect to private-sector credit exposures located in the United States (U.S.-based credit exposures) at zero percent. Following a phase-in period, the amount of the CCyB will vary between 0 and 2.5 percent of risk-weighted assets. Under the phase-in schedule, the maximum potential amount of the CCyB for U.S.-based credit exposures is 0.625 percentage points in 2016, 1.25 percentage points in 2017, 1.875 percentage points in 2018, and 2.5 percentage points in 2019 and all subsequent years.[11] To provide banking organizations with sufficient time to adjust to any change to the CCyB, an increase in the amount of the CCyB for U.S.-based credit exposures will have an effective date 12 months after the determination, unless the Board determines that a more immediate implementation is necessary based on economic conditions.[12] In contrast, Regulation Q states that a decision by the Board to decrease the amount of the CCyB for U.S.-based credit exposures would become effective the day after the Board decides to decrease the CCyB

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[9] 12 CFR 217.11(b)(1).

[10] Id.

[11] 12 CFR 217.300(a)(2).

[12] 12 CFR 217.11(b)(2)(v)(A).

or the earliest date permissible under applicable law or regulation, whichever is later.[13] The amount of the CCyB for U.S.-based credit exposures will return to 0 percent 12 months after the effective date of any CCyB adjustment, unless the Board announces a decision to maintain the current amount or adjust it again before the expiration of the 12-month period.[14]

The Board expects to make decisions about the appropriate level of the CCyB on U.S.-based credit exposures jointly with the OCC and FDIC. In addition, the Board expects that the CCyB amount for U.S.-based credit exposures would be the same for covered insured depository institutions as for covered depository institution holding companies. The CCyB is designed to take into account the broad macroeconomic and financial environment in which banking organizations function and the degree to which that environment impacts the resilience of the group of advanced approaches institutions. Therefore, the Board's determination of the appropriate level of the CCyB for U.S.-based credit exposures would be most directly linked to the condition of the overall financial environment rather than the condition of any individual banking organization. But, the overall CCyB requirement for a banking organization will vary based on the organization's particular composition of private sector credit exposures located across national jurisdictions.

[13] 12 CFR 217.11(b)(2)(v)(B).

[14] 12 CFR 217.11(b)(2)(vi).

II. Proposed Policy Statement

The proposed policy statement (Policy Statement) describes the framework that the Board would follow in setting the amount of the CCyB for U.S.-based credit exposures. The framework consists of a set of principles for translating assessments of financial-system vulnerabilities that are regularly undertaken at the Board into the appropriate level of the CCyB. Those assessments are informed by a broad array of quantitative indicators of financial and economic performance and a set of empirical models. In addition, the framework includes a discussion of how the Board would assess whether the CCyB is the most appropriate policy instrument (among available policy instruments) to address the highlighted financial-system vulnerabilities.

The proposed Policy Statement is organized as follows. Section 1 provides background on the proposed Policy Statement. Section 2 is an outline of the proposed Policy Statement and describes its scope. Section 3 provides a broad description of the objectives of the CCyB, including a description of the ways in which the CCyB is expected to protect large banking organizations and the broader financial system. Section 4 provides a broad description of the factors that the Board considers in setting the CCyB, including specific financial-system vulnerabilities and types of quantitative indicators of financial and economic performance, and outlines of empirical models the Board may use as inputs to that decision. Further, section 4 describes a set of principles that the Board expects to use for combining judgmental assessments with quantitative indicators to determine the appropriate level of the CCyB. Section 5 discusses how the Board will communicate the level of the CCyB and any changes to the CCyB. Section 6 describes how the Board plans to monitor the effects of the CCyB, including what indicators and effects will be monitored.

The Board seeks comment on all aspects of the proposed Policy Statement.

Question 1. In what ways could the Board improve its proposed framework for making decisions on the CCyB?

Question 2. The proposed Policy Statement describes a set of principles for translating judgmental assessments of financial-system vulnerabilities into specific levels of the CCyB, a set of empirical models used as inputs to the judgmental process that distill and translate quantitative indicators of financial and economic performance into potential settings for the CCyB, and an assessment of whether the CCyB is the most appropriate policy instrument to address highlighted financial-system vulnerabilities. Are there any other considerations that should form part of the CCyB decision-making framework?

