Daniel K Tarullo: Capital and liquidity standards

Testimony by Mr Daniel K Tarullo, Member of the Board of Governors of the Federal Reserve System, before the Committee on Financial Services, US House of Representatives, Washington DC, 16 June 2011.

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Chairman Bachus, Ranking Member Frank, and other members of the Committee, thank you for your invitation to testify today about capital and liquidity standards and their relationship to international competitiveness.

I will start by explaining how new international standards on regulatory capital and liquidity will foster global financial stability. Next, I will discuss several areas in which international work to enhance the resiliency of the financial system continues. Then I will turn to the agenda for implementation of these standards across national jurisdictions, as well as reforms in other areas such as derivatives markets and resolution regimes. In particular, I will address the need to expand the implementation agenda beyond assuring that the international standards are incorporated into national legislation and regulations. This is especially the case where the opaqueness of financial firms hinders observation of compliance with applicable standards, such as with minimum capital and liquidity requirements. Here it will be essential for international bodies of regulators to adopt effective oversight and monitoring mechanisms, in order to achieve the financial stability benefits that the minimum standards promise, to prevent the emergence of significant competitive disadvantages for internationally active firms, and promote international cooperation in addressing the technical and policy questions that will arise.

Capital and liquidity standards

The recent financial crisis exposed significant weaknesses in the regulatory capital requirements for large banking institutions in many parts of the world, including the United States. The amount of capital held by many banking institutions proved to be inadequate given the risks that had built up in the financial system. In some cases, especially for holdings of asset-backed securities in the trading books of the largest banks, it was evident that capital requirements were set far too low.

In addition, it became apparent that some of the instruments that qualified for regulatory capital purposes as tier 1 capital, which was the core measure of capital adequacy, were not truly loss absorbing, at least not in a way that permitted a financial firm to remain a viable financial intermediary. During the crisis, market assessments of the strength of financial firms focused on common equity, the most loss-absorbent form of capital. Many market participants questioned whether levels of common equity at the largest institutions would be sufficient to withstand potential losses. In conducting stress tests under the Supervisory Capital Assessment Program in the winter and early spring of 2009, we focused predominantly on common equity ratios. It was the disclosure of these ratios, along with our insistence that firms raise additional common equity to meet these ratios, that helped reassure financial markets of the continued viability of the nation's nineteen largest bank holding companies.

The uncertainty about institutions' financial strength had also contributed to severe liquidity problems at the height of the crisis. Investors and other counterparties were unwilling to extend credit of any sort in the absence of reliable information on the firms' true capital positions. Institutions that substantially relied on short-term funding were unable to roll over this funding. Moreover, exacerbating this liquidity squeeze, many of the largest institutions were unable to unwind positions that they had assumed could be liquidated even in stressed markets.

The crisis thus revealed capital and liquidity shortfalls and confirmed that weaknesses in one group of internationally active firms could quickly be transmitted globally. In response, national prudential regulators represented on the Basel Committee on Banking Supervision have developed new standards to enhance the stability of the global financial system. In July 2009, the Basel Committee adopted more stringent regulatory capital standards for trading activities and securitization exposures. Subsequently, in December 2010, the Basel Committee published its Basel III framework.

Basel III represents a major step forward for capital standards. Basel III not only promotes a higher *quantity* of capital by raising the minimum level of capital required at banking organizations. It also addresses the *quality* of capital by introducing for the first time a specific common equity capital requirement, thereby helping to ensure that a bank's capital structure is composed of truly loss-absorbing forms of capital. In addition, Basel III enlarges the range of risks accounted for in the regulatory capital requirements and improves their measurement, particularly for the counterparty credit risk associated with over-the-counter (OTC) derivatives. The Basel agreement also adds for the first time an international leverage ratio as a complement to the long-standing Basel risk-based capital ratios.

