# Daniel K Tarullo: Dodd-Frank 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, 11 July 2013.

* * *

Chairman Johnson, Ranking Member Crapo, and other members of the Committee, thank you for the opportunity to testify on the Federal Reserve's activities in mitigating systemic risk and implementing the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act).

With the third anniversary of the Dodd-Frank Act upon us, it is a good time to reflect on what has been accomplished, what still needs to be done, and how the work on the Dodd-Frank Act fits with other regulatory reform projects. Indeed, the deliberate pace and multi-pronged nature of the implementation of the act – occasioned as it is by complicated issues and decisionmaking processes – may be obscuring what will be far-reaching changes in the regulation of financial firms and markets. Indeed, the Federal Reserve and other banking supervisors have already created a very different supervisory environment than what was prevalent just a few years ago.

Today, I will review recent progress in key areas of financial regulatory reform, with special – though not exclusive – attention to implementation of the Dodd-Frank Act, including how that law affects the regulation of community banks. I will also highlight areas in which proposals are still outstanding and, in a few cases, in which we intend to make new proposals in the relatively near future.

## Implementation of Basel III capital rules

Let me begin by noting the completion of our major rulemakings on capital regulation. Although most of the provisions in these rules do not directly implement provisions of the Dodd-Frank Act, implementation of that law is occurring against the backdrop of implementation of the Basel III framework.

This month, the Federal Reserve, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation (FDIC) approved final rules implementing the Basel III capital framework, as well as certain related changes required by the Dodd-Frank Act.[1] The rules establish an integrated regulatory capital framework designed to ensure that U.S. banking organizations maintain strong capital positions, enabling them to absorb substantial losses on a going-concern basis and to continue lending to creditworthy households and businesses even during economic downturns.

The rules increase the quantity and improve the quality of regulatory capital of the U.S. banking system by setting strict eligibility criteria for regulatory capital instruments, by raising the minimum tier 1 capital ratio from 4 percent to 6 percent of risk-weighted assets, and by establishing a new minimum common equity tier 1 capital ratio of 4.5 percent of risk-weighted assets. The rules also require a capital conservation buffer of 2.5 percent of risk-weighted assets to ensure that banking organizations build capital during benign economic periods so that they can withstand serious economic downturns and still remain above the minimum capital levels. In addition, the rules improve the methodology for calculating risk-weighted assets to enhance risk sensitivity and incorporate certain provisions of the Dodd-Frank Act,

[1] See www.federalreserve.gov/newsevents/press/bcreg/20130702a.htm.

such as sections 171 and 939A.[2] The rules also contain certain provisions, including a supplementary leverage ratio and a countercyclical capital buffer, that apply only to large and internationally active banking organizations, consistent with their systemic importance and their complexity. The rules will have several important consequences.

First, they consolidate the progress made by banks and regulators over the past four years in improving the quality and quantity of capital held by banking organizations. Second, they remedy shortcomings in our existing generally applicable risk-weighted asset calculations that became apparent during the financial crisis. In so doing, they also enhance the effectiveness of the Collins Amendment, the scope of which we have extended through these rules by applying standardized floors to capital buffer, as well as minimum requirements. Third, adoption of these rules meets international expectations for U.S. implementation of the Basel III capital framework. This gives us a firm position from which to press our expectations that other countries implement Basel III fully and faithfully.

In crafting these rules, the banking agencies made a number of changes to the 2012 proposals, mostly to address concerns by community banks. For example, the new rules maintain current practice on risk weighting residential mortgages and provide community banking organizations the option of maintaining existing standards on the regulatory capital treatment of "accumulated other comprehensive income" (AOCI) and pre-existing trust preferred securities. These changes from the proposed rule are meant to reduce the burden and complexity of the rules for community banks while preserving the benefits of more rigorous capital standards. Most banking organizations already meet the higher capital standards, and the rules will help preserve the benefits of the stronger capital positions banks have built under the oversight of regulators since the financial crisis.

The capital rules also apply risk-based and leverage capital requirements to certain savings and loan holding companies for the first time. In another change from the proposal, savings and loan holding companies with significant commercial and insurance underwriting activities will not be subject to the final rules at this time. During the comment period, these firms raised significant concerns regarding the appropriateness of the proposed regulatory capital framework for their business models. To address these concerns, the Federal Reserve will take additional time to evaluate the appropriate regulatory capital framework for these entities.

All financial institutions subject to the new rules will have a significant transition period to meet the requirements. The phase-in period for smaller, less complex banking organizations will not begin until January 2015, while the phase-in period for larger institutions begins in January 2014.

