

Daniel K Tarullo: Dodd-Frank Act implementation

Testimony by Mr Daniel K Tarullo, Member of the Board of Governors of the Federal Reserve System, before the Committee on Banking, Housing, and Urban Affairs, US Senate, Washington DC, 6 June 2012.

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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's implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act).

As we approach the second anniversary of the Dodd-Frank Act, implementation of the financial reforms enacted by the Congress remains a formidable task. At the Federal Reserve, staff teams with a wide range of expertise continue to contribute to Dodd-Frank Act projects, many as part of joint rule-making efforts with other federal agencies. We have been working to put final Dodd-Frank Act rules in place and to negotiate and implement international reforms compatible with various Dodd-Frank Act provisions; these include enhanced capital requirements for systemically important banks, liquidity requirements, resolution mechanisms, and margining requirements for over-the-counter derivatives.

As we continue rule implementation and the related international initiatives, we are trying to provide as much clarity as possible to financial markets and the public about the post-crisis financial regulatory landscape, and are also taking the time to consider comments and alternatives carefully. In addition, the Federal Reserve continues to work cooperatively with other supervisors to ensure that prudential supervision is conducted in a manner that supports these important reforms.

As a final introductory point, it bears noting that both the Dodd-Frank Act reforms and the international regulatory reforms share an important feature – a strong focus on the largest, most complex, and most interconnected financial firms and the systemic risks posed by those firms. This effort reflects the provenance of both the Dodd-Frank Act and international reform initiatives, which were motivated largely by the failure or near failure of a number of major financial firms and the significant public policy problems created by the market perception that such firms are “too big to fail.” As the Federal Reserve implements reforms, we have maintained this core focus on the largest firms by proposing rules that try to mitigate the systemic risks posed by those firms and minimize the burden on smaller entities, particularly community banks. Similarly, we seek to implement reforms in a manner that is faithful to statutory requirements and that maximizes financial stability and other economic benefits at the least cost to credit availability and economic growth.

This morning I will briefly describe the Federal Reserve's progress on several important Dodd-Frank Act rules and recent reforms to the international bank regulatory framework. I will also describe briefly the Federal Reserve's role in supervising and examining the largest financial firms in cooperation with other federal and state supervisors.

Enhanced capital standards

While robust bank capital requirements alone cannot ensure the safety and soundness of our financial system, they are central to good financial regulation precisely because capital is available to absorb all kinds of potential losses – unanticipated as well as anticipated. Indeed, the best way to safeguard against taxpayer-funded bailouts in the future is for our large financial institutions to have capital buffers commensurate with their own risk profiles and the damage that would be done to the financial system if such institutions were to fail. Recent events serve to remind us that the presence of substantial amounts of high-quality capital is the best way to ensure that significant losses at individual firms are borne by their shareholders, and not by depositors or taxpayers. Ensuring the capital adequacy of financial

firms requires both improvement of the traditional, firm-based approach to capital regulation and the creation of a more systemic, or macroprudential, component of capital regulation.

With respect to improving the traditional approach to capital regulation, the Federal Reserve's work has principally involved the development of stronger regulatory capital standards in cooperation with other supervisors in the Basel Committee on Banking Supervision. This work includes the so-called Basel 2.5 reforms that strengthened the market-risk capital requirements of Basel II. This work also includes the Basel III reforms, which improve the quality of regulatory capital, increase the quantity of required minimum regulatory capital, require banks to maintain a capital conservation buffer and, for the first time internationally, introduce a minimum leverage ratio. The Federal Reserve and other U.S. banking agencies are moving to finalize regulations to implement Basel 2.5 in the United States and soon will be proposing regulations to implement Basel III.

These significant changes to the international regulatory capital framework have been supplemented by an important element of the Dodd-Frank Act known as the "Collins Amendment." The Collins Amendment provides a safeguard against declines in minimum capital requirements in the Basel II capital regime based on bank internal modeling. The Federal Reserve and other U.S. banking agencies issued final rules to implement this provision in June 2011.

Capital surcharges for systemically important financial firms

The recent financial crisis also made clear that the existing international regulatory capital framework was not sufficiently responsive to macroprudential concerns, such as the threat to financial stability posed by systemically important financial institutions. Accordingly, in Basel Committee deliberations, the Federal Reserve advocated for capital surcharges on the world's largest, most interconnected banking organizations based on their global systemic importance. Last year, an international agreement was reached on a framework for such surcharges, to be implemented during the same 2016–2019 transition period for the capital conservation buffers in Basel III. This initiative is consistent with the Federal Reserve's obligation under section 165 of the Dodd-Frank Act to impose more stringent capital standards on systemically important financial institutions, including the requirement that these additional standards be graduated based on the systemic footprint of the institution.

