Daniel K Tarullo: Bank supervision

Speech by 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, 4 August 2009.

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

*   *   *

Chairman Dodd, Ranking Member Shelby, and other members of the Committee, thank you for your invitation to testify this morning. The financial crisis had many causes, including global imbalances in savings and capital flows, the rapid integration of lending activities with the issuance, trading, and financing of securities, the existence of gaps in the regulatory structure for the financial system, and widespread failures of risk management across a range of financial institutions. Just as the crisis had many causes, the response of policymakers must be broad in scope and multifaceted.

Improved prudential supervision – the topic of today's hearing – is a necessary component of the policy response. The crisis revealed supervisory shortcomings among all financial regulators, to be sure. But it also demonstrated that the framework for prudential supervision and regulation had not kept pace with changes in the structure, activities, and growing interrelationships of the financial sector. Accordingly, it is essential both to refocus the regulation and supervision of banking institutions under existing authorities and to augment those authorities in certain respects.

In my testimony today, I will begin by suggesting the elements of an effective framework for prudential supervision. Then I will review actions taken by the Federal Reserve within its existing statutory authorities to strengthen supervision of banks and bank holding companies in light of developments in the banking system and the lessons of the financial crisis. Finally, I will identify some gaps and weaknesses in the system of prudential supervision. One potential gap has already been addressed through the cooperative effort of federal and state banking agencies to prevent insured depository institutions from engaging in "regulatory arbitrage" through charter conversions. Others, however, will require congressional action.

Elements of an effective framework for prudential supervision

An effective framework for the prudential regulation and supervision of banking institutions includes four basic elements.

First, of course, there must be sound regulation and supervision of each insured depository institution. Applicable regulations must be well-designed to promote the safety and soundness of the institution. Less obvious, perhaps, but of considerable importance, is the usefulness of establishing regulatory requirements that make use of market discipline to help confine undue risk-taking in banking institutions. Supervisory policies and techniques also must be up to the task of enforcing and supplementing regulatory requirements.

Second, there must be effective supervision of the companies that own insured depository institutions. The scope and intensity of this supervision should vary with the extent and complexity of activities conducted by the parent company or its nonbank subsidiaries. When a bank holding company is essentially a shell, with negligible activities or ownership stakes outside the bank itself, holding company regulation can be less intensive and more modest in scope. But when material activities or funding are conducted at the holding company level, or when the parent owns nonbank entities, the intensity of scrutiny must increase in order to protect the bank from both the direct and indirect risks of such activities or affiliations and to ensure that the holding company is able to serve as a source of strength to the bank on a continuing basis. The task of holding company supervision thus involves an examination of the relationships between the bank and its affiliates as well as an evaluation of risks associated with those nonbank affiliates. Consolidated capital requirements also play a key role, by helping ensure that a holding company maintains adequate capital to support its group-wide activities and does not become excessively leveraged.

Third, there cannot be significant gaps or exceptions in the supervisory and regulatory coverage of insured depository institutions and the firms that own them. Obviously, the goals of prudential supervision will be defeated if some institutions are able to escape the rules and requirements designed to achieve those goals. There is a less obvious kind of gap, however, where supervisors are restricted from obtaining relevant information or reaching activities that could pose risks to banking organizations.

Fourth, prudential supervision – especially of larger institutions – must complement and support regulatory measures designed to contain systemic risk and the too-big-to-fail problem, topics that I have discussed in previous appearances before this Committee.[1] One clear lesson of the financial crisis is that important financial risks may not be readily apparent if supervision focuses only on the exposures and activities of individual institutions. For example, the liquidity strategy of a banking organization may appear sound when viewed in isolation but, when examined alongside parallel strategies of other institutions, may be found to be inadequate to withstand periods of financial stress.

Strengthening prudential supervision and regulation

The crisis has revealed significant risk-management deficiencies at a wide range of financial institutions, including banking organizations. It also has challenged some of the assumptions and analysis on which conventional supervisory wisdom has been based. For example, the collapse of Bear Stearns, which at the end was unable to borrow privately even with U.S. government securities as collateral, has undermined the widely held belief that a company can readily borrow against high-quality collateral, even in stressed environments. Moreover, the growing co-dependency between financial institutions and markets – evidenced by the significant role that investor and counterparty runs played in the crisis – implies that supervisors must pay closer attention to the potential for financial markets to influence the safety and soundness of banking organizations. These and other lessons of the financial crisis have led to changes in regulatory and supervisory practices in order to improve prudential oversight of banks and bank holding companies, as well as to advance a macroprudential, or systemic, regulatory agenda.