## Stress testing and capital planning requirements for large banking firms

Important as higher capital requirements and a better quality of capital are to the safety and soundness of financial institutions, conventional capital requirements are by their nature somewhat backward-looking. First, they reflect loss expectations based on past experience. Second, losses that actually reduce reported capital levels are often formally taken by institutions well after the likelihood of losses has become clear. Rigorous stress testing helps compensate for these shortcomings through a forward-looking assessment of the losses that

[2] Section 171 of the Dodd-Frank Act, commonly referred to as the Collins Amendment, requires the federal banking agencies to establish minimum risk-based and leverage capital requirements for bank holding companies, savings and loan holding companies, insured depository institutions, and nonbank financial holding companies designated by the Financial Stability Oversight Council for supervision by the Federal Reserve. Under section 171, among other things, these minimum capital requirements may not be less than, nor quantitatively lower than, the generally applicable capital requirements that were in effect for insured depository institutions on the date of enactment of the Dodd-Frank Act. Section 939A requires all federal agencies to remove references to credit ratings in their regulations, including the capital rules.

would be suffered under stipulated adverse economic scenarios, so that capital can be built and maintained at levels high enough for the firms to withstand such losses and still remain viable financial intermediaries. In the middle of the financial crisis, the Federal Reserve created and applied a stress test to the nation's largest financial firms. The next year, Congress mandated stress tests for a larger group of firms in the Dodd-Frank Act. This fall, we will extend the full set of stress testing requirements to the dozen or so banking organizations with greater than $50 billion in assets covered in the Dodd-Frank Act but not fully covered in our previous stress tests.

Regular, comprehensive stress testing, with published results, has already become a key part of both capital regulation and overall prudential supervision. In the annual Comprehensive Capital Analysis and Review (CCAR), the Federal Reserve requires each large bank holding company to demonstrate that it has rigorous, forward-looking capital planning processes that effectively account for the unique risks of the firm and maintains sufficient capital to continue to operate through times of extreme economic and financial stress. CCAR and Dodd-Frank Act stress tests have shown the significant supervisory value of conducting coordinated cross-firm analysis of the major risks facing large banks.

The Federal Reserve has used stress testing and its broader supervisory authority to prompt a doubling over the past four years of the common equity capital of the nation's 18 largest bank holding companies, which collectively hold more than 70 percent of the total assets of all U.S. bank holding companies. Specifically, the aggregate tier 1 common equity ratio – which is based on the strongest form of loss-absorbing capital – at the 18 firms covered by the stress test has more than doubled, from 5.6 percent at the end of 2008 to 11.3 percent at the end of 2012. That reflects an increase in tier 1 common equity from $393 billion to $792 billion during the same period.

## Enhanced prudential requirements for large banking 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) as systemically important. The required standards include capital requirements, liquidity requirements, stress testing, single-counterparty credit limits, an early remediation regime, and risk-management and resolution-planning requirements. The sections also require that these prudential standards become more stringent as the systemic footprint of a firm increases.

The Federal Reserve has issued proposed rules to implement sections 165 and 166 for both large U.S. banking firms and foreign banks operating in the United States. In addition, earlier this week the federal banking agencies jointly issued a proposal to implement higher leverage ratio standards for the largest, most systemically important U.S. banking organizations. We have already finalized the rules on resolution planning and stress testing, and we are working diligently this year toward finalization of the remaining standards.

On liquidity, we will also be implementing the Basel III quantitative liquidity requirements for large U.S. banking firms. We expect that the federal banking agencies will issue a proposal later this year to implement the Basel Committee's Liquidity Coverage Ratio for large U.S. banking firms. These quantitative liquidity requirements would complement the stricter set of qualitative liquidity standards that the Federal Reserve has already proposed pursuant to section 165 of the Dodd-Frank Act.

On capital, we will be proposing risk-based capital surcharges on the most systemically important U.S. banking firms. The proposal will be based on the risk-based capital surcharge framework developed by the Basel Committee for global systemically important banks, under which the size of the surcharge will increase with a banking firm's systemic importance. These surcharges are a critical element of the Federal Reserve's efforts to force the most systemic financial firms to internalize the externalities caused by their potential failure and to

reduce any residual subsidies such firms may enjoy as a result of market perceptions that they may be too big to fail. We anticipate issuing a proposed regulation on these capital surcharges around the end of this year.

