

Daniel K Tarullo: Regulatory reform

Testimony of Mr Daniel K Tarullo, Member of the Board of Governors of the US Federal Reserve System, before the Committee on Financial Services, US House of Representatives, Washington DC, 29 October 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 Frank, Ranking Member Bachus, and other members of the Committee, thank you for the invitation to testify this morning on systemic regulation, prudential matters, resolution authority, and securitization. The financial crisis was the product of many factors, including the tight integration of lending activities with the issuance, trading, and financing of securities; gaps in the financial regulatory structure; widespread failures of risk management across a range of financial institutions; and, to be sure, significant shortcomings in financial supervision. More fundamentally, though, it demonstrated that the regulatory framework had not kept pace with far-reaching changes in the financial sector, and the concomitant growth of new sources of risk to both individual institutions and the financial system as a whole.

Because the roots of the crisis reached so deeply into the very nature of the financial system, a broad program of reform is required. Much can be, and needs to be, done by supervisors – under their existing statutory authorities – to contain systemic risk generally and the too-big-to-fail problem in particular. As the discussion draft released by Chairman Frank recognizes, there is also a clear need for the Congress to provide significant additional authority and direction to the regulatory agencies.

Essential elements of this legislative agenda include: ensuring that all financial institutions that may pose significant risk to the financial system are subject to robust consolidated supervision; establishing a systemic risk oversight council to identify, and coordinate responses to, emerging risks to financial stability; directing all financial supervisors to take account of risks to the broader financial system as part of their normal oversight responsibilities; establishing a new special resolution process that allows the government to wind down in an orderly way a failing financial institution that threatens the entire financial system while also creating a credible process for imposing losses on the firm's shareholders and creditors and assuring that the financial industry, not taxpayers, ultimately bears any additional costs associated with the resolution process; providing for consistent and robust prudential supervision of key payment, clearing, and settlement arrangements; and addressing weaknesses in the securitization process that came to light during the crisis.

Chairman Frank's discussion draft addresses each of these areas and, in the Board's view, provides a strong framework for achieving a safer, more stable financial system. In addition to addressing these areas for legislative change, I will discuss some of the actions the Federal Reserve and our supervisory colleagues are taking under existing authorities to strengthen the supervision and regulation of financial institutions – particularly large, complex institutions – and to prevent regulatory arbitrage.

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 large, interconnected financial firms – such as investment banks and insurance companies – that traditionally have not been subject to the type of mandatory prudential regulation and consolidated supervision

applicable to bank holding companies. Chairman Frank's discussion draft would close this important gap in our regulatory structure by providing for all financial institutions that may pose significant risks to the financial system to be subject to the framework for consolidated prudential supervision that currently applies to bank holding companies. As I will discuss shortly, it also provides for these firms to be subject to enhanced standards, reflective of the risk they pose to the financial system. These provisions should prevent financial firms that do not own a bank – but that nonetheless pose risks to the overall financial system because of the size, risks, or interconnectedness of their financial activities – from avoiding comprehensive supervisory oversight.

In one sense, a requirement that all systemically important firms be subject to prudential supervision would not lead to a major change in our regulatory system. During the financial crisis, a number of very large financial firms became bank holding companies. Thus, the Federal Reserve has already become the consolidated supervisor of most of the nation's large, interconnected financial institutions. Yet a critical part of a reform agenda directed at systemic risk and the too-big-to-fail problem is ensuring that *other* financial firms that may pose a systemic threat also are subject to robust consolidated supervision. Such a measure would allow the regulatory system to adapt if activities migrate from supervised institutions to other firms, leading those firms to become very large and interconnected, or in response to other developments in the financial system. Moreover, such a provision would serve as a kind of insurance policy against the possibility of a firm that opted for the benefits of being a bank holding company during the financial crisis deciding to exit that status during calmer times.

The discussion draft also would require the development of enhanced regulation and supervision, including robust capital, liquidity, and risk-management requirements, to address and mitigate systemic risks. Enhanced requirements, particularly for large, interconnected firms, are needed not only to protect the stability of individual institutions and the financial system as a whole, but also to counteract any incentive for financial firms to become very large in order to be perceived as too big to fail. This perception can materially weaken what should be the normal market incentive of creditors to monitor the firm's risk-taking and appropriately price these risks in their transactions with the firm. When this incentive is weakened, moral hazard increases, allowing the firm to raise funds at a price that may not fully reflect the firm's risk profile. As a result, the firm is likely to choose a level of risk that is excessive both for itself and, potentially, for society at large. Moreover, this distortion creates a playing field that is tilted against smaller firms not perceived as having the same degree of government support. Development of a mechanism for the orderly resolution of nonbank financial firms that threaten financial stability, which I will discuss later, is an important additional tool for addressing the too-big-to-fail problem.