Basel III likewise includes two sets of international standards for liquidity, the first efforts to develop quantitative standards for liquidity management. One standard, the Liquidity Coverage Ratio (LCR), is designed to ensure firms' ability to withstand short-term liquidity shocks through adequate holdings of highly liquid assets. The other, the Net Stable Funding Ratio (NSFR), is intended to avoid significant maturity mismatches over longer-term horizons. These new standards are an important part of the global effort to enhance the financial system's ability to withstand stresses comparable to those faced during the recent financial crisis.

Areas for continued international work

The risk-based capital requirements finalized in Basel III, and applicable to all internationally active banks, will be central to an effective framework for financial stability. There is an additional capital standard – along with the liquidity standards just mentioned – where the considerable work done to date still needs to be completed in the Basel Committee. Global initiatives have also been started in two other areas covered by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), derivatives regulation, and resolution regimes, but a good deal remains to be done before we have agreement on appropriate international measures to promote global financial stability and to assure congruence between U.S. practices and those of other major financial centers.

An important capital policy initiative that has yet to be completed pertains to additional capital requirements for systemically important financial institutions (SIFIs). Section 165 of the Dodd-Frank Act directs the Federal Reserve to impose enhanced prudential standards, including capital requirements, on bank holding companies with consolidated assets of $50 billion or more. These requirements must be more stringent than those for firms that do not pose a similar risk to U.S. financial stability, and must increase in stringency based on the systemic footprint of the firm.

Last year, we proposed development of a comparable enhanced international capital requirement for SIFIs. Such a requirement would promote international financial stability while avoiding significant competitive disadvantage for any country's firms. Work on the subject of SIFI capital surcharges in the Basel Committee started a bit slowly, but it has picked up considerably in recent months. Although there is not yet consensus, we are hopeful that in the next several months the Committee will agree upon a proposal and can seek public comment. This international process would roughly coincide with the domestic notice and comment process for rules proposed by the Federal Reserve covering enhanced prudential standards for SIFIs. The parallelism of the international and domestic processes should facilitate the goal of congruence between U.S. and international standards.

While the Basel III capital standards take effect during a transition period beginning in 2013, implementation of the two sets of liquidity standards will not begin until 2015 for the LCR and 2018 for the NSFR. The central bank governors and heads of supervision recognized that there may be a number of unintended consequences arising from the specifics of the LCR. For this reason, the Federal Reserve, supported by our counterparts from a number of other central banks, suggested a multi-year observation period before the LCR takes effect. During this period, the U.S. agencies and a Basel Committee working group will collect data, solicit comments from banks, analyze the effects of the new liquidity measures on financial markets and the broader economy, and determine whether the standards need to be amended to avoid adverse unintended consequences. With respect to the NSFR, while the Basel Committee countries are committed to having this standard in place in 2018, considerable technical work is still needed to refine this measure in the coming years.

In addition to these ongoing efforts regarding capital and liquidity, I would like to emphasize the importance of international cooperation on reforms to the derivatives market. In the United States, the market regulators and banking agencies are implementing the requirements of the Dodd-Frank Act to strengthen the infrastructure and regulation of the OTC derivatives market. This task includes enhancing the role of central counterparties, which can be an important tool for managing counterparty credit risk in the derivatives market, and introducing new margin requirements for certain derivatives activities that are not cleared with a central counterparty.

Even as these initiatives are underway in the United States, it is important that progress on reforming the OTC derivatives market continue at the international level. In 2009, the Group of Twenty (G-20) leaders set out commitments related to reform of the OTC derivatives markets that, when implemented by national authorities, will form a broadly consistent international regulatory approach.[1] As work on the G-20 commitments is being pursued in a number of international groups, continued attention will be required to ensure that the convergence process continues in a timely fashion. In addition, there is need for agreement on a topic not covered by the G-20 declaration – that of global minimum margin requirements for derivatives not cleared through a central counterparty. Such an agreement would increase the stability of the financial system by reducing the likelihood of a race to the bottom in jurisdictions that do not implement equivalent standards.

