

## Daniel K Tarullo: Regulatory restructuring

Testimony by Mr Daniel K Tarullo, Member of the Board of Governors of the US Federal Reserve System, before the Committee on Banking, Housing, and Urban Affairs, US Senate, Washington DC, 23 July 2009.

*The original speech, which contains various links to the documents mentioned, can be found on the US Federal Reserve System's website.*

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Chairman Dodd, Ranking Member Shelby, and other members of the Committee, I appreciate the opportunity to discuss how to improve the U.S. financial regulatory system so as to contain systemic risk and to address the related problem of too-big-to-fail financial institutions. Experience over the past two years clearly demonstrates that the United States needs a comprehensive strategy to help prevent financial crises and to mitigate the effects of crises that may occur.

The roots of this crisis lie in part in the fact that regulatory powers and capacities lagged the increasingly tight integration of conventional lending activities with the issuance, trading, and financing of securities. This crisis did not begin with depositor runs on banks, but with investor runs on firms that financed their holdings of securities in the wholesale money markets. An effective agenda for containing systemic risk thus requires adjustments by all our financial regulatory agencies under existing authorities. It also invites action by the Congress to fill existing gaps in regulation, remove impediments to consolidated oversight of complex institutions, and provide the instruments necessary to cope with serious financial problems that do arise.

In keeping with the Committee's interest today in a systemic risk agenda, I will identify some of the key administrative and legislative elements that should be a part of that agenda. Ensuring that all systemically important financial institutions are subject to effective consolidated supervision is a critical first step. Second, a more macroprudential outlook – that is, one that takes into account the safety and soundness of the financial system as a whole, as well as individual institutions – needs to be incorporated into the supervision and regulation of these firms and financial institutions more generally. Third, better and more formal mechanisms should be established to help identify, monitor, and address potential or emerging systemic risks across the financial system as a whole, including gaps in regulatory or supervisory coverage that could present systemic risks. A council with broad representation across agencies and departments concerned with financial supervision and regulation is one approach to this goal. Fourth, a new resolution process for systemically important nonbank financial firms should be created that would allow the government to wind down a troubled systemically important firm in an orderly manner. Fifth, all systemically important payment, clearing, and settlement arrangements should be subject to consistent and robust oversight and prudential standards.

The role of the Federal Reserve in a reoriented financial regulatory system derives, in our view, directly from its position as the nation's central bank. Financial stability is integral to the achievement of maximum employment and price stability, the dual mandate that Congress has conferred on the Federal Reserve as its objectives in the conduct of monetary policy. Indeed, there are some important synergies between systemic risk regulation and monetary policy, as insights garnered from each of those functions informs the performance of the other. Close familiarity with private credit relationships, particularly among the largest financial institutions and through critical payment and settlement systems, makes monetary policy makers better able to anticipate how their actions will affect the economy. Conversely,

the substantial economic analysis that accompanies monetary policy decisions can reveal potential vulnerabilities of financial institutions.

While the improvements in the financial regulatory framework outlined above would involve some expansion of Federal Reserve responsibilities, that expansion would be an incremental and natural extension of the Federal Reserve's existing supervisory and regulatory responsibilities, reflecting the important relationship between financial stability and the roles of a central bank. An effective and comprehensive agenda for addressing systemic risk will also require new responsibilities for other federal agencies and departments, including the Treasury, Securities and Exchange Commission (SEC), Commodity Futures Trading Commission (CFTC), and Federal Deposit Insurance Corporation (FDIC).

### **Consolidated supervision of systemically important financial institutions**

The current financial crisis has clearly demonstrated that risks to the financial system can arise not only in the banking sector, but also from the activities of other financial firms – such as investment banks or insurance organizations – that traditionally have not been subject, either by law or in practice, to the type of regulation and consolidated supervision applicable to bank holding companies. While effective consolidated supervision of potentially systemic firms is not, by itself, sufficient to foster financial stability, it certainly is a necessary condition. The Administration's recent proposal for strengthening the financial system would subject *all* systemically important financial institutions to the same framework for prudential supervision on the same consolidated or group-wide basis that currently applies to bank holding companies. In doing so, it would also prevent systemically important firms that have become bank holding companies during the crisis from reversing this change and escaping prudential supervision in calmer financial times. While this proposal is an important piece of an agenda to contain systemic risk and the too-big-to-fail problem, it would not actually entail a significant expansion of the Federal Reserve's mandate.