Question 3. To what extent does the Board's proposed framework for determining the appropriate level of the CCyB capture the appropriate set of financial-system vulnerabilities? Are there any vulnerabilities that should also be considered or are there vulnerabilities that should be given greater or less consideration? How should vulnerabilities developing outside of the banking sector be considered as compared to vulnerabilities developing inside of the banking sector?

III. Administrative Law Matters

A. Use of Plain Language

Section 722 of the Gramm-Leach-Bliley Act (Pub. L. No. 106-102, 113 Stat. 1338, 1471, 12 U.S.C. 4809) requires the Federal banking agencies to use plain language in all proposed and final rules published after January 1, 2000. The Board has sought to present the proposed policy statement in a simple and straightforward manner, and invites comment on the use of plain language.

B. Paperwork Reduction Act Analysis

In accordance with the requirements of the Paperwork Reduction Act of 1995 (44 U.S.C. 3506), the Board has reviewed the proposed policy statement to assess any information collections. There are no collections of information as defined by the Paperwork Reduction Act in the proposal.

C. Regulatory Flexibility Act Analysis

The Board is providing an initial regulatory flexibility analysis with respect to this proposed Policy Statement. As discussed above, the proposed Policy Statement is designed to provide additional information regarding the factors that the Board expects to consider in evaluating whether to change the CCyB applicable to private-sector credit exposures located in the United States. The Regulatory Flexibility Act, 5 U.S.C. 601 et seq. (RFA), generally requires that an agency prepare and make available an initial regulatory flexibility analysis in connection with a notice of proposed rulemaking. Under regulations issued by the Small Business Administration, a small entity includes a bank holding company with assets of $550 million or less (small bank holding company).[15] As of December 31, 2014, there were approximately 3,441 small BHCs, 187 small SLHCs, and 644 small state member banks.

The proposed Policy Statement would relate only to advanced approaches institutions, which, generally, are banking organizations with total consolidated assets of $250 billion or more, that have total consolidated on-balance sheet foreign exposure of $10 billion or more, are a subsidiary of an advanced approaches depository institution, or that elect to use the advanced approaches framework.[16] Banking organizations that would be covered by the proposed Policy Statement substantially exceed the $550 million asset threshold at which a banking entity would qualify as a small bank holding company, small savings and loan holding company, or small state member bank. Currently, no small top-tier bank holding company, small top-tier savings and loan holding company, or small state member bank is an advanced approaches institution, so there would be no additional projected compliance requirements imposed on small bank holding companies, small savings and loan holding companies, or small state member banks.

Therefore, there are no significant alternatives to the proposal that would have less economic impact on small banking organizations. There are no projected reporting, recordkeeping, or other compliance requirements of the proposal. The Board does not believe that the proposal duplicates, overlaps, or conflicts with any other Federal rules.

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[15] See 13 CFR 121.201. Effective July 14, 2014, the Small Business Administration revised the size standards for banking organizations to $550 million in assets from $500 million in assets. 79 FR 33647 (June 12, 2014).

[16] 12 CFR 217.100(b)(1).

In light of the foregoing, the Board does not believe that the proposal, if adopted in final form, would have a significant economic impact on a substantial number of small entities. Nonetheless, the Board seeks comment on whether the proposal would impose undue burdens on, or have unintended consequences for, small organizations, and whether there are ways such potential burdens or consequences could be minimized in a manner consistent with the purpose of the proposal. A final regulatory flexibility analysis will be conducted after consideration of comments received during the public comment period.

List of Subjects

12 CFR Part 217

Administrative practice and procedure, Banks, banking. Holding companies, Reporting and recordkeeping requirements, Securities.

Authority and Issuance

For the reasons stated in the Supplementary Information, the Board of Governors of the Federal Reserve System proposes to add the Policy Statement as set forth at the end of the Supplementary Information as appendix A to part 217 of 12 CFR chapter II as follows:

PART 217 – CAPITAL ADEQUACY OF BANK HOLDING COMPANIES, SAVINGS AND LOAN HOLDING COMPANIES, AND STATE MEMBER BANKS

1. The authority citation for part 217 continues to read as follows:

Authority: 12 U.S.C. 248(a), 321–338a, 481-486, 1462a, 1467a, 1818, 1828, 1831n, 1831o, 1831p–l, 1831w, 1835, 1844(b), 1851, 3904, 3906-3909, 4808, 5365, 5368, 5371.