The discussion draft would reinforce the changes in supervision already under way at the Federal Reserve and the other banking agencies. As already announced, we have strengthened capital requirements for trading activities and securitization exposures. We continue to work with other regulators to strengthen the capital requirements for other types of on- and off-balance-sheet exposures and to improve the quality of capital overall.¹

Beyond these generally applicable capital requirements, we must develop capital standards and other supervisory tools addressed specifically to the systemic risks of large, interconnected firms. One possible approach is a special charge – possibly a special capital requirement – that would adjust based on the risks posed by the firm to the financial system. Ideally, this requirement would be calibrated to become more stringent as the firm's systemic risks increase, although developing a metric for such a requirement would be highly

¹ See Bank for International Settlements (2009), "Basel II Capital Framework Enhancements Announced by the Basel Committee," press release, July 13; and Basel Committee on Banking Supervision (2009), *Enhancements to the Basel II Framework* (Basel, Switzerland: Basel Committee, July).

challenging. Another potentially promising option is to require that selected financial institutions issue specified amounts of contingent capital. Such capital could take the form of debt instruments that convert to common equity during times of macroeconomic stress or when losses erode the institution's capital base. Such instruments would pre-position capital on the balance sheets of each of these institutions, ready to be converted into the form that provides the best loss-absorption capacity precisely when that capacity is most needed. And, if well devised, it would inject an additional element of market discipline into large financial firms, because the price of those instruments would reflect market perceptions of the stability of the firm.

The financial crisis also highlighted weaknesses in liquidity risk management at major financial institutions, including an overreliance on short-term funding. To address these issues, the Federal Reserve helped lead the development of revised international principles for sound liquidity risk management, which have been incorporated into new interagency guidance now out for public comment.² Together with our U.S. and international counterparts, we are also considering quantitative standards for liquidity exposures similar to those for capital adequacy, with the goal of ensuring that internationally active firms can fund themselves even during periods of severe market instability. With supervisory encouragement, large banking organizations have, for the most part, already significantly increased their liquidity buffers and are strengthening their management of liquidity risks.

Beyond modifying applicable rules and standards, the Federal Reserve is revamping its approach toward supervising the largest financial institutions. In doing so, we have drawn on our experience earlier this year in conducting the special Supervisory Capital Assessment Program (SCAP), which involved forward-looking, cross-firm, aggregate analyses of 19 of the largest bank holding companies. While the SCAP itself was an extraordinary exercise for an extraordinary time, we are incorporating into our ongoing supervisory process the essential SCAP approach of bringing firm-specific assessments of on-site examiners together with systematic analyses of industry experience, economic trends, and possible stress scenarios. Thus, we have increased our emphasis on horizontal examinations, which focus on particular risks or activities across a group of banking organizations, and we have broadened the scope of the resources we bring to bear on these reviews.

For example, we currently are conducting a horizontal assessment of internal processes for evaluating capital adequacy at the largest U.S. banking organizations, focusing in particular on how shortcomings in fundamental risk management and governance for these processes could impair firms' abilities to estimate capital needs. This exercise is central to the goal of having each firm maintain adequate capital to provide a buffer against possible losses associated with its particular set of activities and exposures. Using findings from these reviews, we will work with firms over the next year to bring their processes into line with supervisory expectations. Supervisors will use the information provided by firms about their processes as one factor in the assessment of the adequacy of firms' overall capital levels. For instance, if a firm cannot demonstrate a strong ability to estimate capital needs, then supervisors will place less credence on the firm's own internal capital evaluation and may demand higher capital cushions, among other things.

As part of this overall approach to large institution supervision, we are creating an enhanced quantitative surveillance program for large, complex organizations that would use supervisory information, firm-specific data analysis, and market-based indicators in an effort

² See Basel Committee on Banking Supervision (2008), *Principles for Sound Liquidity Risk Management and Supervision* (Basel: Basel Committee, September). Information about the proposed guidance is available at Board of Governors of the Federal Reserve System, Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, Office of Thrift Supervision, and National Credit Union Administration (2009), "Agencies Seek Comment on Proposed Interagency Guidance on Funding and Liquidity Risk Management", joint press release, June 30.

to identify emerging risks to specific firms as well as to the industry as a whole. This work will be performed by a multidisciplinary group composed of our economic and market researchers, supervisors, market operations specialists, and other experts within the Federal Reserve System. In addition, periodic scenario analysis will be used to enhance our understanding of the consequences of changes in the economic environment for both individual firms and for the broader system. Finally, to support and complement these initiatives, we are working with the other federal banking agencies to develop more-comprehensive and more-frequent information-reporting requirements for the largest firms.

