Ben S Bernanke: Dodd-Frank implementation – monitoring systemic risk and promoting financial stability

Testimony by Mr Ben S Bernanke, Chairman of the Board of Governors of the Federal Reserve System, before the Committee on Banking, Housing, and Urban Affairs, US Senate, Washington DC, 12 May 2011.

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Chairman Johnson, Ranking Member Shelby, and other members of the Committee, thank you for the opportunity to testify on the Federal Reserve Board's role in monitoring systemic risk and promoting financial stability, both as a member of the Financial Stability Oversight Council (FSOC) and under our own authority.

Financial Stability Oversight Council

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) created the FSOC to identify and mitigate threats to the financial stability of the United States. During its existence thus far, the FSOC has promoted interagency collaboration and established the organizational structure and processes necessary to execute its duties.[1] The FSOC and its member agencies also have completed studies on limits on proprietary trading and investments in hedge funds and private equity funds by banking firms (the Volcker rule), on financial sector concentration limits, on the economic effects of risk retention, and on the economic consequences of systemic risk regulation. The FSOC is currently seeking public comments on proposed rules that would establish a framework for identifying nonbank financial firms and financial market utilities that could pose a threat to financial stability and that therefore should be designated for more stringent oversight. Importantly, the FSOC has begun systematically monitoring risks to financial stability and is preparing its inaugural annual report.

Additional financial stability-related reforms at the Federal Reserve

In addition to its role on the FSOC, the Federal Reserve has other significant financial stability responsibilities under the Dodd-Frank Act, including supervisory jurisdiction over thrift holding companies and nonbank financial firms that are designated as systemically important by the council. The act also requires the Federal Reserve (and other financial regulatory agencies) to take a macroprudential approach to supervision and regulation; that is, in supervising financial institutions and critical infrastructures, we are expected to consider the risks to overall financial stability in addition to the safety and soundness of individual firms.

A major thrust of the Dodd-Frank Act is addressing the too-big-to-fail problem and mitigating the threat to financial stability posed by systemically important financial firms. As required by the act, the Federal Reserve is developing more-stringent prudential standards for large banking organizations and nonbank financial firms designated by the FSOC. These standards will include enhanced risk-based capital and leverage requirements, liquidity requirements, and single-counterparty credit limits. The standards will also require

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[1] The FSOC's internal structure consists of a Deputies Committee – composed of personnel from all of the voting and nonvoting members – and six other standing committees, each with its own specific duties. The Deputies Committee, under the direction of the FSOC members, coordinates the work of the six committees and aims to ensure that the FSOC fulfills its mission in an effective and timely manner.

systemically important financial firms to adopt so-called living wills that will spell out how they can be resolved in an orderly manner during times of financial distress. The act also directs the Federal Reserve to conduct annual stress tests of large banking firms and designated nonbank financial firms and to publish a summary of the results. To meet the January 2012 implementation deadline for these enhanced standards, we anticipate putting out a package of proposed rules for comment this summer. Our goal is to produce a well-integrated set of rules that meaningfully reduces the probability of failure of our largest, most complex financial firms, and that minimizes the losses to the financial system and the economy if such a firm should fail.

The Federal Reserve is working with other U.S. regulatory agencies to implement Dodd-Frank reforms in additional areas, including the development of risk retention requirements for securitization sponsors, margin requirements for noncleared over-the-counter derivatives, incentive compensation rules, and risk-management standards for central counterparties and other financial market utilities.

The Federal Reserve has made significant organizational changes to better carry out its responsibilities. Even before the enactment of the Dodd-Frank Act, we were strengthening our supervision of the largest, most complex financial firms. We created a centralized multidisciplinary body called the Large Institution Supervision Coordinating Committee to oversee the supervision of these firms. This committee uses horizontal, or cross-firm, evaluations to monitor interconnectedness and common practices among firms that could lead to greater systemic risk. It also uses additional and improved quantitative methods for evaluating the performance of firms and the risks they might pose. And it more efficiently employs the broad range of skills of the Federal Reserve staff to supplement supervision. We have established a similar body to help us effectively carry out our responsibilities regarding the oversight of systemically important financial market utilities.

More recently, we have also created an Office of Financial Stability Policy and Research at the Federal Reserve Board. This office coordinates our efforts to identify and analyze potential risks to the broader financial system and the economy. It also helps evaluate policies to promote financial stability and serves as the Board's liaison to the FSOC.

International regulatory coordination

As a complement to those efforts under Dodd-Frank, the Federal Reserve has been working for some time with other regulatory agencies and central banks around the world to design and implement a stronger set of prudential requirements for internationally active banking firms. These efforts resulted in the agreements reached in the fall of 2010 on the major elements of the new Basel III prudential framework for globally active banks. The requirements under Basel III that such banks hold more and better-quality capital and more-robust liquidity buffers should make the financial system more stable and reduce the likelihood of future financial crises. We are working with the other U.S. banking agencies to incorporate the Basel III agreements into U.S. regulations.

More remains to be done at the international level to strengthen the global financial system. Key tasks ahead for the Basel Committee and the Financial Stability Board include determining how to further increase the loss-absorbing capacity of systemically important banking firms and strengthening resolution regimes to minimize adverse systemic effects from the failure of large, complex banks. As we work with our international counterparts, we are striving to keep international regulatory standards as consistent as possible, to ensure that multinational firms are adequately supervised, and to maintain a level international playing field.

Thank you. I would be pleased to take your questions.