PART 217 – CAPITAL ADEQUACY OF BANK HOLDING COMPANIES, SAVINGS AND LOAN HOLDING COMPANIES, AND STATE MEMBER BANKS

2. Appendix A to part 217 is added to read as follows:

Appendix A to Part 217 – The Federal Reserve Board's Framework for Implementing the Countercyclical Capital Buffer

1. Background

The Board of Governors of the Federal Reserve System (Board) issued a final regulatory capital rule (Regulation Q) in coordination with the Office of the Comptroller of the Currency (OCC) and the Federal Deposit Insurance Corporation (FDIC) that strengthened risk-based and leverage capital requirements applicable to insured depository institutions and depository institution holding companies (banking organizations).[1] Among those changes was the introduction of a countercyclical capital buffer (CCyB) for large, internationally active banking organizations.[2]

[1] See 78 FR 62018 (October 11, 2013) (Board and OCC); 79 FR 20754 (April 14, 2014) (FDIC).

[2] 12 CFR 217.11(b). The CCyB applies only to banking organizations subject to the advanced approaches capital rules, which generally apply to those banking organizations with greater than $250 billion in assets or more than $10 billion in on-balance-sheet foreign exposures. See 12 CFR 217.100(b). An advanced approaches institution is subject to the CCyB regardless of

The CCyB is a macroprudential policy tool that the Board can increase during periods of rising vulnerabilities in the financial system and reduce when vulnerabilities recede. It is designed to increase the resilience of large banking organizations when policymakers see an elevated risk of above-normal losses. Increasing the resilience of large banking organizations should, in turn, improve the resilience of the broader financial system. Above-normal losses often follow periods of rapid asset price appreciation or credit growth that are not well supported by underlying economic fundamentals. The circumstances in which the Board would most likely use the CCyB as a supplemental, macroprudential tool to augment minimum capital requirements and other capital buffers would be to address circumstances when potential systemic vulnerabilities are somewhat above normal. By requiring large banking organizations to hold additional capital during those periods of excess and removing the requirement to hold additional capital when the vulnerabilities have diminished, the CCyB also is expected to moderate fluctuations in the supply of credit over time.[3] Further, Regulation Q established the initial CCyB amount with respect to U.S.-based credit exposures at zero percent and provided that the maximum potential amount of the CCyB for credit exposures in the United States was 2.5 percent of risk-weighted assets.[4]

The Board expects to make decisions about the appropriate level of the CCyB on U.S.-based credit exposures jointly with the OCC and FDIC, and expects that the CCyB amount for U.S.-based credit exposures will be the same for covered depository institution holding companies and insured depository institutions. The CCyB is designed to take into account the macrofinancial environment in which banking organizations

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whether it has completed the parallel run process and received notification from its primary Federal supervisor. See 12 CFR 217.121(d).

[3] Implementation of the CCyB also helps respond to the Dodd-Frank Act's requirement that the Board seek to make its capital requirements countercyclical 12 U.S.C. 1844(b), 1464a(g)(1), and 3907(a)(1) (codifying sections 616(a), (b), and (c) of the Dodd-Frank Act).

[4] The CCyB is subject to a phase-in arrangement between 2016 and 2019. See 12 CFR 217.300(a)(2).

function and the degree to which that environment impacts the resilience of the group of advanced approaches institutions. Therefore, the appropriate setting of the CCyB for private sector credit exposures located in the United States (U.S.-based credit exposures) is not closely linked to the characteristics of an individual institution. However, the overall CCyB for each institution will differ because the CCyB is weighted based on a banking organization's particular composition of private-sector credit exposures across national jurisdictions.

2. Overview and Scope of the Policy Statement

This Policy Statement describes the framework that the Board will follow in setting the amount of the CCyB for U.S.-based credit exposures. The framework consists of a set of principles for translating assessments of financial-system vulnerabilities that are regularly undertaken by the Board into the appropriate level of the CCyB. Those assessments are informed by a broad array of quantitative indicators of financial and economic performance and a set of empirical models. In addition, the framework includes an assessment of whether the CCyB is the most appropriate policy instrument (among available policy instruments) to address the highlighted financial-system vulnerabilities.

