Ben S Bernanke: The Dodd-Frank Act

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, 21 July 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 first anniversary of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act).[1]

On this anniversary, it is worth reminding ourselves of why the Congress passed sweeping financial reforms a year ago. The financial crisis of 2008–09 was unprecedented in its scope and severity. Some of the world's largest financial firms collapsed or nearly did so, sending shock waves through the highly interconnected global financial system. Critical financial markets came under enormous stress. Asset prices fell sharply and flows of credit to American families and businesses were disrupted. The crisis, in turn, wreaked havoc on the U.S. and global economies, causing sharp declines in production and trade and putting millions out of work. Extraordinary actions by authorities around the world helped stabilize the situation, but, nearly three years later, the recovery from the crisis in the United States and in many other countries remains far from complete.

In response to the crisis, we have seen a comprehensive re-thinking and reform of financial regulation, both in the United States and around the world. Among the core objectives of both the Dodd-Frank Act and the global regulatory reform effort are: enhancing regulators' ability to monitor and address threats to financial stability, strengthening both the prudential oversight and resolvability of systemically important financial institutions (SIFIs), and improving the capacity of financial markets and infrastructures to absorb shocks. I will briefly discuss each of these objectives.

First, to help regulators better anticipate and prepare for threats to financial stability, legislatures in both the United States and other developed economies have instructed central banks and regulatory agencies to adopt what has been called a *macroprudential* approach to supervision and regulation – that is, an approach that supplements traditional supervision and regulation of individual firms or markets with explicit consideration of threats to the stability of the financial system as a whole. Under a macroprudential approach, regulators are enjoined not only to look for emerging financial risks but also to try to identify structural weaknesses or gaps in the regulatory system, thereby helping the regulatory framework keep pace with financial innovation and other market developments.

As you know, the Dodd-Frank Act created a council of regulators, the Financial Stability Oversight Council, to coordinate efforts to identify and mitigate threats to U.S. financial stability across a range of institutions and markets. The Council's monitoring efforts are well under way, and this new organization has contributed to what has been a very positive atmosphere of consultation and coordination among its member agencies. The Council is also moving forward with its rulemaking responsibilities, including rules under which it will be able to designate systemically important nonbank financial institutions and financial market utilities for additional supervisory oversight, including by the Federal Reserve. For its part, the Federal Reserve has also made organizational changes to promote a macroprudential approach to regulation. Among these changes is the establishment of high-level, multidisciplinary working groups to oversee the supervision of large, complex banking firms

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[1] An appendix to this testimony provides details on the Federal Reserve's progress in meeting its responsibilities under the Dodd-Frank Act.

and financial market utilities, with a strong focus on developments that have implications for financial stability. We have also created an Office of Financial Stability Policy and Research to help coordinate our efforts to identify and analyze potential risks to the broader financial system and to serve as liaison with the Council.

A second major objective of financial reform is to mitigate the threats to financial stability posed by the too-big-to-fail problem. Here the Dodd-Frank Act takes a two-pronged approach. The first prong empowers the Federal Reserve to reduce a SIFI's probability of failure through tougher prudential regulation and supervision, including enhanced risk-based capital and leverage requirements, liquidity requirements, single-counterparty credit limits, stress testing, an early remediation regime, and activities restrictions. The Federal Reserve and other agencies face the ongoing challenge of aligning domestic regulations with international agreements, including the Basel III requirements for globally active banks. These efforts are going well; in particular, the Federal Reserve expects to issue proposed rules on the oversight of SIFIs later this summer and, working with other banking agencies, is on schedule to implement Basel III.

Ending too-big-to-fail also requires allowing a SIFI to fail if it cannot meet its obligations – and to do so without inflicting serious damage on the broader financial system. Thus, the second prong of the Dodd-Frank Act's effort to end too-big-to-fail empowers the Federal Reserve and the Federal Deposit Insurance Corporation (FDIC) to reduce the effect on the system in the event of a SIFI's failure through tools such as the new orderly liquidation authority and improved resolution planning by firms and supervisors. In particular, the Federal Reserve is working with the FDIC to require SIFIs to better prepare for their own resolution by adopting so-called living wills. A joint final rule on living wills is expected later this summer.

Reducing the likelihood of a severe financial crisis also requires strengthening the resilience of our financial markets and infrastructure – a third major objective of the Dodd-Frank Act. Toward that end, provisions of the act improve the transparency and stability of the over-the-counter derivatives markets and strengthen the oversight of financial market utilities and other critical parts of our financial infrastructure. We and our colleagues at the Securities and Exchange Commission, the Commodity Futures Trading Commission, and other agencies are moving this work forward, in consultation as appropriate with foreign regulators and international bodies. The U.S. agencies are also working together to address structural weaknesses in areas not specifically addressed by the Dodd-Frank Act, such as the triparty repo market and the money market mutual fund industry.

To be sure, any sweeping reform comes with costs and uncertainties. In implementing the statute, the Federal Reserve is committed to the promulgation of rules that are economically sensible, appropriately weigh costs and benefits, protect smaller community institutions, and, most important, promote the sound extension of credit in the service of economic growth and development. A full transition to the new system will require much more work by both the public and private sectors, and no doubt we will learn lessons along the way. However, as we work together to implement financial reform, we must not lose sight of the reason that we began this process: ensuring that events like those of 2008 and 2009 are not repeated. Our long-term economic health requires that we do everything possible to achieve that goal.

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