Daniel K Tarullo: Modernizing bank supervision and regulation

Testimony of Mr Daniel K Tarullo, Member of the Board of Governors of the US Federal Reserve System, before the Committee on Banking, Housing, and Urban Affairs, US Senate, Washington DC, 19 March 2009.

The original speech, which contains various links to the documents mentioned, can be found on the US Federal Reserve System's website.

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Chairman Dodd, Ranking Member Shelby, and other members of the Committee, I appreciate this opportunity to present the views of the Federal Reserve Board on the important issue of modernizing financial supervision and regulation.

For the last year and a half, the U.S. financial system has been under extraordinary stress. Initially, this financial stress precipitated a sharp downturn in the U.S. and global economies. What has ensued is a very damaging negative feedback loop: The effects of the downturn – rising unemployment, declining profits, and decreased consumption and investment – have exacerbated the problems of financial institutions by reducing further the value of their assets. The impaired financial system has, in turn, been unable to supply the credit needed by households and businesses alike.

The catalyst for the current crisis was a broad-based decline in housing prices, which has contributed to substantial increases in mortgage delinquencies and foreclosures and significant declines in the value of mortgage-related assets. However, the mortgage sector is just the most visible example of what was a much broader credit boom, and the underlying causes of the crisis run deeper than the mortgage market. They include global imbalances in savings and capital flows, poorly designed financial innovations, and weaknesses in both the risk-management systems of financial institutions and the government oversight of such institutions.

While stabilizing the financial system to set the stage for economic recovery will remain its top priority in the near term, the Federal Reserve has also begun to evaluate regulatory and supervisory changes that could help reduce the incidence and severity of future financial crises. Today's Committee hearing is a timely opportunity for us to share our thinking to date and to contribute to your deliberations on regulatory modernization legislation.

Many conclusions can be drawn from the financial crisis and the period preceding it, ranging across topics as diverse as capital adequacy requirements, risk measurement and management at financial institutions, supervisory practices, and consumer protection. In the Board's judgment, one of the key lessons is that the United States must have a comprehensive strategy for containing systemic risk. This strategy must be multifaceted and involve oversight of the financial system as a whole, and not just its individual components, in order to improve the resiliency of the system to potential systemic shocks. In pursuing this strategy, we must ensure that the reforms we enact now are aimed not just at the causes of our current crisis, but at other sources of risk that may arise in the future.

Systemic risk refers to the potential for an event or shock triggering a loss of economic value or confidence in a substantial portion of the financial system, with resulting major adverse effects on the real economy. A core characteristic of systemic risk is the potential for contagion effects. Traditionally, the concern was that a run on a large bank, for example, would lead not only to the failure of that bank, but also to the failure of other financial firms because of the combined effect of the failed bank's unpaid obligations to other firms and market uncertainty as to whether those or other firms had similar vulnerabilities. In fact, most recent episodes of systemic risk have begun in markets, rather than through a classic run on a bank. A sharp downward movement in asset prices has been magnified by certain market practices or vulnerabilities. Soon market participants become uncertain about the values of those assets, an uncertainty that spreads to other assets as liquidity freezes up. In the worst case, liquidity problems become solvency problems. The result has been spillover effects both within the financial sector and from the financial sector to the real economy.

In my remarks, I will discuss several components of a broad policy agenda to address systemic risk: consolidated supervision, the development of a resolution regime for systemically important nonbank financial institutions; more uniform and robust authority for the prudential supervision of systemically important payment and settlement systems; consumer protection; and the potential benefits of charging a governmental entity with more express responsibility for monitoring and addressing systemic risks in the financial system. In elaborating this agenda, I will both discuss the actions the Federal Reserve is taking under existing authorities and identify areas in which we believe legislation is needed.

Effective consolidated supervision of systemically important firms

For the reasons I have just stated, supervision of individual financial firms is not a sufficient condition for fostering financial stability. But it is surely a necessary condition. Thus a first component of an agenda for systemic risk regulation is that each systemically important financial firm be subject to effective consolidated supervision. This means ensuring both that regulatory requirements apply to each such firm and that the consequent supervision is effective.