3. The Objectives of the CCyB

The objectives of the CCyB are to strengthen banking organizations' resilience against the build-up of systemic vulnerabilities and reduce fluctuations in the supply of credit. The CCyB supplements the minimum capital requirements and the capital conservation buffer, which themselves are designed to provide substantial resilience to unexpected losses created by normal fluctuations in economic and financial conditions. The capital surcharge on global systemically important banking organizations adds an additional layer of defense for the largest and most systemically important institutions, whose financial distress can have outsized effects on the rest of the financial system and real economy.[5] However, periods of financial excesses, as reflected in episodes of rapid asset price appreciation or credit growth not well supported by underlying economic fundamentals, are often followed by above-normal losses that leave banking organizations and other financial institutions undercapitalized. Therefore, the Board would most likely apply the CCyB in those circumstances when systemic vulnerabilities are somewhat above normal.

The CCyB is expected to help provide additional resilience for advanced approaches institutions, and by extension the broader financial system, against elevated vulnerabilities primarily in two ways. First, advanced approaches institutions will likely hold more capital to avoid limitations on capital distributions and discretionary bonus payments resulting from implementation of the CCyB. Strengthening their capital positions when financial conditions are accommodative would increase the capacity of advanced approaches institutions to absorb outsized losses during a future significant economic downturn or period of financial instability, thus making them more resilient. The second and related goal of the CCyB is to promote a more sustainable supply of credit over the economic cycle.

During a credit cycle downturn, better-capitalized institutions have been shown to be more likely to have continued access to funding and less likely to take actions that lead to broader financial-sector distress and its associated macroeconomic costs, such as large-scale sales of assets at prices below their fundamental value and sharp contractions in credit supply.[6] Therefore, it is likely that as a result of the CCyB having been put into place during a period of rapid credit creation, advanced approaches institutions would be better positioned to continue their important intermediary functions during a subsequent

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[5] See 80 FR 49082 (August 14, 2015).

[6] For additional background on the relationship between financial distress and economic outcomes, see Carmen Reinhart and Kenneth Rogoff (2009), *This Time is Different*. Princeton University Press; Òscar Jordà & Moritz Schularick & Alan M Taylor (2011), "Financial Crises, Credit Booms, and External Imbalances: 140 Years of Lessons," *IMF Economic Review*, Palgrave Macmillan, vol. 59(2), pages 340-378; and Bank for International Settlements (2010), “Assessing the Long-Run Economic Impact of Higher Capital and Liquidity Requirements.”

economic contraction. A timely and credible reduction in the CCyB requirement during a period of high credit losses could reinforce those beneficial effects of a higher base level of capital, because it would permit advanced approaches institutions either to realize loan losses promptly and remove them from their balance sheets or to expand their balance sheets, for example by continuing to lend to creditworthy borrowers.

Likewise, during a period of cyclically increasing vulnerabilities, advanced approaches institutions might react to an increase in the CCyB by tightening lending standards, otherwise reducing their risk exposure, augmenting their capital, or some combination of those actions. They may choose to raise capital by taking actions that would increase net income, reducing capital distributions through share repurchases or dividends, or issuing new equity. In this regard, an increase in the CCyB would not prevent advanced approaches institutions from maintaining their important role as credit intermediaries, but would reduce the likelihood that banking organizations with insufficient capital would foster unsustainable credit growth or engage in imprudent risk taking. The specific combination of adjustments and the relative size of each adjustment will depend in part on the initial capital positions of advanced approaches institutions, the cost of debt and equity financing, and the earnings opportunities presented by the economic situation at the time.[7]

4. The Framework for Setting the U.S. CCyB

The Board regularly monitors and assesses threats to financial stability by synthesizing information from a comprehensive set of financial-sector and macroeconomic indicators, supervisory information, surveys, and other interactions with

[7] For estimates of the size of certain adjustments, see Samuel G. Hanson, Anil K. Kashyap, and Jeremy C. Stein (2011), "A Macroprudential Approach to Financial Regulation," *Journal of Economic Perspectives* 25(1), pp. 3-28; Skander J. Van den Heuvel (2008), “The Welfare Cost of Bank Capital Requirements.” *Journal of Monetary Economics* 55, pp. 298-320.

market participants.[8] In forming its view about the appropriate size of the U.S. CCyB, the Board will consider a number of financial-system vulnerabilities, including but not limited to, asset valuation pressures and risk appetite, leverage in the nonfinancial sector, leverage in the financial sector, and maturity and liquidity transformation in the financial sector. The decision will reflect the implications of the assessment of overall financial-system vulnerabilities as well as any concerns related to one or more classes of vulnerabilities. The specific combination of vulnerabilities is important because an adverse shock to one class of vulnerabilities could be more likely than another to exacerbate existing pressures in other parts of the economy or financial system.