Working with other domestic and foreign supervisors, the Federal Reserve has taken steps to require the strengthening of capital, liquidity, and risk management at banking organizations. There is little doubt that, in the period before the crisis, capital levels were insufficient to serve as a needed buffer against loss, particularly at some of the largest financial institutions, both in the United States and elsewhere. Measures to strengthen the capital requirements for trading activities and securitization exposures – two areas where banking organizations have experienced greater losses than anticipated – were recently announced by the Basel Committee on Banking Supervision. Additional efforts are under way to improve the quality of the capital used to satisfy minimum capital ratios, to strengthen the capital requirements for other types of on- and off-balance-sheet exposures, and to establish capital buffers in good times that can be drawn down as economic and financial conditions deteriorate. Capital buffers, though not easy to design or implement in an

[1] See Daniel K. Tarullo (2009), "Regulatory Restructuring," statement before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, July 23; and Daniel K. Tarullo (2009), "Modernizing Bank Supervision and Regulation," statement before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, March 19.

efficacious fashion, could be an especially important step in reducing the procyclical effects of the current capital rules. Further review of accounting standards governing valuation and loss provisioning also would be useful, and might result in modifications to the accounting rules that reduce their procyclical effects without compromising the goals of disclosure and transparency.

The Federal Reserve also helped lead the Basel Committee's development of enhanced principles of liquidity risk management, which were issued last year.[2] Following up on that initiative, on June 30, 2009, the federal banking agencies requested public comment on new *Interagency Guidance on Funding and Liquidity Risk Management*, which is designed to incorporate the Basel Committee's principles and clearly articulate consistent supervisory expectations on liquidity risk management.[3] The guidance re-emphasizes the importance of cash flow forecasting, adequate buffers of contingent liquidity, rigorous stress testing, and robust contingent funding planning processes. It also highlights the need for institutions to better incorporate liquidity costs, benefits, and risks in their internal product pricing, performance measurement, and new product approval process for all material business lines, products, and activities.

With respect to bank holding companies specifically, the supervisory program of the Federal Reserve has undergone some basic changes. As everyone is aware, many of the financial firms that lay at the center of the crisis were not bank holding companies; some were not subject to mandatory prudential supervision of any sort. During the crisis a number of very large firms became bank holding companies – in part to reassure markets that they were subject to prudential oversight and, in some cases, to qualify for participation in various government liquidity support programs. The extension of holding company status to these firms, many of which are not primarily composed of a commercial bank, highlights the degree to which the traditional approach to holding company supervision must evolve.

Recent experience also reinforces the value of holding company supervision in addition to, and distinct from, bank supervision. Large organizations increasingly operate and manage their businesses on an integrated basis with little regard for the corporate boundaries that typically define the jurisdictions of individual functional supervisors. Indeed, the crisis has highlighted the financial, managerial, operational, and reputational linkages among the bank, securities, commodity, and other units of financial firms.

The customary focus on protecting the bank within a holding company, while necessary, is clearly not sufficient in an era in which systemic risk can arise wholly outside of insured depository institutions. Similarly, the premise of functional regulation that risks within a diversified organization can be evaluated and managed properly through supervision focused on individual subsidiaries within the firm has been undermined further; the need for greater attention to the potential for damage to the bank, the organization within which it operates, and, in some cases, the financial system generally, requires a more comprehensive and integrated assessment of activities throughout the holding company.

Appropriate enhancements of both prudential and consolidated supervision will only increase the need for supervisors to be able to draw on a broad foundation of economic and financial knowledge and experience. That is why we are incorporating economists and other experts from non-supervisory divisions of the Federal Reserve more completely into the process of supervisory oversight. The insights gained from the macroeconomic analyses associated

---

[2] See Basel Committee on Banking Supervision (2008), Principles for Sound Liquidity Risk Management and Supervision (Basel, Switzerland: Bank for International Settlements, September).

[3] See Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of Thrift Supervision, and National Credit Union Administration (2009), "Agencies Seek Comment on Proposed Interagency Guidance on Funding and Liquidity Risk Management," joint press release, June 30.

with the formulation of monetary policy and from the familiarity with financial markets derived from our open market operations and payments systems responsibilities can add enormous value to holding company supervision.