As to the issue of effectiveness, many of the current problems in the banking and financial system stem from risk-management failures at a number of financial institutions, including some firms under federal supervision. Clearly, these lapses are unacceptable. The Federal Reserve has been involved in a number of exercises to understand and document the risk-management lapses and shortcomings at major financial institutions, including those undertaken by the Senior Supervisors Group, the President's Working Group on Financial Markets, and the multinational Financial Stability Forum.[1]

Based on the results of these and other efforts, the Federal Reserve is taking steps to improve regulatory requirements and risk management at regulated institutions. Our actions have covered liquidity risk management, capital planning and capital adequacy, firm-wide risk identification, residential lending, counterparty credit exposures, and commercial real estate. Liquidity and capital have been given special attention.

The crisis has undermined previous conventional wisdom that a company, even in stressed environments, may readily borrow funds if it can offer high-quality collateral. For example, the inability of Bear Stearns to borrow even against U.S. government securities helped cause its collapse. As a result, we have been working to bring about needed improvements in institutions' liquidity risk-management practices. Along with our U.S. supervisory colleagues, we are closely monitoring the liquidity positions of banking organizations – on a daily basis for the largest and most critical firms – and are discussing key market developments and our supervisory analyses with senior management. We use these analyses and findings from examinations to ensure that liquidity and funding management, as well as contingency funding plans, are sufficiently robust and incorporate various stress scenarios. Looking beyond the present period, we also have underway a broader-ranging examination of liquidity requirements.

Similarly, the Federal Reserve is closely monitoring the capital levels of banking organizations on a regular basis and discussing our evaluation with senior management. As

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[1] See Senior Supervisors Group (2008), "Observations on Risk Management Practices during the Recent Market Turbulence)," March 6; President's Working Group on Financial Markets (2008), "Policy Statement on Financial Market Developments," March 13; and Financial Stability Forum (2008), "Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience," April 7.

part of our supervisory process, we have been conducting our own analysis of loss scenarios to anticipate the potential future capital needs of institutions. These needs may arise from, among other things, future losses or the potential for off-balance-sheet exposures and assets to come on balance sheet. Here, too, we have been discussing our analyses with bankers and ensuring that their own internal analyses reflect a broad range of scenarios and capture stress environments that could impair solvency. We have intensified efforts to evaluate firms' capital planning and to bring about improvements where needed.

Going forward, we will need changes in the capital regime as the financial environment returns closer to normal conditions. Working with other domestic and foreign supervisors, we must strengthen the existing capital rules to achieve a higher level and quality of required capital. Institutions should also have to establish strong capital buffers above current regulatory minimums in good times, so that they can weather financial market stress and continue to meet customer credit needs. This is but one of a number of important ways in which the current procyclical features of financial regulation should be modified, with the aim of counteracting rather than exacerbating the effects of financial stress. Finally, firms whose failure would pose a systemic risk must be subject to especially close supervisory oversight of their risk-taking, risk management, and financial condition, and be held to high capital and liquidity standards.

Turning to the reach of consolidated supervision, the Board believes there should be statutory coverage of all systemically important financial firms – not just those affiliated with an insured bank as provided for under the Bank Holding Company Act of 1956 (BHC Act). The current financial crisis has highlighted a fact that had become more and more apparent in recent years – that risks to the financial system can arise not only in the banking sector, but also from the activities of financial firms that traditionally have not been subject to the type of consolidated supervision applied to bank holding companies. For example, although the Securities and Exchange Commission (SEC) had authority over the broker-dealer and other SEC-registered units of Bear Stearns and the other large investment banks, it did not have statutory authority to supervise the diversified operations of these firms on a consolidated basis. Instead, the SEC was forced to rely on a voluntary regime for monitoring and addressing the capital and liquidity risks arising from the full range of these firms' operations.

