Daniel K Tarullo: Dodd-Frank Act

Speech 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, 14 February 2013.

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Chairman Johnson, Ranking Member Crapo, and other members of the committee, thank you for the opportunity to testify on implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act). In today's testimony, I will provide an update on the Federal Reserve's recent activities pertinent to the Dodd-Frank Act and describe our regulatory and supervisory priorities for 2013.

The Federal Reserve, in many cases jointly with other regulatory agencies, has made steady and considerable progress in implementing the Congressional mandates in the Dodd-Frank Act, though obviously some work remains. Throughout this effort, the Federal Reserve has maintained a focus on financial stability. In the process of rule development, we have placed particular emphasis on mitigating systemic risks. Thus, among other things, we have proposed varying the application of the Dodd-Frank Act's special prudential rules based on the relative size and complexity of regulated financial firms. This focus on systemic risk is also reflected in our increasingly systematic supervision of the largest banking firms.

Recent regulatory reform milestones

Strong bank capital requirements, while not alone sufficient to guarantee the safety and soundness of our banking system, are central to promoting the resiliency of banking firms and the financial sector as a whole. Capital provides a cushion to absorb a firm's expected and unexpected losses, helping to ensure that those losses are borne by shareholders rather than taxpayers. The financial crisis revealed, however, that the regulatory capital requirements for banking firms were not sufficiently robust. It also confirmed that no single capital measure adequately captures a banking firm's risks of credit and trading losses. A good bit of progress has now been made in strengthening and updating traditional capital requirements, as well as devising some complementary measures for larger firms.

As you know, in December 2010 the Basel Committee on Banking Supervision (Basel Committee) issued the Basel III package of reforms to its framework for minimum capital requirements, supplementing an earlier set of changes that increased requirements for important classes of traded assets. Last summer, the Federal Reserve, the Office of the Comptroller of the Currency (OCC), and the Federal Deposit Insurance Corporation (FDIC) issued for comment a set of proposals to implement the Basel III capital standards for all large, internationally active U.S. banking firms. In addition, the proposals would apply risk-based and leverage capital requirements to savings and loan holding companies for the first time. The proposals also would modernize and harmonize the existing regulatory capital standards for all U.S. banking firms, which have not been comprehensively updated since their introduction twenty-five years ago, and incorporate certain new legislative provisions, including elements of sections 171 and 939A of the Dodd-Frank Act.

To help ensure that all U.S. banking firms maintain strong capital positions, the Basel III proposals would introduce a new common equity capital requirement, raise the existing tier 1 capital minimum requirement, implement a capital conservation buffer on top of the regulatory minimums, and introduce a more risk-sensitive standardized approach for calculating risk-weighted assets. Large, internationally active banking firms also would be subject to a supplementary leverage ratio and a countercyclical capital buffer and would face higher capital requirements for derivatives and certain other capital markets exposures they hold. Taken together, these proposals should materially reduce the probability of failure of

U.S. banking firms – particularly the probability of failure of the largest, most complex U.S. banking firms.

In October 2012, the Federal Reserve finalized rules implementing stress testing requirements under section 165 of the Dodd-Frank Act. Consistent with the statute, the rules require annual supervisory stress tests for bank holding companies with $50 billion or more in assets and any nonbank financial companies designated by the Financial Stability Oversight Council (Council). The rules also require company-run stress tests for a broader set of regulated financial firms that have $10 billion or more in assets. The new Dodd-Frank Act supervisory stress test requirements are generally consistent with the stress tests that the Federal Reserve has been conducting on the largest U.S. bank holding companies since the Supervisory Capital Assessment Program in the spring of 2009. The stress tests allow supervisors to assess whether firms have enough capital to weather a severe economic downturn and contribute to the Federal Reserve's ability to make assessments of the resilience of the U.S. banking system under adverse economic scenarios. The stress tests are an integral part of our capital plan requirement, which provides a structured way to make horizontal evaluations of the capital planning abilities of large banking firms.