The recently completed Supervisory Capital Assessment Program (SCAP) heralds some of the changes in the Federal Reserve's approach to prudential supervision of the largest banking organizations. This unprecedented process involved, at its core, forward-looking, cross-firm, and aggregate analyses of the 19 largest bank holding companies, which together control a majority of the assets and loans within the financial system. Bank supervisors in the SCAP defined a uniform set of parameters to apply to each firm being evaluated, which allowed us to evaluate on a consistent basis the expected performance of the firms under both a baseline and more-adverse-than-expected scenario, drawing on individual firm information and independently estimated outcomes using supervisory models.

Drawing on this experience, we are prioritizing and expanding our program of horizontal examinations to assess key operations, risks, and risk-management activities of large institutions. For the largest and most complex firms, we are creating an enhanced quantitative surveillance program that will use supervisory information, firm-specific data analysis, and market-based indicators to identify developing strains and imbalances that may affect multiple institutions, as well as emerging risks to specific firms. Periodic scenario analyses across large firms will enhance our understanding of the potential impact of adverse changes in the operating environment on individual firms and on the system as a whole. This work will be performed by a multi-disciplinary group composed of our economic and market researchers, supervisors, market operations specialists, and accounting and legal experts. This program will be distinct from the activities of on-site examination teams so as to provide an independent supervisory perspective as well as to complement the work of those teams.

Capital serves as an important bulwark against potential unexpected losses for banking organizations of all sizes, not just the largest ones. Accordingly, internal capital analyses of banking organizations must reflect a wide range of scenarios and capture stress environments that could impair solvency. Earlier this year, we issued supervisory guidance for all bank holding companies regarding dividends, capital repurchases, and capital redemptions.[4] That guidance also reemphasized the Federal Reserve's long-standing position that bank holding companies must serve as a source of strength for their subsidiary banks.

Commercial real estate (CRE) is one area of risk exposure that has gained much attention recently. We began to observe rising CRE concentrations earlier this decade and, in light of the central role that CRE lending played in the banking problems of the late 1980s and early 1990s, led an interagency effort to issue supervisory guidance directed at the risks posed by CRE concentrations. This guidance, which generated significant controversy at the time it was proposed, was finalized in 2006 and emphasized the need for banking organizations to incorporate realistic risk estimates for CRE exposures into their strategic- and capital-planning processes, and encouraged institutions to conduct stress tests or similar exercises to identify the impact of potential CRE shocks on earnings and capital. Now that weaker housing markets and deteriorating economic conditions have, in fact, impaired the quality of CRE loans at many banking organizations, we are monitoring carefully the effect that declining collateral values may have on CRE exposures and assessing the extent to which banking organizations have been complying with the CRE guidance. At the same time, we have taken actions to ensure that supervisory and regulatory policies and practices do not inadvertently curtail the availability of credit to sound borrowers.

---

[4] See Board of Governors of the Federal Reserve System (2009), Supervision and Regulation Letter SR 09-4, "Applying Supervisory Guidance and Regulations on the Payment of Dividends, Stock Redemptions, and Stock Repurchases at Bank Holding Companies," February 24 (as revised on March 27, 2009).

While CRE exposures represent perhaps an "old" problem, the crisis has newly highlighted the potential for compensation practices at financial institutions to encourage excessive risk-taking and unsafe and unsound behavior – not just by senior executives, but also by other managers or employees who have the ability, individually or collectively, to materially alter the risk profile of the institution. Bonuses and other compensation arrangements should not provide incentives for employees at any level to behave in ways that imprudently increase risks to the institution, and potentially to the financial system as a whole. The Federal Reserve worked closely with other supervisors represented on the Financial Stability Board to develop principles for sound compensation practices, which were released earlier this year.[5] The Federal Reserve expects to issue soon our own guidance on this important subject to promote compensation practices that are consistent with sound risk-management principles and safe and sound banking.

Finally, I would note the importance of continuing to analyze the practices of financial firms and supervisors that preceded the crisis, with the aim of fashioning additional regulatory tools that will make prudential supervision more effective and efficient. One area that warrants particular attention is the potential for supervisory agencies to enlist market discipline in pursuit of regulatory ends. For example, supervisors might require that large financial firms maintain specific forms of capital so as to increase their ability to absorb losses outside of a bankruptcy or formal resolution procedure. Such capital could be in contingent form, converting to common equity only when necessary because of extraordinary losses. While the costs, benefits, and feasibility of this type of capital requires further study, policymakers should actively seek ways of motivating the private owners of banking organizations to monitor the financial positions of the issuing firms more effectively.