In contrast, all holding companies that own a bank – regardless of size – are subject to consolidated supervision for safety and soundness purposes under the BHC Act.[2] A robust consolidated supervisory framework, like the one embodied in the BHC Act, provides a supervisor the tools it needs to understand, monitor and, when appropriate, restrain the risks associated with an organization's consolidated or group-wide activities. These tools include the authority to establish consolidated capital requirements for the organization, obtain reports from and conduct examinations of the organization and any of its subsidiaries, and require the organization or its subsidiaries to alter their risk-management practices or take other actions to address risks that threaten the safety and soundness of the organization.

Application of a similar regime to systemically important financial institutions that are not bank holding companies would help promote the safety and soundness of these firms and the stability of the financial system generally. It also is worth considering whether a broader application of the principle of consolidated supervision would help reduce the potential for risk-taking to migrate from more-regulated to less-regulated parts of the financial sector. To

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[2] Through the exploitation of a loophole in the BHC Act, certain investment banks, as well as other financial and nonfinancial firms, acquired control of a federally insured industrial loan company (ILC) while avoiding the prudential framework that Congress established for the corporate owners of other full-service insured banks. For the reasons discussed in prior testimony before this Committee, the Board continues to believe that this loophole in current law should be closed. See Testimony of Scott G. Alvarez, General Counsel of the Board, before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, Oct. 4, 2007.

be fully effective, consolidated supervisors must have clear authority to monitor and address safety and soundness concerns in all parts of an organization. Accordingly, specific consideration should be given to modifying the limits currently placed on the ability of consolidated supervisors to monitor and address risks at an organization's functionally regulated subsidiaries.

Improved resolution processes

The importance of extending effective consolidated supervision to all systemically important firms is, of course, linked to the perception of market participants that such firms will be considered too-big-to-fail, and will thus be supported by the government if they get into financial difficulty. This perception has obvious undesirable effects, including possible moral hazard effects if firms are able to take excessive risks because of market beliefs that they can fall back on government assistance. In addition to effective supervision of these firms, the United States needs improved tools to allow the orderly resolution of systemically important nonbank financial firms, including a mechanism to cover the costs of the resolution if government assistance is required to prevent systemic consequences. In most cases, federal bankruptcy laws provide an appropriate framework for the resolution of nonbank financial institutions. However, this framework does not sufficiently protect the public's strong interest in ensuring the orderly resolution of nondepository financial institutions when a failure would pose substantial systemic risks.

Developing appropriate resolution procedures for potentially systemic financial firms, including bank holding companies, is a complex and challenging task that will take some time to complete. We can begin, however, by learning from other models, including the process currently in place under the Federal Deposit Insurance Act (FDIA) for dealing with failing insured depository institutions and the framework established for Fannie Mae and Freddie Mac under the Housing and Economic Recovery Act of 2008. Both models allow a government agency to take control of a failing institution's operations and management, act as conservator or receiver for the institution, and establish a "bridge" institution to facilitate an orderly sale or liquidation of the firm. The authority to "bridge" a failing institution through a receivership to a new entity reduces the potential for market disruption, limits the value-destruction impact of a failure, and – when accompanied by haircuts on creditors and shareholders – mitigates the adverse impact of government intervention on market discipline.

Any new resolution regime would need to be carefully crafted. For example, clear guidelines are needed to define which firms could be subject to the new, alternative regime and the process for invoking that regime, analogous perhaps to the procedures for invoking the so-called systemic risk exception under the FDIA. In addition, given the global operations of many large and diversified financial firms and the complex regulatory structures under which they operate, any new resolution regime must be structured to work as seamlessly as possible with other domestic or foreign insolvency regimes that might apply to one or more parts of the consolidated organization.

In addition to developing an alternative resolution regime for systemically critical financial firms, policymakers and experts should carefully review whether improvements can be made to the existing bankruptcy framework that would allow for a faster and more orderly resolution of financial firms generally. Such improvements could reduce the likelihood that the new alternative regime would need to be invoked or government assistance provided in a particular instance to protect financial stability and, thereby, could promote market discipline.