A final issue that must remain on the international reform agenda is the development in major financial centers of effective resolution regimes for SIFIs. The Dodd-Frank Act gave the Federal Deposit Insurance Corporation (FDIC) authority to resolve failing financial firms where necessary to mitigate serious effects on financial stability. The efficacy of this mechanism and market discipline more generally will both be increased if other significant jurisdictions have parallel authority, with similar expectations for how SIFIs operating in multiple jurisdictions will be resolved. Work has been underway for some time at the Basel Committee and the Financial Stability Board to identify key attributes of effective regimes that will facilitate resolution of SIFIs while preserving critical market functions. In cooperation with our colleagues at the FDIC, we have encouraged these efforts, as well as an exploration of possible channels for avoiding impediments to successful resolution of firms with substantial operations in multiple jurisdictions.

Implementation of international standards

The financial stability benefits of the Basel III reforms will be realized only if they are implemented rigorously and consistently across jurisdictions. In this regard, it is important to note that incorporating internationally acceptable standards into national legislation or

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[1] See G-20 (2009), "Leaders' Statement: The Pittsburgh Summit," September.

regulations is only the first step in effective implementation. A second, critical step is ensuring that these standards are, in practice, rigorously enforced by national supervisors and observed by firms across all the Basel Committee countries.

In the United States, the Federal Reserve, FDIC, and Office of the Comptroller of the Currency (collectively, the banking agencies) are working to update and enhance risk-based capital standards, and introduce liquidity standards through a series of rulemakings. These rulemakings will be used to align U.S. capital and liquidity regulations with Basel III. In accordance with the internationally agreed-upon implementation timeframes, the banking agencies plan to issue a notice of proposed rulemaking in 2011 and a final rule in 2012 that would implement the Basel III reforms. We expect that other jurisdictions will be adopting regulations or, where necessary, legislation in a similar timeframe. The Basel Committee will review progress and identify any potential inconsistencies with the terms of Basel III.

Monitoring the incorporation of Basel agreements into national law is a fairly straightforward exercise, though no less important for that. It is also a familiar exercise in the Basel Committee. In this regard, the international leverage ratio the Basel Committee has adopted and is currently monitoring serves as an important backstop to risk-based ratios that rely extensively on banks' models. It is notable that analysts that follow significant global financial institutions use a leverage ratio to gain insights into the credibility of banks' average risk-weighted assets. The Federal Reserve Board is fully committed to ensuring a robust leverage ratio remains in place for internationally active institutions.

Despite extensive sharing of information on supervisory practices, the Basel Committee has, over the years, found it difficult to achieve what I have characterized as the second critical step in the implementation of international capital accords – that is, rigorous and consistent application of those rules by supervisors and firms across countries, as reflected in reported capital levels and amounts of risk-weighted assets of individual banks. An international process for monitoring implementation on a bank-by-bank basis has become increasingly necessary as capital standards have relied to a greater extent on internal market-risk or credit-risk models, the parameters and operation of which are not transparent. This tendency has combined with the relatively opaque nature of bank balance sheets to complicate external efforts to assess how banks are meeting their capital requirements.

One area that has deservedly received attention of late is the potential for differences in the calculation of risk-weighted assets across banks, both currently and prospectively under the Basel III standards. In particular, market participants have focused on differences in measured risk exposure. Analysts have pointed out that large U.S. banks generally have markedly higher average risk weights, ratios of risk-weighted assets to total assets, and ratios of common equity to total assets, adjusted for differences in accounting, than some of their foreign competitors. These large disparities cannot be easily explained away through differences in risk profiles, which are largely similar within the business lines of competing banks.

Indeed, with regard to capital for trading activities, where a commonly disclosed measure of risk is one-day value-at-risk (VaR),[2] U.S. trading banks appear to hold multiples of the capital non-U.S. trading banks hold per unit of VaR. Precisely because of the opacity of bank balance sheets and their internal risk models, we do not yet fully understand the reasons for these disparities. Some observers have suggested that U.S. stringency in application of the rules and standards may be a factor. Gaining insight into these differences and taking action to more closely align capital requirements for similar risk exposures across countries will take concerted work within the Basel Committee.