The Federal Reserve also issued in December of last year a proposal to implement enhanced prudential standards and early remediation requirements for foreign banks under sections 165 and 166 of the Dodd-Frank Act. The proposal is generally consistent with the set of standards previously proposed for large U.S. bank holding companies. The proposal generally would require foreign banks with a large U.S. presence to organize their U.S. subsidiaries under a single intermediate holding company that would serve as a platform for consistent supervision and regulation. The U.S. intermediate holding companies of foreign banks would be subject to the same risk-based capital and leverage requirements as U.S. bank holding companies. In addition, U.S. intermediate holding companies and the U.S. branches and agencies of foreign banks with a large U.S. presence would be required to meet liquidity requirements similar to those applicable to large U.S. bank holding companies. The proposals respond to fundamental changes in the scope and scale of foreign bank activities in the United States in the last fifteen years. They would increase the resiliency and resolvability of the U.S. operations of foreign banks, help protect U.S. financial stability, and promote competitive equity for all large banking firms operating in the United States. The comment period for this proposal closes at the end of March.

Priorities for 2013

The Federal Reserve's supervisory and regulatory program in 2013 will concentrate on four tasks: (1) continuing key Dodd-Frank Act and Basel III regulatory implementation work; (2) further developing systematic supervision of large banking firms; (3) improving the resolvability of large banking firms; and (4) reducing systemic risk in the shadow banking system.

Carrying forward the key Dodd-Frank Act and Basel III regulatory implementation work

Capital, Liquidity, and Other Prudential Requirements for Large Banking Firms. Given the centrality of strong capital standards, a top priority this year will be to update the bank regulatory capital framework with a final rule implementing Basel III and the updated rules for standardized risk-weighted capital requirements. The banking agencies have received more than 2,000 comments on the Basel III capital proposal. Many of the comments have been directed at certain features of the proposed rule considered especially troubling by community and smaller regional banks, such as the new standardized risk weights for mortgages and the treatment of unrealized gains and losses on certain debt securities. These criticisms underscore the difficulty in fashioning standardized requirements applicable to all banks that balance risk sensitivity with the need to avoid excessive complexity. Here, though, I think there is a widespread view that the proposed rule erred on the side of too

much complexity. The three banking agencies are carefully considering these and all comments received on the proposal and hope to finalize the rulemaking this spring.

The Federal Reserve also intends to work this year toward finalization of its proposals to implement the enhanced prudential standards and early remediation requirements for large banking firms under sections 165 and 166 of the Dodd-Frank Act. As part of this process, we intend to conduct shortly a quantitative impact study of the single-counterparty credit limits element of the proposal. Once finalized, these comprehensive standards will represent a core part of the new regulatory framework that mitigates risks posed by systemically important financial firms and offsets any benefits that these firms may gain from being perceived as "too big to fail."

We also anticipate issuing notices of some important proposed rulemakings this year. The Federal Reserve will be working to propose a risk-based capital surcharge applicable to systemically important banking firms. This rulemaking will implement for U.S. firms the approach to a systemic surcharge developed by the Basel Committee, which varies in magnitude based on the measure of each firm's systemic footprint. Following the passage of the Dodd-Frank Act, which called for enhanced capital standards for systemically important firms, the Federal Reserve joined with some other key regulators from around the world in successfully urging the Basel Committee to adopt a requirement of this sort for all firms of global systemic importance.

Another proposed rulemaking will cover implementation by the three federal banking agencies of the recently completed Basel III quantitative liquidity requirements for large global banks. The financial crisis exposed defects in the liquidity risk management of large financial firms, especially those which relied heavily on short-term wholesale funding. These new requirements include the liquidity coverage ratio (LCR), which is designed to ensure that a firm has a sufficient amount of high quality liquid assets to withstand a severe standardized liquidity shock over a 30-day period. The Federal Reserve expects that the U.S. banking agencies will issue a proposal in 2013 to implement the LCR for large U.S. banking firms. The Basel III liquidity standards should materially improve the liquidity risk profiles of internationally active banks and will serve as a key element of the enhanced liquidity standards required under the Dodd-Frank Act.

