Daniel K Tarullo: The international agenda for financial regulation

Speech by Mr Daniel K Tarullo, Member of the Board of Governors of the Federal Reserve System, at the American Bar Association Banking Law Committee Fall Meeting, Washington DC, 4 November 2011.

*   *   *

Long before the recent financial crisis, banking regulation had acquired an important international dimension. The crisis renewed attention to the interconnectedness among national financial markets. In its aftermath, accordingly, the international focus on banking regulation has grown even more extensive. Today I will discuss three subjects germane to the increasingly significant international regulatory agenda.

First are the steps needed to complete the reform agenda on capital and liquidity standards, including some implementation issues in the United States. Second are areas that I believe should be priorities for international work in 2012 – cross-border resolution of financial firms, wholesale funding markets, and over-the-counter (OTC) derivatives reform. And third are some institutional changes that will be required in the relevant international bodies to assure that they fulfill their promise of promoting a safe and efficient international financial system.

Before turning to these topics, I think it important to state the goals that should inform U.S. involvement in international financial regulatory efforts. In recognition of the fact that financial distress can quickly and dramatically cross national borders, we seek to protect our own financial system by promoting the adoption of strong, common regulatory standards and effective supervisory practices for large financial firms and important financial market infrastructures around the world. Such standards and practices can also help prevent major competitive disadvantage for U.S. firms.

Completing the agenda on minimum capital and liquidity standards

Strong capital and liquidity standards are central to these goals and to the overall reform agenda for financial regulation. The crisis showed that liquidity problems can be an independent source of severe stress, perhaps even for firms that might otherwise have remained solvent. But it also confirmed that capital standards themselves had been wholly inadequate in a number of respects: Required capital levels were much too low, particularly trading book capital requirements. In evaluating the condition of financial firms at the height of the crisis, markets focused on common equity ratios and virtually ignored the Tier 1 ratio enshrined by Basel I and Basel II. Moreover, markets and supervisors both used a much more forward-looking capital calculation than under prevailing regulatory requirements – subtracting losses that they estimated would be sustained in an adverse scenario to determine whether firms would have enough capital to remain viable financial intermediaries. Finally, the significant interconnectedness among globally active firms, and the high degree of correlation in their assets, underscored the vulnerability of the entire international financial system to the potential failure of these firms.

In response to these revealed regulatory shortcomings, the Basel Committee has announced four sets of changes to minimum prudential standards for internationally active banks: First, in 2009 it revised and strengthened the market risk requirements of Basel II, in what has become known as Basel 2.5. Second, last year it issued Basel III, which improved the quality and increased the quantity of minimum capital requirements, created a capital conservation buffer, and introduced an international leverage ratio requirement. Third, and coincident with Basel III, the committee issued a framework for quantitative liquidity requirements. Fourth, it has just today released the rules text of its assessment methodology for determining an additional capital requirement for global systemically important banks (G-SIBs) – popularly referred to as a "capital surcharge."

In the Basel Committee itself, work on Basel 2.5 and Basel III has been essentially complete for some time. As reported recently by the committee,[1] implementation of Basel 2.5 and Basel III into national legislation or regulations is at various stages of progress around the world.

Two points are worth making with respect to U.S. implementation. First, while U.S. bank regulatory agencies have published a proposed regulation for the new market risk capital requirements, we did not include the trading book securitization and resecuritization portions of Basel 2.5. The complication here, and with part of Basel III implementation, lies in the use of agency credit ratings. The Dodd-Frank Wall Street Reform and Consumer Protection Act requires the removal of agency credit ratings from all regulations throughout the government. The banking agencies thus need to develop substitutes for agency ratings in each of the quite different contexts within the capital standards where they are used. This has not been the easiest of tasks, but I believe we are now close to convergence on the approaches we will take in fashioning these substitutes. Thus we should soon be able to draft a proposed regulation for the rest of Basel 2.5. Work on the Basel III rule has had to compete for staff time with all the other rulemakings currently underway at the banking agencies, but I would expect a proposed regulation in the first quarter of 2012.

My second point pertains to the six-year transition period for Basel III, which by its terms phases in the requirements for both the improved quality and increased quantity of capital in somewhat backloaded stages beginning in January 2013. Questions have arisen – particularly here in the United States, though elsewhere as well – as to supervisory expectations for capital levels during this rather lengthy period. Specifically, there has been some uncertainty as to whether supervisors intend to “pull forward” the various transition points outlined in Basel III. While the Federal Reserve intends to ensure that firms are on a steady path to full Basel III compliance, we do not intend to require firms to raise external capital or reduce their risk-weighted assets in order to meet any target earlier than at the time specified in the Basel III transition schedule. However, because this issue is complicated somewhat both by certain expectations stated in Basel III and by the relationship of Basel III implementation to the Federal Reserve’s requirement for annual capital planning by certain large bank holding companies, I think it may be useful to provide some further details on our expectations.