Addressing gaps and weaknesses in the regulatory framework

While the actions that I have just discussed should help make banking organizations and the financial system stronger and more resilient, the crisis also has highlighted gaps and weaknesses in the underlying framework for prudential supervision of financial institutions that no regulatory agency can rectify on its own. One, which I will mention in a moment, has been addressed by the banking agencies working together. Others require congressional attention.

Charter conversions and regulatory arbitrage

The dual banking system and the existence of different federal supervisors create the opportunity for insured depository institutions to change charters or federal supervisors. While institutions may engage in charter conversions for a variety of sound business reasons, conversions that are motivated by a hope of escaping current or prospective supervisory actions by the institution's existing supervisor undermine the efficacy of the prudential supervisory framework.

Accordingly, the Federal Reserve welcomed and immediately supported an initiative led by the Federal Deposit Insurance Corporation (FDIC) to address such regulatory arbitrage. This initiative resulted in a recent statement of the Federal Financial Institutions Examination Council reaffirming that charter conversions or other actions by an insured depository institution that would result in a change in its primary supervisor should occur only for legitimate business and strategic reasons.[6] Importantly, this statement also provides that

---

[5] See Financial Stability Forum (2009), FSF Principles for Sound Compensation Practices, April 2. The Financial Stability Forum has subsequently been renamed the Financial Stability Board.

[6] See Federal Financial Institutions Examination Council (2009), "FFIEC Issues Statement on Regulatory Conversions," press release, July 1.

conversion requests should not be entertained by the proposed new chartering authority or supervisor while serious or material enforcement actions are pending with the institution's current chartering authority or primary federal supervisor. In addition, it provides that the examination rating of an institution and any outstanding corrective action programs should remain in place when a valid conversion or supervisory change does occur.

Systemically important financial institutions

The Lehman experience clearly demonstrates that the financial system and the broader economy can be placed at risk by the failure of financial firms that traditionally have not been subject to the type of consolidated supervision applied to bank holding companies. As I discussed in my most recent testimony before this Committee, the Federal Reserve believes that all systemically important financial firms – not just those affiliated with a bank – should be subject to, and robustly supervised under, a statutory framework for consolidated supervision like the one embodied in the Bank Holding Company Act (BHC Act).

Doing so would help promote the safety and soundness of these firms individually and the stability of the financial system generally. Indeed, given the significant adverse effects that the failure of such a firm may have on the financial system and the broader economy, the goals and implementation of prudential supervision and systemic risk reduction are inextricably intertwined in the case of these organizations. For example, while the strict capital, liquidity, and risk-management requirements that are needed for these organizations are traditional tools of prudential supervision, the supervisor of such firms will need to calibrate these standards appropriately to account for the firms' systemic importance.

Industrial loan companies and thrifts

Another gap in existing law involves industrial loan companies (ILCs). ILCs are state-chartered banks that have full access to the federal safety net, including FDIC deposit insurance and the Federal Reserve's discount window and payments systems; have virtually all of the deposit-taking powers of commercial banks; and may engage in the full range of other banking services, including commercial, mortgage, credit card, and consumer lending activities, as well as cash management services, trust services, and payment-related services, such as Fedwire, automated clearinghouse, and check-clearing services.

A loophole in current law, however, permits any type of firm – including a commercial company or foreign bank – to acquire an FDIC-insured ILC chartered in a handful of states without becoming subject to the prudential framework that the Congress has established for the corporate owners of other full-service insured banks. Prior to the crisis, several large firms – including Lehman Brothers, Merrill Lynch, Goldman Sachs, Morgan Stanley, GMAC, and General Electric – took advantage of this opportunity by acquiring ILCs while avoiding consolidated supervision under the BHC Act.

The Federal Reserve has long supported closing this loophole, subject to appropriate "grandfather" provisions for the existing owners of ILCs. Such an approach would prevent additional firms from acquiring a full-service bank and escaping the consolidated supervision framework and activity restrictions that apply to bank holding companies. It also would require that all firms controlling an ILC, including a grandfathered firm, be subject to consolidated supervision. For reasons of fairness, the Board believes that the limited number of firms that currently own an ILC and are not otherwise subject to the BHC Act should be permitted to retain their nonbanking or commercial affiliations, subject to appropriate restrictions to protect the federal safety net and prevent abuses.