The Board intends to monitor a wide range of financial and macroeconomic quantitative indicators including, but not limited to, measures of relative credit and liquidity expansion or contraction, a variety of asset prices, funding spreads, credit condition surveys, indices based on credit default swap spreads, options implied volatility, and measures of systemic risk.[9] In addition, empirical models that translate a manageable set of quantitative indicators of financial and economic performance into potential settings for the CCyB, when used as part of a comprehensive judgmental assessment of all available information, can be a useful input to the Board's deliberations. Such models may include those that rely on small sets of indicators—such as the credit-to-GDP ratio, its growth rate, and combinations of the credit-to-GDP ratio with trends in the prices of residential and commercial real estate—which some academic research has shown to be useful in identifying periods of financial excess followed by a period of crisis on a cross-country basis.[10] Such models may also include those that consider larger

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[8] Tobias Adrian, Daniel Covitz, and Nellie Liang (2014), "Financial Stability Monitoring." *Finance and Economics Discussion Series* 2013-021. Washington: Board of Governors of the Federal Reserve System, http://www.federalreserve.gov/pubs/feds/2013/201321/201321pap.pdf.

[9] See 12 CFR 217.11(b)(2)(iv).

[10] See, e.g., Jorda, Oscar, Moritz Schularick and Alan Taylor, 2012. "When Credit Bites Back: Leverage, Business Cycles and Crises," Working Papers 1224, University of California, Davis, Department of Economics, and Drehmann, Mathias, Claudio Borio, and Kostas Tsatsaronis,

sets of indicators, which have the advantage of representing conditions in all key sectors of the economy, especially those specific to risk-taking, performance, and the financial condition of large banks.[11]

However, no single indictor or fixed set of indicators can adequately capture all the key vulnerabilities in the U.S. economy and financial system. Moreover, adjustments in the CCyB that were tightly linked to a specific model or set of models would be imprecise due to the relatively short period that some indicators are available, the limited number of past crises against which the models can be calibrated, and limited experience with the CCyB as a macroprudential tool. As a result, the types of indicators and models considered in assessments of the appropriate level of the CCyB are likely to change over time based on advances in research and the experience of the Board with this new macroprudential tool.

The Board will determine the appropriate level of the CCyB for U.S.-based credit exposures based on its analysis of the above factors. Generally, a zero percent U.S. CCyB amount would reflect an assessment that U.S. economic and financial conditions are broadly consistent with a financial system in which levels of system-wide vulnerabilities are not somewhat above normal. The Board could increase the CCyB as vulnerabilities build, and a 2.5 percent CCyB amount for U.S.-based credit exposures would reflect an assessment that the U.S. financial sector is experiencing a period of significantly elevated or rapidly increasing system-wide vulnerabilities. Importantly, as a macroprudential policy tool, the CCyB will be activated and deactivated based on broad

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2012. "Characterizing the financial cycle: don't lose sight of the medium term!" BIS Working Papers 380, Bank for International Settlements. Jorda, Oscar, Moritz Schularick and Alan Taylor, 2015. "Leveraged Bubbles," Center for Economic Policy Research Discussion Paper No. DP10781. BCBS (2010), "Guidance for national authorities operating the countercyclical capital buffer," BIS.

[11] See, e.g., Aikman, David, Michael T. Kiley, Seung Jung Lee, Michael G. Palumbo, and Missaka N. Warusawitharana (2015), "Mapping Heat in the U.S. Financial System," Finance and Economics Discussion Series 2015-059. Washington: Board of Governors of the Federal Reserve System, http://dx.doi.org/10.17016/FEDS.2015.059 (providing an example of the range of indicators used and type of analysis possible).

developments and trends in the U.S. financial system, rather than the activities of any individual banking organization.

Similarly, the Board would remove or reduce the CCyB when the conditions that led to its activation abate or lessen, rather than leaving the nonzero level of the buffer in place over periods when financial and economic developments suggest the absence of notable risks to financial stability. Indeed, for it to be most effective, the CCyB should be deactivated or reduced in a timely manner. This would reduce the likelihood that advanced approaches institutions would significantly pare their risk-weighted assets in order to maintain their capital ratios during a downturn.