In the first place, the Federal Reserve *will* require bank holding companies that are subject to our proposed capital plan rule (generally companies with $50 billion or more in total assets) to take affirmative steps to improve capital ratios, such as external capital raises, when those steps would be needed to meet each Basel III transition target on time.

Next, I would remind everyone of a statement made by the Governors and Heads of Supervision (GHOS) – the oversight body of the Basel Committee – in announcing agreement on Basel III in September 2010. The GHOS said that banks should “maintain prudent earnings retention policies” so as to meet both the new minimum equity standard and the conservation buffer “as soon as reasonably possible.”[2] In the spirit of that statement, we will expect large bank holding companies that have not yet met the fully phased-in Basel III requirements (including any expected G-SIB capital surcharge) to improve their capital ratios steadily during the transition period through prudent earnings retention policies, even if they already meet any applicable intermediate targets. In practical terms, we will monitor their progress through our review of the capital plans that we require large bank holding companies to submit annually. That is, we will be comfortable with proposed capital distributions only when we are convinced they are consistent with a bank holding company

1 Basel Committee on Banking Supervision (2011), Progress Report on Basel III Implementation (Bank for International Settlements: Basel, Switzerland, October).

2 See Bank for International Settlements (2010), “Group of Governors and Heads of Supervision Announces Higher Global Minimum Capital Standards,” press release, September 12.

readily and without difficulty meeting the new capital requirements as they come into effect. We will provide more detail on this point in a few weeks when we issue guidance and instructions for the 2012 capital review.

Last, it is important to note that supervisors may require banking organizations to increase capital ratios above the minimum levels specified in Basel I and II for a variety of safety and soundness reasons. Institution-specific measures of this sort are explicitly contemplated in both Basel II and U.S. banking regulations. During the financial crisis, we used our safety and soundness authority to require banks to hold sufficient capital to weather the impact of the crisis and the serious recession that followed. Similarly, our annual capital plan review is a forward-looking exercise that, in estimating losses and reduced revenues that would follow an adverse economic scenario, may result in requiring banks to maintain more capital than would a static snapshot of minimum capital levels.

Unlike the Basel 2.5 and Basel III capital standards, the quantitative liquidity framework requires further work in the Basel Committee. The committee has developed two complementary liquidity requirements: The Liquidity Coverage Ratio (LCR) was designed to promote short-term liquidity resiliency of firms, while the Net Stable Funding Ratio (NSFR) was directed at medium-term structural liquidity mismatches. The framework presented to the GHOS in 2010 was genuinely pathbreaking, in that it was the first effort ever to establish quantitative liquidity requirements. Precisely because of the novelty of this exercise, questions were raised in the GHOS as to how the definition and calibration of the new ratios aligned with actual experience in the crisis, and whether the ratios might result in some adverse unintended consequences on financial markets. Consequently, the GHOS agreed to delay implementation of both standards and provide for what were termed "observation periods," during which further analysis will be done and changes very likely made.

Here, though, it is important to draw a distinction between the two standards. In recognition of the fact that the NSFR needs considerable work, which is not yet under way, it is not scheduled to become effective until 2018. The LCR, on the other hand, will go into effect in 2015. The Basel Committee has recently agreed to accelerate its review of the LCR so as to be able to make changes well before that date and, thereby, give firms and markets ample time to prepare and, as necessary, adjust.

In the coming months, the Federal Reserve, after consulting with the other U.S. banking agencies, will be making recommendations for changes in the LCR. We have not yet finished developing those recommendations, but I expect that we will, among other things, suggest recalibration of certain deposit run-off and commitment draw-down rates, as well as modification of the buffer definition to place a greater focus on the liquidity characteristics of assets, as opposed to such things as the credit ratings associated with the assets. We are also examining how the regulations might be best applied during liquidity stress events to maximize the benefits for financial stability. Several other possible changes are also under consideration, including altering the LCR so as to limit certain arbitrage opportunities that appear possible from its current structure.

Finally, let me turn to the Basel Committee's framework for calibrating capital surcharges for banks of global systemic importance. It is informed by the fact that failure of a systemically important firm would have substantially greater negative consequences on the financial system than the failure of other firms, even quite sizeable ones. Thus, the surcharge attempts to reduce the chances of a G-SIB's failure so as to bring the expected impact of failure of such a firm – that is, its expected damage to the system upon failure discounted by the possibility that it will, in fact, fail – more in line with that of other sizeable firms. Moreover, the metrics for determining G-SIB status are heavily weighted toward the kind of interconnectedness features that pose macroprudential risks.