The proposal would entail two tasks – first identifying, and then effectively supervising, these systemically important institutions. As to supervision, the Bank Holding Company Act of 1956 (BHCA) designates the Federal Reserve as the consolidated supervisor of all bank holding companies. That act provides the Federal Reserve a range of tools to understand, monitor and, when appropriate, restrain the risks associated with an organization's consolidated or group-wide activities. Under this framework, the Federal Reserve has the authority to establish consolidated capital requirements for bank holding companies. In addition, subject to certain limits I will discuss later, the act permits the Federal Reserve to obtain reports from and conduct examinations of a bank holding company and any of its subsidiaries. It also grants authority to require the organization or its subsidiaries to alter their risk-management practices or take other actions to address risks that threaten the safety and soundness of the organization.

Under the BHCA, the Federal Reserve already supervises some of the largest and most complex financial institutions in the world. In the course of the financial crisis, several large financial firms that previously were not subject to mandatory consolidated supervision – including Goldman Sachs, Morgan Stanley, and American Express – became bank holding companies, in part to assure market participants that they were subject to robust prudential supervision on a consolidated basis. While the number of additional financial institutions that would be subject to supervision under the Administration's approach would of course depend on standards or guidelines adopted by the Congress, the criteria offered by the Administration suggest to us that the initial number of newly regulated firms would probably be relatively limited. One important feature of this approach is that it provides ongoing authority to identify and supervise other firms that may become systemically important in the future, whether through organic growth or the migration of activities from regulated entities.

Determining precisely which firms would meet these criteria will require considerable analysis of the linkages between firms and markets, drawing as much or more on economic and

financial analysis as on bank supervisory expertise. Financial institutions are systemically important if the failure of the firm to meet its obligations to creditors and customers would have significant adverse consequences for the financial system and the broader economy. At any point in time, the systemic importance of an individual firm depends on a wide range of factors. Obviously, the consequences of a firm's failure are more likely to be severe if the firm is large, taking account of both its on- and off-balance sheet activities. But size is far from the only relevant consideration. The impact of a firm's financial distress depends also on the degree to which it is interconnected, either receiving funding from, or providing funding to, other potentially systemically important firms, as well as on whether it performs crucial services that cannot easily or quickly be executed by other financial institutions. In addition, the impact varies over time: the more fragile the overall financial backdrop and the condition of other financial institutions, the more likely a given firm is to be judged systemically important. If the ability of the financial system to absorb adverse shocks is low, the threshold for systemic importance will more easily be reached. Judging whether a financial firm is systemically important is thus not a straightforward task, especially because a determination must be based on an assessment of whether the firm's failure would likely have systemic effects during a *future* stress event, the precise parameters of which cannot be fully known.

For supervision of firms identified as systemically important to be effective, we will need to build on lessons learned from the current crisis and on changes we are already undertaking in light of the broader range of financial firms that have come under our supervision in the last year. In October, we issued new consolidated supervision guidance for bank holding companies that provides for supervisory objectives and actions to be calibrated more directly to the systemic significance of individual institutions and bolsters supervisory expectations with respect to the corporate governance, risk management, and internal controls of the largest, most complex organizations.<sup>1</sup> We are also adapting our internal organization of supervisory activities to take better advantage of the information and insight that the economic and financial analytic capacities of the Federal Reserve can bring to bear in financial regulation.