Oversight of payment and settlement systems

As suggested earlier, a comprehensive strategy for controlling systemic risk must focus not simply on the stability of individual firms. Another element of such a strategy is to provide close oversight of important arenas in which firms interact with one another. Payment and settlement systems are the foundation of our financial infrastructure. Financial institutions and markets depend upon the smooth functioning of these systems and their ability to manage counterparty and settlement risks effectively. Such systems can have significant risk-reduction benefits – by improving counterparty credit risk management, reducing settlement risks, and providing an orderly process to handle participant defaults – and can improve transparency for participants, financial markets, and regulatory authorities. At the same time, these systems inherently centralize and concentrate clearing and settlement risks. Thus, if a system is not well designed and able to appropriately manage the risks arising from participant defaults or operational disruptions, significant liquidity or credit problems could result.

Well before the current crisis erupted, the Federal Reserve was working to strengthen the financial infrastructure that supports trading, payments, clearing, and settlement in key financial markets. Because this infrastructure acts as a critical link between financial institutions and markets, ensuring that it is able to withstand – and not amplify – shocks is an important aspect of reducing systemic risk, including the very real problem of institutions that are too big or interconnected to be allowed to fail in a disorderly manner.

The Federal Reserve Bank of New York has been leading a major joint initiative by the public and private sectors to improve arrangements for clearing and settling credit default swaps (CDS) and other over-the-counter (OTC) derivatives. As a result, the accuracy and timeliness of trade information has improved significantly. In addition, the Federal Reserve, working with other supervisors through the President's Working Group on Financial Markets, has encouraged the development of well-regulated and prudently managed central clearing counterparties for OTC trades. Along these lines, the Board has encouraged the development of two central counterparties for CDS in the United States – ICE Trust and the Chicago Mercantile Exchange. In addition, in 2008, the Board entered into a memorandum of understanding with the SEC and the Commodity Futures Trading Commission to promote the application of common prudential standards to central counterparties for CDS and to facilitate the sharing of information among the agencies with respect to such central counterparties. The Federal Reserve also is consulting with foreign financial regulators regarding the development and oversight of central counterparties for CDS in other jurisdictions to promote the application of consistent prudential standards.

The New York Federal Reserve Bank, in conjunction with other domestic and foreign supervisors, continues its effort to establish increasingly stringent targets and performance standards for OTC market participants. In addition, we are working with market participants to enhance the resilience of the triparty repurchase agreement (repo) market. Through this market, primary dealers and other major banks and broker-dealers obtain very large amounts of secured financing from money market mutual funds and other short-term, risk-averse investors.[3] We are exploring, for example, whether a central clearing system or other improvements might be beneficial for this market, given the magnitude of exposures generated and the vital importance of the market to both dealers and investors.

Even as we pursue these and similar initiatives, however, the Board believes additional statutory authority is needed to address the potential for systemic risk in payment and settlement systems. Currently, the Federal Reserve relies on a patchwork of authorities, largely derived from our role as a banking supervisor, as well as on moral suasion to help ensure that critical payment and settlement systems have the necessary procedures and controls in place to manage their risks. By contrast, many major central banks around the world have an explicit statutory basis for their oversight of these systems. Given how important robust payment and settlement systems are to financial stability, and the functional

3 Primary dealers are broker-dealers that trade in U.S. government securities with the Federal Reserve Bank of New York. The New York Reserve Bank's Open Market Desk engages in trades on behalf of the Federal Reserve System to implement monetary policy.

similarities between many payment and settlement systems, a good case can be made for granting the Federal Reserve explicit oversight authority for systemically important payment and settlement systems.

The Federal Reserve has significant expertise regarding the risks and appropriate risk-management practices at payment and settlement systems, substantial direct experience with the measures necessary for the safe and sound operation of such systems, and established working relationships with other central banks and regulators that we have used to promote the development of strong and internationally-accepted risk management standards for the full range of these systems. Providing such authority would help ensure that these critical systems are held to consistent and high prudential standards aimed at mitigating systemic risk.