With one exception, we expect to finalize the remaining proposed enhanced prudential standards around the end of the year as well. The one exception is single-counterparty credit limits. We are conducting a quantitative impact study (QIS) on the effects of the counterparty credit limits included in the proposed rule. Based on the comments received and ongoing internal staff analysis, we concluded that a QIS was needed to help us better assess the optimal structure of the rule. Moreover, since the Federal Reserve issued its single-counterparty credit limit proposal, the Basel Committee began developing a similar large exposure regime that would apply to all global banks. We are coordinating our single-counterparty credit limit rule with this effort.

A core element of the Federal Reserve's proposed enhanced prudential standards for large banking firms is our December 2012 foreign bank proposal. The foreign bank proposal responds to fundamental changes over the last 15 years in the scope and scale of the U.S. operations of foreign banking organizations, many of which have moved beyond their traditional lending activities to engage in substantial capital markets activities and, in some cases, have become more reliant on short-term wholesale U.S. dollar funding. The proposed rule would increase the resiliency of the U.S. operations of foreign banks and help protect U.S. financial stability. The proposal would also promote competitive equality for all large banking firms – domestic and foreign – operating in the United States and would, in many respects, result in greater harmony between how the U.S. operations of foreign banking organizations and the foreign operations of U.S. bank holding companies are regulated.

The foreign bank proposal generally would require foreign banks with a large U.S. presence to organize their U.S. subsidiaries under a single U.S. 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. Importantly, however, the foreign bank proposal does not entail full subsidiarization – foreign banks generally will continue to be allowed to directly branch into the United States on the basis of their consolidated capital. The comment period for this proposal closed at the end of April, and we are now carefully reviewing comments.

**Improving resolvability of large banking firms**

An important reform included in the Dodd-Frank Act was the creation of the Orderly Liquidation Authority (OLA). Under OLA, the FDIC can resolve a systemic financial firm by imposing losses on the shareholders and creditors of the firm and replacing its management, while preserving the operations of the sound, functioning parts of the firm. This authority gives the government a real alternative to the Hobson's choice of bailout or disorderly bankruptcy that authorities faced in 2008. Similar resolution mechanisms are under development in other countries, and the Basel Committee and the Financial Stability Board have devoted considerable attention to developing new international standards for statutory resolution frameworks. Although much work remains to be done by all countries, the Dodd-Frank Act reforms have paved the way for the United States to be a leader in shaping the development of international policy on effective resolution regimes for systemic financial firms.

In implementing OLA, the FDIC is developing the single-point-of-entry (SPOE) resolution approach. SPOE is designed to focus losses on the shareholders and long-term unsecured debt holders of the parent holding company of the failed firm. It aims to produce a well-capitalized bridge holding company in place of the failed parent by converting long-term debt

holders of the parent into equity holders of the bridge. The critical operating subsidiaries of the failed firm would be re-capitalized by the parent, to the extent necessary, and would remain open for business. The SPOE approach should reduce incentives for creditors and customers of the operating subsidiaries to run and, as financial stress increases, for host-country regulators to engage in ring-fencing or other measures disruptive to an orderly, global resolution of the failed firm.

Successful execution by the FDIC of its preferred SPOE approach in OLA depends on the availability of a sufficient combined amount of equity and loss-absorbing debt at the parent holding company of the failed firm. Accordingly, in consultation with the FDIC, the Federal Reserve is working on a regulatory proposal that requires the largest, most complex U.S. banking firms to maintain a minimum amount of outstanding long-term unsecured debt on top of their regulatory capital requirements. Such a requirement could have a number of public policy benefits. Most notably, it would increase the prospects for an orderly resolution under OLA by ensuring that shareholders and long-term debt holders of a systemic financial firm can bear potential future losses at the firm and sufficiently capitalize a bridge holding company in resolution. In addition, by increasing the credibility of OLA, a minimum long-term debt requirement could help counteract the moral hazard arising from taxpayer bailouts and improve market discipline of systemic firms.

The Dodd-Frank Act also requires that all large bank holding companies develop, and submit to supervisors, resolution plans. The Federal Reserve has been working with the FDIC to review resolution plans submitted by the largest U.S. bank holding companies and foreign banks. The largest firms – generally those with $250 billion or more in total nonbank assets – submitted their first annual resolution plans to the Federal Reserve and the FDIC in the third quarter of 2012. These "first-wave" resolution plans yielded valuable information that is being used to identify, assess, and mitigate key challenges to resolvability under the Bankruptcy Code and to support the FDIC's development of backup resolution plans under OLA. These plans also are very useful supervisory tools that have helped the Federal Reserve and the subject firms focus on opportunities to simplify corporate structures and improve management systems in ways that will help the firms be more resilient and efficient, as well as easier to resolve.