This framework includes a range of surcharges in the 1.0–2.5 percent range for what will likely be a global group of about 30 banks, to be phased in as an expansion of the Basel III capital conservation buffer from 2016 to 2019. The framework is consistent with the obligation of the Federal Reserve under section 165 of the Dodd-Frank Act to impose more stringent capital standards on systemically important institutions, including the requirement that these additional standards be graduated based on the systemic importance of the bank.

For illustrative purposes, the Basel Committee used 2009 data to generate a list of banks that were of global systemic importance and, based on the criteria developed from that data, a hypothetical set of "buckets" associated with the different surcharge rates. It is important to note, however, that this list will not be used to determine any bank's surcharge. The list of banks to be covered and the buckets within which they will be placed when the surcharge begins to take effect in 2016 will be based upon data collected in 2014. This is as it should be, since the inclusion and ordering of the firms should be based upon the characteristics of the banks as they have evolved closer to the effective date. Some banks have changed their profiles materially in the past couple of years, and the prospect of capital surcharges may be an incentive for others to do so as well. In this regard, I should also note that the bucket allocation of each G-SIB will be recomputed in each year after 2016.

The use of more up-to-date data means that banks will not know for some time exactly which buckets they will occupy when the surcharge first phases in. The Basel Committee does plan to release by the latter part of 2014 the thresholds for each surcharge "bucket," as well as the denominator reflecting the universe of global banking institutions against which each G-SIB will be measured. To further advance the goals of transparency and predictability, we will continue to work within the Basel Committee to ensure that the indicators used to determine the systemic risk ranking of a firm are clear and based upon publicly available information sources. If additional information is needed by firms to allow for effective capital planning, the Basel Committee should be prepared to develop and release additional guidance.

Next steps for the reform agenda

As I stated earlier, strong capital and liquidity standards are central to an effective financial regulatory system. Well-crafted capital standards provide a buffer against loss from any activities of a bank, while good liquidity standards help provide assurance that a firm will have breathing space during a period of financial stress, whether idiosyncratic or systemic. But we cannot rely solely on these standards, important as they are, to provide a stable financial system.

Basel 2.5, Basel III, and the G-SIB surcharges can only reduce the chances of highly disruptive failure, not eliminate them. A necessary supplement is a strong resolution mechanism for systemically important firms, both to counter too-big-to-fail perceptions and to contain the harm to the financial system that would be caused by the failure of one of these firms. Thus, my first candidate for a priority area of work in 2012 is to take concrete steps to advance the useful analytic work that has been done in the Basel Committee and the Financial Stability Board (FSB) on the resolution of financial firms with substantial international presence.

Here in the United States, the Dodd-Frank Act provides for an orderly liquidation process. Some other jurisdictions have, or are planning to, put in place comparable special-resolution mechanisms. But the co-existence of internationally active firms with nationally based insolvency regimes means that there can be potentially important transborder legal complications when a home jurisdiction places into receivership a firm with significant assets, subsidiaries, and contractual arrangements in other countries. A comprehensive, treaty-like instrument for a global bank resolution regime is almost surely not achievable in the foreseeable future, and perhaps well beyond that. But there should be room for more limited cooperation agreements, coordinated supervisory work on resolution plans, and other devices to make the orderly resolution of a large internationally active firm more feasible.

Similarly, the limits of even well-conceived liquidity requirements suggest a second item that warrants attention in international fora – namely, the problems connected with wholesale funding channels over the last several years. Broadly speaking, threats to financial stability can arise in two ways: first, through the rapid deterioration or failure of a large institution with leverage sufficient to produce widespread knock-on effects and, second, through the breakdown of a significant market in which large numbers of leveraged actors depend upon similar sources of liquidity and backup liquidity. While these two sources of systemic risk can be, and usually are, related, the latter has not been the subject of the broad reform agenda directed at the former.

You will note that the Basel III liquidity standards do not require global banks to reduce their usage of wholesale funding; instead, they require a bank that uses more volatile funding sources to hold more liquid assets. This requirement is critical to a sounder financial system, to be sure, but it does not address completely the potential instability associated with wholesale funding – even in the regulated institutions subject to these requirements, much less in the rest of the financial system. We will need further measures if we are to mitigate the risks of runs seen in 2007–2008 and, somewhat less dramatically, more recently. Because the risk of runs in wholesale funding manifests itself in different ways in different countries' financial systems, the appropriate response will likely be a mix of national and international actions, not an international agreement like Basel III. But for this very reason, it is important that there be ongoing attention to the issue, in order to share ideas for action and monitor the steps various jurisdictions are taking to mitigate the risks.

For example, we in the United States need to move forward with changes to money market funds and triparty repo markets to ensure that they do not serve as a trigger for wholesale funding runs. We also need to address further the issues raised by the dependence of some foreign banking institutions on large amounts of wholesale dollar funding. The responses to these issues may themselves involve a mix of national and international measures.