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[2] A value-at-risk approach measures the potential gain or loss in a position, portfolio, or organization that is associated with a price movement of a given probability over a specified time period.

The Basel Committee leadership has acknowledged that failing to implement Basel III in a globally consistent manner could lead to a competitive race to the bottom and increase risks to the global financial system.[3] The Committee must take action to avoid this outcome, specifically through the Committee's Standards Implementation Group (SIG). The SIG is initiating this year a peer review process, through which teams of experts will assess the extent to which countries have implemented Basel Committee standards. While these reviews will focus initially on standards other than capital, such as stress testing, the process should nevertheless provide insight into how approaches and outcomes related to the implementation of Basel III can be meaningfully monitored and compared.

The SIG has already begun sharing information on the status of Basel III implementation by member countries and is in the early stages of planning comparative work on risk-weighted assets across jurisdictions and banks to promote consistent implementation.

As the Basel Committee moves into this next phase, we will urge the Committee to take a comprehensive approach to monitoring processes that includes three elements. First, the Committee should begin work as soon as possible to develop mechanisms to implement effective cross-country monitoring. Second, this process should go beyond traditional stocktaking exercises to include a careful assessment of the methodologies national regulators use to determine the appropriateness and acceptability of bank practices. Third – and here is where the real work will lie – the Committee must develop a mechanism to validate the actual risk-weighted assets calculated by individual banks under international capital standards.

There are several possibilities for conducting this work. One that has been discussed in the Basel Committee would be to use tools such as benchmarks and test portfolios, in order to provide an accurate, quantifiable comparison of standards implementation across jurisdictions. Another, more far-reaching option would be to use validation teams working under the auspices of the Basel Committee itself to verify the methodologies used at individual banks to ensure their compliance with international standards. They could use expertise gained through horizontal reviews of institutions to make assessments of individual banks in different jurisdictions. A less far-reaching variant of this option would entail national supervisors collaboratively participating in examinations of specific institutions.

As a result of these monitoring and validation processes, outliers (i.e., banks whose risk weights for comparable assets differ materially from those of other banks) could be identified so that national supervisors might perform more in-depth analyses of their banks' processes and outcomes. This would lead to a greater understanding of the disparity in results for certain institutions or jurisdictions based on their assumptions, data, or risk profiles. There can be legitimate reasons that banks may have different risk estimates for similar portfolios. Where disparities are identified, however, national supervisors of outlier banks should be called upon to explain the results to their fellow supervisors, as well as steps they are taking to address situations in which differences may arise from systematic underestimation of risk or manipulation of capital ratios to achieve desired outcomes.

Any of these options would require the Basel Committee, international supervisors, and banking organizations to work together to address confidentiality concerns, as well as other jurisdictional issues. Some options will surely prove more feasible than others. While we do not prejudge which will prove to be most effective, we do maintain that something of this sort is necessary in order to assure that the benefits for financial stability promised by

[3] See, for example, Nout Wellink (2011), "Basel III: A Roadmap to Better Banking Regulation and Supervision," remarks delivered at the FSI High-Level Meeting on the New Framework to Strengthen Financial Stability and Regulatory Priorities, St. Petersburg, Russia, May; and Stefan Walter (2011), "Basel III: Stronger Banks and a More Resilient Financial System," remarks delivered at the Financial Stability Institute Conference on Basel III, Basel, April.

international capital standards are in fact being realized, as well as to prevent some banks from enjoying competitive advantage through lax application of these standards. At the same time, any of these options will give banking supervisors from the countries represented on the Basel Committee an opportunity to work together to address the many issues of implementation, interpretation, and evasion that will surely arise under Basel III.

Thank you for your attention. I would be pleased to answer any questions you might have.