Both the Dodd-Frank Act provision and the Basel framework are motivated by the fact that the failure of a systemically important firm would have dramatically greater negative consequences on the financial system and the economy than the failure of other firms. Stricter capital requirements on systemically important firms should also help offset any funding advantage these firms derive from any remaining perceived status as too-big-to-fail and provide an incentive for such firms to reduce their systemic footprint. The Federal Reserve's aim has been to fashion the enhanced capital requirements of section 165 and work toward an associated international framework in a simultaneous and congruent manner.

Stress testing and capital planning

Recent improvements to the regulatory capital framework have important supervisory complements in the Federal Reserve's development of firm-specific stress testing and capital planning requirements. These supervisory tools serve two related functions. First, they make capital regulation more forward-looking by testing whether firms would have enough capital to remain viable financial intermediaries if they sustained hypothetical losses in asset values and earnings in an adverse macroeconomic scenario. Second, they contribute to the macroprudential dimension of supervision by enabling simultaneous examination of the risks faced by all large financial institutions in a hypothetical adverse economic scenario.

The Dodd-Frank Act creates two forms of stress-testing requirements. These requirements mirror the Supervisory Capital Assessment Program model, a 2009 effort led by the Federal

Reserve that helped restore confidence in the viability of the banking system during the financial crisis. First, the act mandates that the Federal Reserve conduct annual stress tests on all bank holding companies with \$50 billion or more in assets to determine whether they have the capital needed to absorb losses in hypothetical baseline, adverse, and severely adverse economic conditions. Second, the act requires both these companies and certain other regulated financial firms with assets between \$10 billion and \$50 billion to conduct internal stress tests. The Federal Reserve must publish a summary of results of the supervisory stress tests and issue regulations requiring firms to publish a summary of the company-run stress tests.

Regular and rigorous stress testing provides regulators with knowledge that can be applied to both microprudential and macroprudential supervision efforts. Disclosure of the general methodology and firm-specific results of our stress testing has additional regulatory benefits. First, the release of certain details about assumptions, methods, and conclusions exposes the supervisory approach to greater external scrutiny and discussion. Such discussions will almost surely help us improve our assumptions and methodology over time. Second, because bank portfolios are difficult to value without a great deal of detailed information, the stress test results should be very useful to investors in and counterparties of the largest banking firms. Further, I believe the demands of supervisors for well-specified data and projections from firms have improved risk management at these firms. The stress testing that the Federal Reserve has instituted during the past few years has become an important part of our horizontal, interdisciplinary approach to supervising the largest bank holding companies.

Firm-specific capital planning has also become an important supervisory tool. In November 2011, the Federal Reserve issued a new regulation requiring large banking organizations to submit an annual capital plan. This tool serves multiple purposes. First, it provides a regular, structured, and comparative way to promote and assess the capacity of large bank holding companies to understand and manage their capital positions. Second, it provides supervisors with an opportunity to evaluate any capital distribution plans against the backdrop of the firm's overall capital position, a matter of considerable importance given the significant distributions that some firms made in 2007 even as the financial crisis gathered momentum. Third, at least for the next few years, it will provide a regular assessment of whether large bank holding companies will readily meet the Basel 2.5 and Basel III capital requirements as they take effect in the United States.

A stress test is a critical part of the annual capital plan review. But, as these three different purposes indicate, the capital plan review is about more than using a stress test to determine whether a firm's capital distribution plans are consistent with remaining a viable financial intermediary in adverse economic conditions. As indicated during our capital plan reviews in both 2011 and 2012, the Federal Reserve may object to a capital plan because of significant deficiencies in a firm's capital planning process, as well as because one or more relevant capital ratios would fall below required levels under the assumptions of stress and planned capital distributions. Likewise, the stress test is relevant not only for its role in the capital planning process. As noted earlier, it also serves other important purposes, not least of which is increased transparency of both bank holding company balance sheets and the supervisory process of the Federal Reserve.