The pace and magnitude of changes in the CCyB will depend importantly on the underlying conditions in the financial sector and the economy as well as the desired effects of the proposed change in the CCyB. If vulnerabilities are rising gradually, then incremental increases in the level of the CCyB may be appropriate. Incremental increases would allow banks to augment their capital primarily through retained earnings and allow policymakers additional time to assess the effects of the policy change before making subsequent adjustments. However, if vulnerabilities in the financial system are building rapidly, then larger or more frequent adjustments may be necessary to increase loss-absorbing capacity sooner and potentially to mitigate the rise in vulnerabilities.

The Board will also consider whether the CCyB is the most appropriate of its available policy instruments to address the financial-system vulnerabilities highlighted by the framework's judgmental assessments and empirical models. The CCyB primarily is intended to address cyclical vulnerabilities, rather than structural vulnerabilities that do not vary significantly over time. Structural vulnerabilities are better addressed though targeted reforms or permanent increases in financial system resilience. Two key factors for the Board to consider are whether advanced approaches institutions are exposed—either directly or indirectly—to the vulnerabilities identified in the comprehensive judgmental assessment or by the quantitative indicators that suggest activation of the CCyB and whether advanced approaches institutions are contributing—either directly or indirectly—to these highlighted vulnerabilities.

The Board, in setting the CCyB for advanced approaches institutions that it supervises, plans to consult with the OCC and FDIC on their analyses of financial-system vulnerabilities and on the extent to which banking organizations are either exposed to or contributing to these vulnerabilities.

5. Communication of the U.S. CCyB with the Public

The Board expects to consider at least once per year the applicable level of the U.S. CCyB. The Board will review financial conditions regularly throughout the year and may adjust the CCyB more frequently as a result of those monitoring activities.

Further, the Board will continue to communicate with the public in other formats regarding its assessment of U.S. financial stability, including financial-system vulnerabilities. For example, the Board's biannual Monetary Policy Report to Congress, usually published in February and July, will continue to contain a section that reports on developments pertaining to the stability of the U.S. financial system.[12] That portion of the report will be an important vehicle for updating the public on how the Board's current assessment of financial-system vulnerabilities bears on the setting of the CCyB.

6. Monitoring of the Effects of the U.S. CCyB

The effects of the U.S. CCyB ultimately will depend on the level at which it is set, the size and nature of any adjustments in the level, and the timeliness with which it is increased or decreased. The extent to which the CCyB may affect vulnerabilities in the broader financial system depends upon a complex set of interactions between required capital levels at the largest banking organizations and the economy and financial markets. In addition to the direct effects, the secondary economic effects could be amplified if financial markets extract a signal from the announcement of a change in the CCyB about subsequent actions that might be taken by the Board. Moreover, financial market participants might react by updating their expectations about future asset prices in

[12] For the most recent discussion in this format, see box titled "Developments Related to Financial Stability" in Board of Governors of the Federal Reserve System, *Monetary Policy Report to Congress*, July 2015, pp. 24-25.

specific markets or broader economic activity based on the concerns expressed by the regulators in communications announcing a policy change.

The Board will monitor and analyze adjustments by banking organizations and other financial institutions to the CCyB. Factors that will be considered include (but are not limited to) the types of adjustments that affected banking organizations might undertake. For example, it will be useful to monitor whether a change in the CCyB leads to observed changes in risk-based capital ratios at advanced approaches institutions, as well as whether those adjustments are achieved passively through retained earnings, or actively through changes in capital distributions or in risk-weighted assets. Other factors to be monitored include the extent to which loan growth and spreads on loans issued by affected banking organizations change relative to loan growth and loan spreads at banking organizations that are not subject to the buffer. Another key consideration in setting the CCyB and other macroprudential tools is the extent to which the adjustments by advanced approaches institutions to higher capital buffers lead to migration of credit market activity outside of those banking organizations, especially to the nonbank financial sector. Depending on the amount of migration and which institutions are affected, those adjustments could cause the Board to favor either a higher or a lower value of the CCyB.

The Board will also monitor information regarding the levels of and changes in the CCyB in other countries. The Basel Committee on Banking Supervision is expected to maintain this information for member countries in a publically available form on its website.[13] Using that data in conjunction with supervisory and publicly available datasets, Board staff will be able to draw not only upon the experience of the United States but also that of other countries to refine estimates of the effects of changes in the CCyB.

By order of the Board of Governors of the Federal Reserve System, December 21, 2015.

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[13] BIS, Countercyclical capital buffer (CCyB), www.bis.org/bcbs/ccyb/index.htm.

Robert deV. Frierson,
Secretary of the Board.
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