The recently completed Supervisory Capital Assessment Process (SCAP) reflects some of these changes in the Federal Reserve's system for prudential supervision of the largest banking organizations. This unprecedented process specifically incorporated forward-looking, cross-firm, and aggregate analyses of the 19 largest bank holding companies, which together control a majority of the assets and loans within the financial system. Importantly, supervisors in the SCAP defined a uniform set of parameters to apply to each firm being evaluated, which allowed us to evaluate on a consistent basis the expected performance of the firms, drawing on individual firm information and independently estimated outcomes using supervisory models. Drawing on this experience, we will conduct horizontal examinations on a periodic basis to assess key operations, risks, and risk-management activities of large institutions.

We also plan to create a quantitative surveillance program for large, complex financial organizations that will use supervisory information, firm-specific data analysis, and market-based indicators to identify developing strains and imbalances that may affect multiple institutions, as well as emerging risks to specific firms. Periodic scenario analyses across large firms will enhance our understanding of the potential impact of adverse changes in the operating environment on individual firms and on the system as a whole. This work will be performed by a multi-disciplinary group composed of our economic and market researchers, supervisors, market operations specialists, and accounting and legal experts. This program

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<sup>1</sup> See Supervision and Regulation Letter 08-9, "Consolidated Supervision of Bank Holding Companies and the Combined U.S. Operations of Foreign Banking Organizations," and the associated interagency guidance.

will be distinct from the activities of on-site examination teams so as to provide an independent supervisory perspective, as well as to complement the work of those teams.

To be fully effective, consolidated supervisors must have clear authority to monitor and address safety and soundness concerns and systemic risks in all parts of an organization, working in coordination with other supervisors wherever possible. As the crisis has demonstrated, the assessment of nonbank activities is essential to understanding the linkages between depository and nondepository subsidiaries and the risk-profile of the organization as a whole. The Administration's proposal would make useful modifications to the provisions added to the law in 1999 that limit the ability of the Federal Reserve to monitor and address risks within an organization and its subsidiaries on a group-wide basis.<sup>2</sup>

### **A macroprudential approach to supervision and regulation**

The existing framework for the regulation and supervision of banking organizations is focused primarily on the safety and soundness of individual organizations, particularly their insured depository institutions. As the Administration's proposal recognizes, the resiliency of the financial system could be improved by incorporating a more explicit macroprudential approach to supervision and regulation. A macroprudential outlook, which considers interlinkages and interdependencies among firms and markets that could threaten the financial system in a crisis, complements the current microprudential orientation of bank supervision and regulation.

Indeed, a more macroprudential focus is essential in light of the potential for explicit regulatory identification of systemically important firms to exacerbate the "too big to fail" problem. Unless countervailing steps are taken, the belief by market participants that a particular firm is too big to fail, and that shareholders and creditors of the firm may be partially or fully protected from the consequences of a failure, has many undesirable effects. It materially weakens the incentive of shareholders and creditors of the firm to restrain the firm's risk-taking, provides incentives for financial firms to become very large in order to be perceived as too big to fail, and creates an unlevel competitive playing field with smaller firms that may not be regarded as having implicit government support.

Creation of a mechanism for the orderly resolution of systemically important nonbank financial firms, which I will discuss later, should help remediate this problem. In addition, capital, liquidity, and risk-management requirements for systemically important firms will need to be strengthened to help counteract moral hazard effects, as well as the greater potential risks these institutions pose to the financial system and to the economy. We believe that the agency responsible for supervision of these institutions should have the authority to adopt and apply such requirements, and thus have clear accountability for their efficacy. Optimally, these requirements should be calibrated based on the relative systemic importance of the institution, a different measure than a firm's direct credit and other risk exposures as calculated in traditional capital or liquidity regulation.

It may also be beneficial for supervisors to require that systemically important firms maintain specific forms of capital so as to increase their ability to absorb losses outside of a bankruptcy or formal resolution procedure. Such capital could be in contingent form, converting to common equity only when necessary to mitigate systemic risk. A macroprudential approach also should be reflected in regulatory capital standards more

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<sup>2</sup> The Administration's proposal also would close the loophole in current law that allowed certain investment banks, as well as other financial and nonfinancial firms, to acquire control of a federally insured industrial loan company (ILC) while avoiding the prudential framework that Congress established for the corporate owners of other full-service insured banks. The Board has for many years supported such a change.

generally, so that banks are required to increase their capital levels in good times in order to create a buffer that can be drawn down as economic and financial conditions deteriorate.