Enhanced liquidity standards

As with capital, the financial crisis also brought attention to defects in the liquidity risk-management practices of large financial firms. As seen during the crisis, a financial firm – particularly one with significant amounts of short-term funding – can become illiquid before it becomes insolvent, as creditors run in the face of uncertainty about the firm's viability. While higher levels and quality of capital can mitigate some of this risk, it was widely agreed that quantitative liquidity requirements should be developed. The Basel Committee generated two liquidity standards: one, a Liquidity Coverage Ratio (LCR) with a 30-day time horizon; the

other, a Net Stable Funding Ratio (NSFR) with a one-year time horizon. However, insofar as this was the first-ever effort to specify such requirements, the Governors and Heads of Supervision of the countries represented on the Basel Committee determined that implementation of both frameworks should be delayed while they are subject to further examination and possible revision. As is the case with enhanced capital standards for the largest banking firms, the Basel Committee's liquidity initiatives are consistent with the Federal Reserve's obligation under section 165 of the Dodd-Frank Act to impose more stringent liquidity standards on the largest bank holding companies as well as other systemically important nonbank financial firms.

The LCR has been actively reconsidered within the Basel Committee over the last year or so. As this work proceeds, four types of changes appear particularly ripe for consideration. First, the LCR's definition of high-quality liquid assets should be broadened. In this regard, we support efforts to move away from the current credit risk-based approach and toward a quantitative liquidity-based approach. Second, some of the assumptions embedded in the LCR about run rates of liabilities and the liquidity of assets might be grounded more firmly in actual experience during the crisis, as the LCR may overstate in particular the liquidity risks of commercial banking activities. Third, additional consideration needs to be given to the liquidity risks inherent in trading activities that rely upon large amounts of short-term wholesale funding. Fourth, the LCR could be better adapted to ensure usability of the high-quality liquid asset buffer in appropriate circumstances: for example, by making credibly clear that ordinary minimum liquidity levels need not be maintained in the midst of a crisis. As currently constituted, the LCR may have the unintended effect of exacerbating a period of stress by forcing liquidity hoarding. The Basel Committee will likely suggest a set of changes to the LCR later this year, with a goal of introducing the LCR in 2015. Work on the NSFR is on a considerably slower track; the current plan is for implementation in 2018.

Enhanced prudential standards for the largest financial firms

Sections 165 and 166 of the Dodd-Frank Act require the Federal Reserve to establish a broad set of enhanced prudential standards, both for bank holding companies with total consolidated assets of \$50 billion or more and for nonbank financial companies designated by the Financial Stability Oversight Council (Council). In addition to enhanced risk-based capital and liquidity requirements and stress testing, the required standards also include single-counterparty credit limits, an early remediation regime, and risk-management and resolution-planning requirements. Sections 165 and 166 also require that these prudential standards become more stringent as the systemic footprint of a firm increases.

In December, the Federal Reserve issued a package of proposed rules to implement sections 165 and 166 of the Dodd-Frank Act. The Federal Reserve's proposed rules would apply the same set of enhanced prudential standards to covered companies that are bank holding companies and to covered companies that are nonbank financial companies designated by the Council. As we made clear in the proposal, however, the Federal Reserve expects to tailor the application of the enhanced standards to different companies individually or by category, taking into consideration each company's capital structure, riskiness, complexity, financial activities, size, and any other risk-related factors that the Federal Reserve deems appropriate. The comment period for our enhanced prudential standards proposal closed on April 30. Nearly 100 comment letters were received. The Federal Reserve is currently reviewing those comments carefully as we work to develop final rules.

The Volcker Rule

Section 619 of the Dodd-Frank Act, commonly known as the "Volcker Rule," generally prohibits banking entities from engaging in proprietary trading or acquiring an ownership interest in, sponsoring, or having certain relationships with a hedge fund or private equity fund. In October, the Federal Reserve joined the Office of the Comptroller of the Currency

(OCC), the Federal Deposit Insurance Corporation (FDIC), and the Securities and Exchange Commission in seeking public comment on a proposal to implement the Volcker Rule. The Commodities Futures Trading Commission issued its substantially similar proposal for comment shortly thereafter. Because of the importance and complexity of the issues raised by the statutory provisions that make up the Volcker Rule, the Federal Reserve and other agencies provided the public with a 120-day opportunity to submit comments. The comment period is now closed, and nearly 19,000 public comments were received. The agencies are now working together to review and consider these comments and put final implementing rules in place as soon as practicable.

In April, after consultation with the other agencies, the Federal Reserve issued guidance on a Volcker Rule conformance period that was intended to help limit any confusion about when banking entities will need to comply with the final rules once issued. The Federal Reserve's statement clarified that a banking entity has the full two-year period provided by the statute (i.e., until July 21, 2014), unless that period is extended by the Board, to fully conform its activities and investments to the requirements of the Volcker Rule, including any final implementing rules adopted by the agencies.