Volcker Rule, Swaps Push-out, and Risk Retention. Section 619 of the Dodd-Frank Act, known as the "Volcker rule," generally prohibits a banking entity 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 2011, the federal banking agencies and the Securities and Exchange Commission sought public comment on a proposal to implement the Volcker rule. The Commodity Futures Trading Commission subsequently issued a substantially similar proposal. The rulemaking agencies have spent the past year carefully analyzing the nearly 19,000 public comments on the proposal and have made significant progress in crafting a final rule that is faithful to the language of the statute and maximizes bank safety and soundness and financial stability at the least cost to the liquidity of the financial markets, credit availability, and economic growth.

Section 716 of the Dodd-Frank Act generally prohibits the provision of federal assistance, such as FDIC deposit insurance or Federal Reserve discount window credit, to swap dealers and major swap participants. The Federal Reserve is currently working with the OCC and the FDIC to develop a proposed rule that would provide clarity on how and when the section 716 requirements would apply to U.S. insured depository institutions and their affiliates and to U.S. branches of foreign banks. We expect to issue guidance on the implementation of section 716 before the July 21, 2013, effective date of the provision.

To implement the risk retention requirements in section 941 of the Dodd-Frank Act, the Federal Reserve, along with other federal regulatory agencies, issued in March 2011 a proposal that generally would force securitization sponsors to retain at least 5 percent of the credit risk of the assets underlying a securitization. The agencies have reviewed the

substantial volume of comments on the proposal and the definition of a qualified mortgage in the recent final "ability-to-pay" rule of the Consumer Financial Protection Bureau (CFPB). As you know, the CFPB's definition of qualified mortgage serves as the floor for the definition of exempt qualified residential mortgages in the risk retention framework. The agencies are working closely together to determine next steps in the risk retention rulemaking process, with a view toward crafting a definition of a qualified residential mortgage that is consistent with the language and purposes of the statute and helps ensure a resilient market for private-label mortgage-backed securities.

Improving systematic supervision of large banking firms

Given the risks to financial stability exposed by the financial crisis, the Federal Reserve has reoriented its supervisory focus to look more broadly at systemic risks and has strengthened its micro-prudential supervision of large, complex banking firms. Within the Federal Reserve, the Large Institution Supervision Coordinating Committee (LISCC) was set up to centralize the supervision of large banking firms and to facilitate the execution of horizontal, cross-firm analysis of such firms on a consistent basis. The LISCC includes senior staff from various divisions of the Board and from the Reserve Banks. It fosters interdisciplinary coordination, using quantitative methods to evaluate each firm individually, relative to other large firms, and as part of the financial system as a whole.

One major supervisory exercise conducted by the LISCC each year is a Comprehensive Capital Analysis and Review (CCAR) of the largest U.S. banking firms.[1] Building on supervisory work coming out of the crisis, CCAR was established to ensure that each of the largest U.S. bank holding companies (1) has rigorous, forward-looking capital planning processes that effectively account for the unique risks of the firm and (2) maintains sufficient capital to continue operations throughout times of economic and financial stress. CCAR, which uses the annual stress test as a key input, enables the Federal Reserve to make a coordinated, horizontal assessment of the resilience and capital planning abilities of the largest banking firms and, in doing so, creates closer linkage between micro-prudential and macro-prudential supervision. Large bank supervision at the Federal Reserve will include more of these systematic, horizontal exercises.

Improving the resolvability of large banking firms

One important goal of post-crisis financial reform has been to counter too-big-to-fail perceptions by reducing the anticipated damage to the financial system and economy from the failure of a major financial firm. To this end, the Dodd-Frank Act created the Orderly Liquidation Authority (OLA), a mechanism designed to improve the prospects for an orderly resolution of a systemic financial firm, and required all large bank holding companies to develop, and submit to supervisors, resolution plans. Certain other countries that are home to large, globally active banking firms are working along roughly parallel lines. The Basel Committee and the Financial Stability Board have devoted considerable attention to the orderly resolution objective by developing new standards for statutory resolution frameworks, firm-specific resolution planning, and cross-border cooperation. Although much work remains to be done by all countries, the Dodd-Frank Act reforms have generally put the United States ahead of its global peers on the resolution front.