Consumer protection

Another lesson of this crisis is that pervasive consumer protection problems can signal, and even lead to, trouble for the safety and soundness of financial institutions and for the stability of the financial system as a whole. Consumer protection in the area of financial services is not, and should not be, limited to practices with potentially systemic consequences. However, as we evaluate the range of measures that can help contain systemic problems, it is important to recognize that good consumer protection can play a supporting role by – among other things – promoting sound underwriting practices.

Last year the Board adopted new regulations under the Home Ownership and Equity Protection Act to enhance the substantive protections provided high-cost mortgage customers, such as requiring tax and insurance escrows in certain cases and limiting the use of prepayment penalties. These rules also require lenders providing such high-cost loans to verify the income and assets of a loan applicant and prohibit lenders from making such a loan without taking into account the ability of the borrower to repay the loan from income or assets other than the home's value. More recently, the Board adopted new rules to protect credit card customers from a variety of unfair and deceptive acts and practices. The Board will continue to update its consumer protection regulations as appropriate to provide households with the information they need to make informed credit decisions and to address new unfair and deceptive practices that may develop as practices and products change.

Systemic risk authority

One issue that has received much attention recently is the possible benefit of establishing a systemic risk authority that would be charged with monitoring, assessing and, if necessary, curtailing systemic risks across the entire U.S. financial system.

At a conceptual level, expressly empowering a governmental authority with responsibility to help contain systemic risks should, if implemented correctly, reduce the potential for large adverse shocks and limit the spillover effects of those shocks that do occur, thereby enhancing the resilience of the financial system. However, no one should underestimate the challenges involved with developing or implementing a supervisory and regulatory program for systemic risks. Nor should the establishment of such an authority be viewed as a panacea that will eliminate periods of significant stress in the financial markets and so reduce the need for the other important reforms that I have discussed.

The U.S. financial sector is extremely large and diverse – with value added amounting to nearly $1.1 trillion or 8 percent of gross domestic product in 2007. Systemic risks may arise across a broad range of firms or markets, or they may be concentrated in just a few key institutions or activities. They can occur suddenly, such as from a rapid and substantial decline in asset prices, even if the probability of their occurrence builds up slowly over time. Moreover, as the current crisis has illustrated, systemic risks may arise at nonbank entities (for example, mortgage brokers), from sectors outside the traditional purview of federal supervision (for example, insurance firms), from institutions or activities that are based in other countries or operate across national boundaries, or from the linkages and interdependencies among financial institutions or between financial institutions and markets. And, while the existence of systemic risks may be apparent in hindsight, identifying such risks ex ante and determining the proper degree of regulatory or supervisory action needed to counteract a particular risk without unnecessarily hampering innovation and economic growth is a very challenging assignment for any agency or group of agencies.[4]

For these reasons, any systemic risk authority would need a sophisticated, comprehensive and multi-disciplinary approach to systemic risk. Such an authority likely would require knowledge and experience across a wide range of financial institutions and markets, substantial analytical resources to identify the types of information needed and to analyze the information obtained, and supervisory expertise to develop and implement the necessary supervisory programs.

To be effective, however, these skills would have to be combined with a clear statement of expectations and responsibilities, and with adequate powers to fulfill those responsibilities. While the systemic risk authority should be required to rely on the information, assessments, and supervisory and regulatory programs of existing financial supervisors and regulators whenever possible, it would need sufficient powers of its own to achieve its broader mission – monitoring and containing systemic risk. These powers likely would include broad authority to obtain information – through data collection and reports, or when necessary, examinations – from a range of financial market participants, including banking organizations, securities firms, key financial market intermediaries, and other financial institutions that currently may not be subject to regular federal supervisory reporting requirements.

How might a properly constructed systemic risk authority use its expertise and authorities to help monitor, assess, and mitigate potentially systemic risks within the financial system? There are numerous possibilities. One area of natural focus for a systemic risk authority would be the stability of systemically critical financial institutions. It also likely would need some role in the setting of standards for capital, liquidity, and risk-management practices for financial firms, given the importance of these matters to the aggregate level of risk within the financial system. By bringing its broad knowledge of the interrelationships between firms and markets to bear, the systemic risk authority could help mitigate the potential for financial firms to be a source of, or be negatively affected by, adverse shocks to the system.