Corporate owners of savings associations should also be subject to the same regulation and examination as corporate owners of insured banks. In addition, grandfathered commercial owners of savings associations should, like we advocate for corporate owners of ILCs, be subject to appropriate restrictions to protect the federal safety net and prevent abuses.

Strengthening the framework for consolidated supervision

Consolidated supervision is intended to provide a supervisor the tools necessary to understand, monitor, and, when appropriate, restrain the risks associated with an organization's consolidated or group-wide activities. Risks that cross legal entities and that are managed on a consolidated basis cannot be monitored properly through supervision directed at any one, or even several, of the legal entity subdivisions within the overall organization.

To be fully effective, consolidated supervisors need the information and ability to identify and address risks throughout an organization. However, the BHC Act, as amended by the so-called Fed-lite provisions of the Gramm-Leach-Bliley Act, places material limitations on the ability of the Federal Reserve to examine, obtain reports from, or take actions to identify or address risks with respect to both nonbank and depository institution subsidiaries of a bank holding company that are supervised by other agencies. Consistent with these provisions, we have worked with other regulators and, wherever possible, sought to make good use of the information and analysis they provide. In the process, we have built cooperative relationships with other regulators – relationships that we expect to continue and strengthen further.

Nevertheless, the restrictions in current law still can present challenges to timely and effective consolidated supervision in light of, among other things, differences in supervisory models – for example, between the safety and soundness approach favored by bank supervisors and the approaches used by regulators of insurance and securities subsidiaries – and differences in supervisory timetables, resources, and priorities. Moreover, the growing linkages among the bank, securities, insurance, and other entities within a single organization that I mentioned earlier heighten the potential for these restrictions to hinder effective group-wide supervision of firms, particularly large and complex organizations. To ensure that consolidated supervisors have the necessary tools and authorities to monitor and address safety and soundness concerns in all parts of an organization on a timely basis, we would urge statutory modifications to the Fed-lite provisions of the Gramm-Leach-Bliley Act. Such changes, for example, should remove the limits first imposed in 1999 on the scope and type of information that the Federal Reserve may obtain from subsidiaries of bank holding companies in furtherance of its consolidated supervision responsibilities, and on the ability of the Federal Reserve to take action against subsidiaries to address unsafe and unsound practices and enforce compliance with applicable law.

Limiting the costs of bank failures

The timely closing and resolution of failing insured depository institutions is critical to limiting the costs of a failure to the deposit insurance fund.[7] The conditions governing when the Federal Reserve may close a failing state member bank, however, are significantly more restrictive than those under which the Office of the Comptroller of the Currency may close a national bank, and are even more restrictive than those governing the FDIC's backup authority to close an insured depository institution after consultation with the appropriate primary federal and, if applicable, state banking supervisor. The Federal Reserve generally may close a state member bank only for capital-related reasons. The grounds for which the OCC or FDIC may close a bank include a variety of non-capital-related conditions, such as if the institution is facing liquidity pressures that make it likely to be unable to pay its obligations in the normal course of business or if the institution is otherwise in an unsafe or unsound condition to transact business. We hope that the Congress will consider providing the

---

[7] Similarly, the creation of a resolution regime that would provide the government the tools it needs to wind down a systemically important nonbank financial firm in an orderly way and impose losses on shareholders and creditors where possible would help the government protect the financial system and economy while reducing the potential cost to taxpayers and mitigating moral hazard.

Federal Reserve powers to close a state member bank that are similar to those possessed by other federal banking agencies.

In view of the number of bank failures that have occurred over the past 18 months and the resulting costs to the deposit insurance fund, policymakers also should explore whether additional triggers – beyond the capital ratios in the current Prompt Corrective Action framework – may be more effective in promoting the timely resolution of troubled institutions at lower cost to the insurance fund. Capital is a lagging indicator of financial difficulties in most instances, and one or more additional measures, perhaps based on asset quality, may be worthy of analysis and consideration.

Conclusion

Thank you for the opportunity to testify on these important matters. We look forward to working with the Congress, the Administration, and the other banking agencies to ensure that the framework for prudential supervision of banking organizations and other financial institutions adjusts, as it must, to meet the challenges our dynamic and increasingly interconnected financial system.