Since the passage of the Dodd-Frank Act, the FDIC has been developing a single-point-of-entry strategy for resolving systemic financial firms under the OLA. As explained by the FDIC, this strategy is intended to effect a creditor-funded holding company recapitalization of the failed financial firm, in which the critical operations of the firm continue, but shareholders

[1] For more information, see www.federalreserve.gov/bankinforeg/ccar.htm.

and unsecured creditors absorb the losses, culpable management is removed, and taxpayers are protected. Key to the ability of the FDIC to execute this approach is the availability of sufficient amounts of unsecured long-term debt to supplement equity in providing loss absorption in a failed firm. In consultation with the FDIC, the Federal Reserve is considering the merits of a regulatory requirement that the largest, most complex U.S. banking firms maintain a minimum amount of long-term unsecured debt. A minimum long-term debt requirement could lend greater confidence that the combination of equity owners and long-term debt holders would be sufficient to bear all losses at the consolidated firm, thereby counteracting the moral hazard associated with taxpayer bailouts while avoiding disorderly failures.

Reducing systemic risk in the shadow banking system

Most of the reforms I have discussed are aimed at addressing systemic risk posed by regulated banking organizations, and all involve action the Federal Reserve can take under its current authorities. Important as these measures are, however, it is worth recalling that the trigger for the acute phase of the financial crisis was the rapid unwinding of large amounts of short-term funding that had been made available to firms not subject to consolidated prudential supervision. Today, although some of the most fragile investment vehicles and instruments that were involved in the pre-crisis shadow banking system have disappeared, non-deposit short-term funding remains significant. In some instances it involves prudentially regulated firms, directly or indirectly. In others it does not. The key condition of the so-called "shadow banking system" that makes it of systemic concern is its susceptibility to destabilizing funding runs, something that is more likely when the recipients of the short-term funding are highly leveraged, engage in substantial maturity transformation, or both.

Many of the key issues related to shadow banking and their potential solutions are still being debated domestically and internationally. U.S. and global regulators need to take a hard, comprehensive look at the systemic risks present in wholesale short-term funding markets. Analysis of the appropriate ways to address these vulnerabilities continues as a priority this year for the Federal Reserve. In the short term, though, there are several key steps that should be taken with respect to shadow banking to improve the resilience of our financial system.

First, the regulatory and public transparency of shadow banking markets, especially securities financing transactions, should be increased. Second, additional measures should be taken to reduce the risk of runs on money market mutual funds. The Council recently proposed a set of serious reform options to address the structural vulnerabilities in money market mutual funds.

Third, we should continue to push the private sector to reduce the risks in the settlement process for tri-party repurchase agreements. Although an industry-led task force made some progress on these issues, the Federal Reserve concluded that important problems were not likely to be successfully addressed in this process and has been using supervisory authority over the past year to press for further and faster action by the clearing banks and the dealer affiliates of bank holding companies.[2] The amount of intraday credit being provided by the clearing banks in the tri-party repo market has been reduced and is scheduled to be reduced much further in the coming years as a result of these efforts. But vulnerabilities in this market remain a concern, and addressing these vulnerabilities will require the cooperation of the broad array of participants in this market and their federal regulators. The Federal Reserve will continue to report to Congress and publicly on progress made to address the risks in the tri-party repo market.

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[2] For additional information, see www.newyorkfed.org/banking/tpr_infr_reform.html

In addition to these concrete steps to address concrete problems, regulators must continue to closely monitor the shadow banking sector and be wary of signs that excessive leverage and maturity transformation are developing outside of the banking system.

Conclusion

The financial regulatory architecture is stronger today than it was in the years leading up to the crisis, but considerable work remains to complete implementation of the Dodd-Frank Act and the post-crisis global financial reform program. Over the coming year, the Federal Reserve will be working with other U.S. financial regulatory agencies, and with foreign central banks and regulators, to propose and finalize a number of ongoing initiatives. In this endeavor, our goal is to preserve financial stability at the least cost to credit availability and economic growth. We are focused on the monitoring of emerging systemic risks, reducing the probability of failure of systemic financial firms, improving the resolvability of systemic financial firms, and building up buffers throughout the financial system to enable the system to absorb shocks.

As we take this work forward, it is important to remember that preventing a financial crisis is not an end in itself. Financial crises are profoundly debilitating to the economic well-being of the nation.

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