It seems most sensible that the role of the systemic risk authority be to complement, not displace, that of a firm's consolidated supervisor (which, as I noted earlier, all systemically critical financial institutions should have). Under this model, the firm's consolidated supervisor would continue to have primary responsibility for the day-to-day supervision of the firm's risk- management practices, including those relating to compliance risk management, and for focusing on the safety and soundness of the individual institution.

Another key issue is the extent to which a systemic risk authority would have appropriately calibrated ability to take measures to address specific practices identified as posing a systemic risk – in coordination with other supervisors when possible, or independently if necessary. For example, there may be practices that appear sound when considered from the perspective of a single firm, but that appear troublesome when understood to be widespread in the financial system, such as if these practices reveal the shared dependence of firms on particular forms of uncertain liquidity.

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4 For example, while the existence of supra-normal profits in a market segment may be an indicator of supra-normal risks, it also may be the result of innovation on the part of one or more market participants that does not create undue risks to the system.

Other activities that a systemic risk authority might undertake include: (1) monitoring large or rapidly increasing exposures – such as to subprime mortgages – across firms and markets; (2) assessing the potential for deficiencies in evolving risk-management practices, broad-based increases in financial leverage, or changes in financial markets or products to increase systemic risks; (3) analyzing possible spillovers between financial firms or between firms and markets, for example through the mutual exposures of highly interconnected firms; (4) identifying possible regulatory gaps, including gaps in the protection of consumers and investors, that pose risks for the system as a whole; and (5) issuing periodic reports on the stability of the U.S. financial system, in order both to disseminate its own views and to elicit the considered views of others.

Thus, there are numerous important decisions to be made on the substantive reach and responsibilities of a systemic risk regulator. How such an authority, if created, should be structured and located within the federal government is also a complex issue. Some have suggested the Federal Reserve for this role, while others have expressed concern that adding this responsibility would overburden the central bank. The extent to which this new responsibility might be a good match for the Federal Reserve, acting either alone or as part of a collective body, depends a great deal on precisely how the Congress defines the role and responsibilities of the authority, and how well they complement those of the Federal Reserve's long-established core missions.

Nevertheless, as Chairman Bernanke has noted, effectively identifying and addressing systemic risks would seem to require some involvement of the Federal Reserve. As the central bank of the United States, the Federal Reserve has a critical part to play in the government's responses to financial crises. Indeed, the Federal Reserve was established by the Congress in 1913 largely as a means of addressing the problem of recurring financial panics. The Federal Reserve plays such a key role in part because it serves as liquidity provider of last resort, a power that has proved critical in financial crises throughout modern history. In addition, the Federal Reserve has broad expertise derived from its other activities, including its role as umbrella supervisor for bank and financial holding companies and its active monitoring of capital markets in support of its monetary policy and financial stability objectives.

It seems equally clear that each financial regulator must be involved in a successful overall strategy for containing systemic risk. In the first place, of course, appropriate attention to systemic issues in the normal regulation of financial firms, markets, and practices may itself support this strategy. Second, the information and insight gained by financial regulators in their own realms of expertise will be important contributions to the demanding job of analyzing inchoate risks to financial stability. Still, while a collective process will surely be valuable in assessing systemic risk, it will be important to assign clearly any responsibilities and authorities for actual systemic risk regulation, since shared authority without clearly delineated responsibility for action is sometimes a prescription for inaction.

Conclusion

I have tried today to identify the elements of an agenda for limiting the potential for financial crises, including actions that the Federal Reserve is taking to address systemic risks and several measures that Congress should consider to make our financial system stronger and safer. In doing so, we must avoid responding only to the current crisis, but must instead fashion a system that will be up to the challenge of regulating a dynamic and innovative financial system. We at the Federal Reserve look forward to working with the Congress on legislation that meets these objectives.