The development and implementation of capital standards for systemically important firms is but one of many elements of an effective macroprudential approach to financial regulation. Direct and indirect exposures among systemically important firms are an obvious source of interdependency and potential systemic risk. Direct credit exposures may arise from lending, loan commitments, guarantees, or derivative counterparty relationships among institutions. Indirect exposures may arise through exposures to a common risk factor, such as the real estate market, that could stress the system by causing losses to many firms at the same time, through common dependence on potentially unstable sources of short-term funding, or through common participation in payment, clearing, or settlement systems.

While large, correlated exposures have always been an important source of risk and an area of focus for supervisors, macroprudential supervision requires special attention to the interdependencies among systemically important firms that arise from common exposures. Similarly, there must be monitoring of exposures that could grow significantly in times of system-wide financial stress, such as those arising from OTC derivatives or the sponsorship of off-balance-sheet financing conduits funded by short-term liabilities that are susceptible to runs. One tool that would be useful in identifying such exposures would be the cross-firm horizontal reviews that I discussed earlier, enhanced to focus on the collective effects of market stresses.

The Federal Reserve also would expect to carefully monitor and address, either individually or in conjunction with other supervisors and regulators, the potential for additional spillover effects. Spillovers may occur not only due to exposures currently on a firm's books, but also as a result of reactions to stress elsewhere in the system, including at other systemically important firms or in key markets. For example, the failure of one firm may lead to deposit or liability runs at other firms that are seen by investors as similarly situated or that have exposures to such firms. In the recent financial crisis, exactly this sort of spillover resulted from the failure of Lehman Brothers, which led to heightened pressures on other investment banks. One tool that could be helpful in evaluating spillover risks would be multiple-firm or system-level stress tests focused particularly on such risks. However, this type of test would greatly exceed the SCAP in operational complexity; thus, properly developing and implementing such a test would be a substantial challenge.

### **Potential role of a council**

The breadth and heterogeneity of the U.S. financial system have been great economic strengths of our country. However, these same characteristics mean that common exposures or practices across a wide range of financial markets and financial institutions may over time pose risks to financial stability, but may be difficult to identify in their early stages. Moreover, addressing the pervasive problem of pro-cyclicality in the financial system will require efforts across financial sectors. To help address these issues, the Administration has proposed the establishment of a Financial Services Oversight Council composed of the Treasury and all of the federal financial supervisory and regulatory agencies, including the Federal Reserve.

The Board sees substantial merit in the establishment of a council to conduct macroprudential analysis and coordinate oversight of the financial system as a whole. The perspective of, and information from, supervisors on such a council with different primary responsibilities would be helpful in identifying and monitoring emerging systemic risks across the full range of financial institutions and markets. A council could be charged with identifying emerging sources of systemic risk, including: large and rising exposures across firms and markets; emerging trends in leverage or activities that could result in increased systemic fragility; possible misalignments in asset markets; potential sources of spillovers between financial firms or between firms and markets that could propagate, or even magnify, financial shocks; and new markets, practices, products, or institutions that may fall through the gaps in

regulatory coverage and become threats to systemic stability. In addition, a council could play a useful role in coordinating responses by member agencies to mitigate emerging systemic risks identified by the council, and by helping coordinate actions to address procyclicality in capital regulations, accounting standards (particularly with regard to reserves), deposit insurance premiums, and other supervisory and regulatory practices. In light of these responsibilities and its broad membership, a council also would be a useful forum for identifying financial firms that are at the cusp of being systemically important and, when appropriate, recommending such firms for designation as systemically important. Finally, should Congress choose to create default authority for regulation of activities that do not fall under the jurisdiction of any existing financial regulator, the council would seem the appropriate instrumentality to determine how the expanded jurisdiction should be exercised.