Prudential supervision of large financial firms

In the wake of the Dodd-Frank Act, the prudential supervision of the largest, most complex financial firms remains a cooperative effort. As before, the law mandates that a variety of federal and state supervisors execute particular supervisory and examination responsibilities for certain parts of a firm. This allocation of supervisory oversight among different agencies reflects, among other factors, the historical development of various types of financial intermediaries in the United States and a series of legislative decisions about regulatory and supervisory structure.

As the regulator and supervisor of bank holding companies, the Federal Reserve's role in this statutory arrangement is typically that of consolidated regulator and supervisor of the parent holding company. Accordingly, our supervisory program for such firms generally takes a broad view of the activities, risks, and management of the consolidated firm, with a particular focus on the capital adequacy, governance, and risk-management practices and competencies of the firm as a whole.

Many of the principal business activities of the largest financial firms are conducted through the functionally regulated subsidiaries of those firms, such as insured depository institutions, broker-dealers, and insurance companies. As required by section 5 of the Bank Holding Company Act, the Federal Reserve generally relies to the fullest extent possible on the examination and supervision of those subsidiaries by the functional regulators. Together, the Federal Reserve and other functional regulators work to discharge the supervisory and examination responsibility given to each agency for particular parts of a large financial firm in a way that maximizes the expertise and resources of each agency and best ensures the safety and soundness of the consolidated firm and each of its constituent parts.

Just as the financial crisis revealed the need for change in the prudential standards applicable to financial firms and activities, so too did it make clear that important changes in supervisory practices were needed to improve both the microprudential and macroprudential oversight of banks and bank holding companies. To that end, even before passage of the Dodd-Frank Act, the Federal Reserve began to reorient its supervisory structure and strengthen its supervision of the largest, most complex financial firms.

The most important change has been creation of the Large Institution Supervision Coordinating Committee (LISCC). The LISCC is founded on several principles: that large institution supervision should be more centralized; that it should conduct regular, simultaneous, horizontal (cross-firm) supervisory exercises; and that it should be more interdisciplinary than it has been in the past. Thus, the LISCC includes senior Federal Reserve staff from research, legal and other divisions at the Board, from the markets and

payments systems groups at the Federal Reserve Bank of New York, and senior bank supervisors from the Board and relevant reserve banks. Relative to previous practices, this approach to supervision relies more on quantitative methods for evaluating the performance and vulnerabilities of firms.

To date, the LISCC has developed and administered various horizontal supervisory exercises, notably the capital stress tests and the related comprehensive capital reviews of the nation's largest bank holding companies, and is now extending its activities to coordinate other supervisory processes more effectively. It also has focused its attention on potential implications for financial stability in the United States from stresses arising in Europe.

Review of JPMorgan Chase & Co. trading loss

In response to the significant trading losses that were recently announced by JPMorgan Chase & Co. (JPMorgan) as a result of trading operations at the London branch of its national bank, the Federal Reserve – in its capacity as consolidated supervisor of the bank holding company – is working with the OCC, the regulator of the national bank, to review the firm's response and remedial actions. In particular, the Federal Reserve has been assisting in the oversight of JPMorgan's efforts to manage and de-risk the portfolio in question. As this process proceeds, we anticipate also working with the OCC and FDIC to identify the changes in risk measurement, management and governance that will be necessary to improve risk-control practices surrounding the firm's trading activities and to address trading strategies that led to these losses.

In addition, the Federal Reserve has been looking at other parts of the holding company to determine if governance, risk management and control weaknesses – similar to those exposed by this incident – are present elsewhere. While we have, to date, found no evidence that they are, this review is not yet complete.

Conclusion

The recent financial crisis disrupted the financial system and the broader economy on a scale and scope not seen since the 1930s. Some of the world's largest financial firms collapsed or required government assistance to stay afloat, sending shock waves through the highly interconnected global financial system. Asset prices fell sharply, flows of credit to American families and businesses slowed dramatically, and millions of people lost their jobs. Extraordinary actions by governments around the world helped to provide stability, but more than four years after the onset of the crisis, the recovery is far from complete. It is critical that we complete the implementation of capital and other prudential measures to prevent another crisis and protect taxpayers from having again to recapitalize financial firms.

Thank you very much for your attention. I would be pleased to answer any questions you may have.