Further work is being done on resolution plans this year. On July 1, bank holding companies in the second group – generally those with between $100 billion and $250 billion in total nonbank assets – submitted their initial plans to the Federal Reserve. The public portions of these resolution plans were made available on the FDIC and Federal Reserve websites on July 2.[3] The first-wave filers will submit updated plans in October that reflect further guidance from the FDIC and the Federal Reserve.

### Structural reform of banking firms

The Dodd-Frank Act also includes provisions calling for structural reform of the U.S. banking system. Key elements are the Volcker Rule in section 619 of the act and the derivatives push-out provision in section 716 of the act.

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. The federal banking agencies and the Securities and Exchange Commission (SEC) jointly proposed a rule to implement the Volcker Rule in October 2011. The Commodity Futures Trading Commission issued a substantially similar proposal a few months later.

---

[3] See www.federalreserve.gov/newsevents/press/bcreg/20130702b.htm.

The rulemaking agencies have carefully analyzed the nearly 19,000 public comments on the proposal and have made steady and significant progress toward crafting a final rule that attempts to maximize bank safety and soundness and financial stability while minimizing cost to the liquidity of the financial markets, credit availability, and economic growth. The implementation of the Volcker Rule has taken a significant amount of time for a variety of reasons – the interpretive and policy issues implicated by the rule are complex, the completion of the Volcker Rule requires negotiations among a variety of banking and market regulators, and the potential costs of getting the Volcker Rule wrong are high. But I think most observers would agree that the agencies need to provide firms, markets, and the public with the product of all this work, so that they can begin to adjust their plans and expectations accordingly. During this Committee's last oversight hearing in February, I expressed the hope that we would complete the Volcker Rule by the end of this year. Since that time, there has been good interagency progress, and I maintain both the hope and expectation of five months ago.

The derivatives push-out provision in 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 provision becomes effective on July 16, 2013, although the statute provides insured depository institutions the right to request a two-year extension from their primary federal supervisor. Last month, the Federal Reserve issued an interim final rule that clarified that uninsured U.S. branches and agencies of foreign banks will be treated in the same manner as insured depository institutions under section 716 and, as a result, will qualify for the same exemptions and two-year transition period available by statute to U.S. insured depository institutions. The interim final rule also establishes the process for state member banks and uninsured state branches or agencies of foreign banks to apply to the Federal Reserve for transition relief.[4] Although the rule is already effective, we are seeking comments on it and will revise the rule, as necessary, in light of comments received.

**Oversight of community banks**

In addition to overseeing large banking firms, the Federal Reserve supervises approximately 800 state-chartered community banks that are members of the Federal Reserve System.[5] Community banks play an important role in extending credit in local economies across the country – particularly, though by no means only, in their lending to small and medium-sized businesses. Recognizing the disproportionate burden that regulatory compliance can impose on smaller institutions, the Federal Reserve has put in place special processes for taking account of the circumstances and more limited compliance resources of community banks, while still achieving safety-and-soundness aims. We created a special subcommittee of our regulatory and supervisory oversight committee to review all proposals with an eye to their effects on community banks. We have also established a Community Depository Institutions Advisory Council to enable community bankers to comment on the economy, lending conditions, supervisory policies, and other matters of interest.

The changes we will be seeing in the financial regulatory architecture as a result of the Dodd-Frank Act and Basel III are principally directed at our largest and most complex financial firms. Many of the Basel III requirements will not apply to smaller banks – including the countercyclical capital buffer, supplementary leverage ratio, trading book reforms, AOCI flow through, higher capital requirements for counterparty credit risk on derivatives, and

[4] For approvals granted by the Board for the two-year transition period, see www.federalreserve.gov/bankinforeg/716f-requests.htm.

[5] For supervisory purposes, community banks are generally defined as those with less than $10 billion in assets.

disclosure requirements. In fact, most of the significant changes from the proposed capital rules published by the three banking agencies last year that we made in the final version of the rules issued earlier this month were in response to concerns expressed by smaller banks. Community banking organizations also will not be subject to the Federal Reserve's additional enhanced prudential standards that larger banking firms face or will face, such as capital plans, stress testing, resolution plans, single-counterparty credit limits, and capital surcharges for systemically important financial firms. In addition, most of the major systemic risk and prudential provisions of the Dodd-Frank Act – such as the Volcker Rule, derivatives push-out, derivatives central clearing requirements, and the Collins Amendment – will have a far smaller impact on community banks than on large banking firms.