A council could be tasked with gathering and evaluating information from the various supervisory agencies and producing an annual report to the Congress on the state of the financial system, potential threats to financial stability, and the responses of member agencies to identified threats. Such a report could include recommendations for statutory changes where needed to address systemic threats due to, for example, growth or changes in unregulated sectors of the financial system. More generally, a council could promote research and other efforts to enhance understanding, both nationally and internationally, of the underlying causes of financial instability and systemic risk and possible approaches to countering such developments.

To fulfill such responsibilities, a council would need access to a broad range of information from its member financial supervisors regarding the institutions and markets under their purview, as well as from other government agencies. Where the information necessary to monitor emerging risks was not available from a member agency, a council likely would need the authority to collect such information directly from financial institutions and markets.<sup>3</sup>

### **Improved resolution process**

A key element to addressing systemic risk is the creation of a new regime that would allow the orderly resolution of systemically important nonbank financial firms. In most cases, the federal bankruptcy laws provide an appropriate framework for the resolution of nonbank financial institutions. However, the bankruptcy code does not sufficiently protect the public's strong interest in ensuring the orderly resolution of a nonbank financial firm whose failure would pose substantial risks to the financial system and to the economy. Indeed, after the Lehman and AIG experiences, there is little doubt that there needs to be a third option between the choices of bankruptcy and bailout.

The Administration's proposal would create such an option by allowing the Treasury to appoint a conservator or receiver for a systemically important nonbank financial institution that has failed or is in danger of failing. The conservator or receiver would have a variety of authorities – similar to those provided the FDIC with respect to failing insured banks – to stabilize and either rehabilitate or wind down the firm in a way that mitigates risks to financial stability and to the economy. For example, the conservator or receiver would have the ability to take control of the management and operations of the failing firm; sell assets, liabilities, and business units of the firm; and repudiate contracts of the firm. These are appropriate tools for a conservator or receiver. However, Congress may wish to consider adding some constraints as well – such as requiring that shareholders bear losses and that creditors be entitled to at least the liquidation value of their claims.

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<sup>3</sup> To facilitate information collections and interagency sharing, a council should have the clear authority for protecting confidential information subject, of course, to applicable law, including the Freedom of Information Act.

Importantly, the proposal would allow the government, through a receivership, to impose "haircuts" on creditors and shareholders of the firm, either directly or by "bridging" the failing institution to a new entity, when consistent with the overarching goal of protecting the financial system and the broader economy. This aspect of the proposal is critical to addressing the too-big-to-fail problem and the resulting moral hazard effects that I discussed earlier.

The Administration's proposal appropriately would establish a high standard for invocation of this new resolution regime and would create checks and balances on its potential use, similar to the provisions governing use of the systemic risk exception to least-cost resolution in the Federal Deposit Insurance Act (FDI Act). The Federal Reserve's participation in this decisionmaking process would be an extension of our long-standing role in protecting financial stability, involvement in the current process for invoking the systemic risk exception under the FDI Act, and status as consolidated supervisor for large banking organizations. The Federal Reserve, however, is not well suited, nor do we seek, to serve as the resolution agency for systemically important institutions under the new framework.

As we have seen during the recent crisis, a substantial commitment of public funds may be needed, at least on a temporary basis, to stabilize and facilitate the orderly resolution of a large, highly interconnected financial firm. The Administration's proposal provides for such funding needs to be addressed by the Treasury, with the ultimate costs of any assistance to be recouped through assessments on financial firms over an extended period of time. We believe the Treasury is the appropriate source of funding for the resolution of systemically important financial institutions, given the unpredictable and inherently fiscal nature of this function. The availability of such funding from Treasury also would eliminate the need for the Federal Reserve to use its emergency lending authority under section 13(3) of the Federal Reserve Act to prevent the failure of specific institutions.