A third priority is the area of OTC derivatives, where strong capital standards alone are not enough to contain systemic risks. We know that OTC derivatives dealers, as a by-product of that business model, become part of a global network of interconnected exposures. When one dealer in the network fails, as we saw in the case of Lehman Brothers, fear of losses at other dealers in the network can cause systemic stress. Capital, which covers only a fraction of exposure, cannot alone prevent this contagion.

To reduce the systemic risk of OTC derivatives, the Group of Twenty (G-20) leaders have agreed to mandate that standardized OTC derivatives must be cleared through a central counterparty. Work in the United States is well under way to implement mandatory clearing. Other countries have begun this work as well, but progress abroad has been slow to date. To help ensure that a global move toward central clearing of derivatives actually reduces systemic risk, it is critical that central counterparties in the derivatives market be very sound and stable. Therefore, it is essential that the Committee on Payment and Settlement Systems (CPSS) and the International Organization of Securities Commissions (IOSCO) complete their important work on strengthening the oversight of central counterparties as soon as possible.

To further build shock absorbers in the derivatives network, non-standardized derivatives that are not suitable for clearing should have margin requirements that are sufficient to prevent contagion when the next Lehman fails. An international working group has been formed for this purpose. We hope to see considerable progress on this element of OTC derivatives reform next year.

Institutional changes

An audience of banking lawyers will appreciate the impact of the institutional features of international arrangements on the substantive output of those arrangements. In the time remaining this afternoon, I cannot do justice to this subject. But I do want to leave you with two observations about the international regulatory reform agenda of the last few years, along with some implications of those observations for desirable institutional changes.

The first observation is that, although there are exceptions, the output of this agenda has largely consisted of what are essentially regulatory rules, intended to be applied to firms through national law. Second, most of these rules are being generated, or at least reviewed, within an overlapping set of organizations and arrangements – the Basel Committee, IOSCO, the FSB, the G-20, and a veritable potpourri of committees functioning under the umbrella of the Bank for International Settlements (BIS).

These rather mundane observations lead, I think, to some rather important institutional implications. It goes without saying that the benefits of international regulatory rules will be realized only if they are implemented rigorously and consistently across jurisdictions. Not only must they be incorporated into national legislation or regulations effectively, they must also be rigorously enforced by national supervisors. We do not need formal dispute mechanisms similar to those in the World Trade Organization, which could undermine supervisory cooperation, but we do need effective, collaborative monitoring mechanisms administered by the supervisors themselves and reported to the public. So, for example, the Federal Reserve has suggested that the Basel Committee go beyond the important function of reviewing legal implementation and also monitor how capital standards are applied within banks. While a variety of methods could be used, we are particularly interested in establishing international validation teams to verify methodologies used at individual banks on such matters as the risk-weighting of trading assets.

Even as the Basel Committee should monitor compliance with the standards it establishes, it must not lose sight of the importance of supervisory cooperation in pursuit of the shared goal of a stable international financial system. The focus on rules and standards over the last few years has been both understandable and necessary, but the Basel Committee should not be purely a negotiating forum. The activities of the Basel Committee in the 1970s and early 1980s were largely informal, involving the sharing of supervisory perspectives and, perhaps more importantly, the establishment of relationships that could be drawn upon when cross-border supervisory problems arose. I regret that these functions have been substantially attenuated over the years. With the increased membership and expanded scope of activities, a return to early practice is not feasible. But other ways must be found to foster the common goals of committee members in promoting safe and sound financial systems.

The overlapping, sometimes competing, activities of all the international committees and arrangements is, like the recent emphasis on rules, completely understandable in light of the number of new and urgent issues to be tackled. Similarly, the involvement of political officials through the G-20 was imperative to galvanize the legislative and regulatory processes of participating countries to undertake the breadth of needed reforms. But as we move toward administering these new standards and arrangements, we must rationalize the often confusing and duplicative process whereby the Basel Committee, the FSB, and some other BIS committees are all involved in the same subjects.

Fortunately, the agenda breaks down rather naturally into the new substantive topics, such as resolution and OTC derivatives, and the further refinement and implementation of established regulatory areas such as capital standards. The new topics play to the coordinating and gap-filling strengths of the FSB, which includes both regulators and finance ministry representatives, and which can parcel out appropriate components of larger projects to standard-setting committees. Work in established regulatory areas obviously falls more appropriately within the province of the Basel Committee (or with respect to some securities regulatory issues, IOSCO), which consists of the regulators with responsibility for administering these standards domestically. In this regard, it is important that the independence of regulators established domestically also be respected internationally.

Conclusion

The international dimension of financial regulation has grown even more important since the financial crisis. Yet there are, as I have suggested, more subjects to be tackled. At the same time, the pursuit of efficient and effective regulation requires priority-setting by, and rationalization of, the web of international arrangements dealing with these issues.