**Constraining systemic risk outside the banking sector**

While strengthening the regulation and improving the resolvability of banking firms is of paramount importance, we should not forget that one of the key elements of the recent financial crisis was the precipitous unwinding of large amounts of short-term wholesale funding that had been made available to highly leveraged and maturity-transforming financial firms, many of which were clearly outside of the traditional banking sector. Nonbank financial intermediaries can provide substantial benefits to an economy, but a complete financial reform program must address financial stability risks that emanate from the shadow banking system. Particularly as we tighten the oversight of the regulated banking system, it will become more and more essential that we are able to monitor and constrain the build-up of systemic risks in the nonbank financial sector.

Among other things, financial stability depends on strong consolidated supervision and regulation of all financial firms whose failure could pose a threat to the financial system – whether or not they own a bank. One of the key lessons of the financial crisis was the prodigious amount of systemic risk that was concentrated in several nonbank financial firms. To mitigate these risks, the Dodd-Frank Act gave the Council authority to bring systemically important financial firms that are not already bank holding companies within the perimeter of Federal Reserve supervision and regulation. Last month, the Council made three proposed designations of nonbank financial firms, and earlier this week the Council made final designations of two of these firms. The Federal Reserve already supervises these two firms as savings and loan holding companies and we will now begin the process of applying relevant enhanced prudential regulatory and supervisory standards. We remain committed to applying a supervisory and regulatory framework to such firms that is tailored to their business mix, risk profile, and systemic footprint – consistent with the Collins Amendment and other legal requirements under the Dodd-Frank Act.

The threats to financial stability from the shadow banking system do not reside solely in a few individual nonbank financial firms with large systemic footprints. Significant threats to financial stability emanate from systemic classes of nonbank financial firms and from vulnerabilities intrinsic to short-term wholesale funding markets. Many of the key problems related to shadow banking and their potential solutions are still being debated domestically and internationally, but some of the necessary steps are already clear.

First, we need to increase the transparency of shadow banking markets so that authorities can monitor for signs of excessive leverage and unstable maturity transformation outside regulated banks. Since the financial crisis, the ability of the Federal Reserve and other regulators to track the types of transactions that are core to shadow banking activities has improved markedly. But there remain several areas, notably involving transactions organized around an exchange of cash and securities, where gaps still exist. For example, many repurchase agreements and securities lending transactions can still only be monitored indirectly. Improved reporting in these areas would better enable regulators to detect emerging risks in the financial system.

Second, we need to reduce further the risk of runs on money market mutual funds. Late last year, the Council issued a proposed recommendation on this subject that offered three reform options. Last month, the SEC issued a proposal that includes a form of the floating net asset value (NAV) option recommended by the Council.

Third, we need to be sure that initiatives to enhance the resilience of the triparty repo market are successfully completed. These marketwide efforts have been underway for some time and have already reduced discretionary intraday credit extended by the clearing banks by approximately 25 percent. Market participants, with the active encouragement of the Federal Reserve and other supervisors, are on track to achieve the practical elimination of all such intraday credit in the triparty settlement process by the end of 2014.

Completing these three reforms would represent a strong start to the job of reducing systemic risk in the short-term wholesale funding markets that are key to the functioning of securities markets. Still, important work would remain. For example, a major source of unaddressed risk emanates from the large volume of short-term securities financing transactions (SFTs) in our financial system, including repos, reverse repos, securities borrowing, and lending transactions. Regulatory reform has mostly passed over these transactions because SFTs appear to involve minimal risks from a microprudential perspective. But SFTs, particularly large matched books of SFTs, create sizable macroprudential risks, including vulnerabilities to runs and asset fire sales. Although the Dodd-Frank Act provides additional tools to address the failure of a systemically important broker-dealer, the existing bank and broker-dealer regulatory regimes have not been designed to materially mitigate these systemic risks. Continued attention to these potential vulnerabilities is needed, both here in the United States and abroad.

## Conclusion

As I hope is apparent from this review of progress on the implementation of regulatory reforms, we are at the beginning of the end of the rulemaking process for most of the major Dodd-Frank Act provisions. Some regulations already finalized are now in effect. Others provide a transition period for firms and markets to prepare for the new rules of the road. Still others will be completed in the coming months. With respect to all three sets of regulations, the emphasis will soon be shifting from rule-writing to rule compliance, interpretation, and enforcement. Here, the benchmarks for progress and performance are less visible, at least until something goes wrong. For that reason, it is all the more important that the regulatory agencies put in place institutional mechanisms to assure strong, sensible oversight of the new regulatory framework.

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

List of Rules, Notices, and Reports of the Federal Reserve Board under the Dodd-Frank Act as of July 2, 2013