### **Payment, clearing, and settlement arrangements**

The current regulatory and supervisory framework for systemically important payment, clearing, and settlement arrangements is fragmented, with no single agency having the ability to ensure that all systemically important arrangements are held to consistent and strong prudential standards. The Administration's proposal would provide the Federal Reserve certain additional authorities for ensuring that all systemically important payment, clearing, and settlement arrangements are subject to robust standards for safety and soundness.

Payment, settlement, and clearing arrangements are the foundation of the nation's financial infrastructure. These arrangements include centralized market utilities for clearing and settling payments, securities, and derivatives transactions, as well as decentralized activities through which financial institutions clear and settle such transactions bilaterally. While payment, clearing, and settlement arrangements can create significant efficiencies and promote transparency in the financial markets, they also may concentrate substantial credit, liquidity, and operational risks. Many of these arrangements also have direct and indirect financial or operational linkages and, absent strong risk controls, can themselves be a source of contagion in times of stress. Thus, it is critical that systemically important systems and activities be subject to strong and consistent prudential standards designed to ensure the identification and sound management of credit, liquidity, and operational risks.

The proposed authority would build on the considerable experience of the Federal Reserve in overseeing systemically important payment, clearing, and settlement arrangements for prudential purposes. Over the years, the Federal Reserve has worked extensively with domestic and foreign regulators to develop strong and internationally recognized standards for critical systems. Further, the Federal Reserve already has direct supervisory responsibility for some of the largest and most critical systems in the United States, including the Depository Trust Company and CLS Bank and has a role in overseeing several other

systemically important systems. Yet, at present, this authority depends to a considerable extent on the specific organizational form of these systems as state member banks. The safe and efficient operation of payment, settlement, and clearing systems is critical to the execution of monetary policy and the flow of liquidity throughout the financial sector, which is why many central banks around the world currently have explicit oversight responsibilities for critical systems.

Importantly, the proposed enhancements to our responsibilities for the safety and soundness of systemically important arrangements would complement – and not displace – the authority of the SEC and CFTC for the systems subject to their supervision under the federal securities and commodities laws. We have an extensive history of working cooperatively with these agencies, as well as international authorities. For example, the Federal Reserve works closely with the SEC in supervising the Depository Trust Company and also works closely with 21 other central banks in supervising the foreign exchange settlements of CLS Bank.

### **Consumer protection**

A word on the consumer protection piece of the Administration's plan may be appropriate here, insofar as we have seen how problems in consumer protection can in some cases contain the seeds of systemic problems. The Administration proposes to shift responsibility for writing and enforcing regulations to protect consumers from unfair practices in financial transactions from the Federal Reserve to a new Consumer Financial Protection Agency. Without extensively entering the debate on the relative merits of this proposal, I do think it important to point out some of the benefits that would be lost through this change.

Both the substance of consumer protection rules and their enforcement are complementary to prudential supervision. Poorly designed financial products and misaligned incentives can at once harm consumers and undermine financial institutions. Indeed, as with subprime mortgages and securities backed by these mortgages, these products may at times also be connected to systemic risk. At the same time, a determination of how to regulate financial practices both effectively and efficiently can be facilitated by the understanding of institutions' practices and systems that is gained through safety and soundness regulation and supervision. Similarly, risk assessment and compliance monitoring of consumer and prudential regulations are closely related, and thus entail both informational advantages and resource savings.

Under Chairman Bernanke's leadership, the Federal Reserve has adopted strong consumer protection measures in the mortgage and credit card areas. These regulations benefited from the supervisory and research capabilities of the Federal Reserve, including expertise in consumer credit markets, retail payments, banking operations, and economic analysis. Involving all these forms of expertise is important for tailoring rules that prevent abuses while not impeding the availability of sensible extensions of credit.

### **Conclusion**

Thank you again for the opportunity to testify on these important matters. The Federal Reserve looks forward to working with Congress and the Administration to enact meaningful regulatory reform that will strengthen the financial system and reduce both the probability and severity of future crises.