The crisis also has highlighted the potential for compensation practices at financial institutions to encourage excessive risk-taking and unsafe and unsound behavior – not just by senior executives, but also by other managers or employees who have the ability, individually or collectively, to materially alter the risk profile of the institution. Bonuses and other compensation arrangements should not provide incentives for employees at any level to behave in ways that imprudently increase risks to the institution, and potentially to the financial system as a whole.

Last week, the Federal Reserve issued proposed guidance on incentive compensation practices to promote the prompt improvement of incentive compensation practices throughout the banking industry.³ This guidance, which is consistent with the international principles and standards issued by the Financial Stability Board earlier this year, will be supplemented by supervisory initiatives to spur and monitor the industry's progress toward the implementation of safe and sound incentive compensation arrangements, identify emerging best practices, and advance the state of practice more generally in the industry.⁴ One of these initiatives involves a special horizontal review of incentive compensation practices at 28 large, complex banking organizations under the Federal Reserve's supervision.

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, large firms increasingly operate and manage their businesses on an integrated, firmwide basis, with little regard for the corporate or national boundaries that define the jurisdictions of individual functional supervisors, and stresses at one subsidiary can rapidly spread within the consolidated organization. A consolidated supervisor thus needs the ability to understand and address risks that may affect the risk profile of the organization as a whole, whether those risks arise from one subsidiary or from the linkages between depository institutions and nondepository affiliates. Chairman Frank's proposal would make useful modifications to the provisions added to the law by the Gramm-Leach-Bliley Act in 1999 that limit the ability of a consolidated supervisor to monitor and address risks within an organization and its subsidiaries on a groupwide basis.

Systemic risk oversight

For purposes of both effectiveness and accountability, the consolidated supervision of an individual firm, whether or not it is systemically important, is best vested with a single agency. However, the broader task of monitoring and identifying systemic risks that might arise from the interaction of different types of financial institutions and markets – both regulated and

³ See Board of Governors of the Federal Reserve System (2009), "Federal Reserve Issues Proposed Guidance on Incentive Compensation," press release, October 22.

⁴ See Financial Stability Forum (2009), *FSF Principles for Sound Compensation Practices*, April, available on the Financial Stability Board's website. (The Financial Stability Forum has subsequently been renamed the Financial Stability Board.) Also see Financial Stability Board (2009), *FSB Principles for Sound Compensation Practices: Implementation Standards*, September.

unregulated – may exceed the capacity of any individual supervisor. Instead, we should seek to marshal the collective expertise and information of all financial supervisors to identify and respond to developments that threaten the stability of the system as a whole.

The discussion draft released by Chairman Frank would advance this objective in two important ways. First, it would establish an oversight council – composed of representatives of the agencies and departments involved in the oversight of the financial sector – that would be responsible for monitoring and identifying emerging systemic risks across the full range of financial institutions and markets. In addition, the council would have the ability to coordinate responses by member agencies to mitigate identified threats to financial stability. And, importantly, the oversight council would have the authority to recommend that its member agencies, either individually or collectively, adopt heightened prudential standards for the firms under the agencies' supervision in order to mitigate potential systemic risks. Examples of such risks could include rising and correlated risk exposures across firms and markets; significant increases in leverage that could result in systemic fragility; and gaps in regulatory coverage that arise in the course of financial change and innovation, including the development of new practices, products, and institutions. The council also would identify those financial firms that should be subjected to enhanced prudential standards and supervision on a consolidated basis.⁵

Second, the discussion draft would reinforce the authority of individual financial agencies to take macroprudential considerations into account in exercising their supervisory and regulatory functions. A macroprudential outlook, which considers interlinkages and interdependencies among firms and markets that could threaten the financial system in a crisis, provides an important complement to the current microprudential focus of financial supervision and regulation. Each supervisor's participation in the oversight council would greatly strengthen that supervisor's ability to see and understand threats to financial stability and craft appropriate responses for the institutions and markets under their supervision.

The Federal Reserve already has begun to incorporate a systemically focused approach into our supervision of large, interconnected firms. Doing so requires that we go beyond considering each institution in isolation and pay careful attention to interlinkages and interdependencies among firms and markets that could threaten the financial system in a crisis. For example, the failure of one firm may lead to runs by wholesale funders of other firms that are seen by investors as similarly situated or that have exposures to the failing firm. These efforts are reflected, for example, in the expansion of horizontal reviews and the quantitative surveillance program I discussed earlier.

Improved resolution process

Another critical element of an agenda to contain systemic risk is the creation of a new regime that would allow financial firms to fail without posing risks to the broader financial system or the economy. 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 Brothers and AIG experiences, there is little doubt that we need an alternative to the existing options of bankruptcy and bailout for such firms.

⁵ To fulfill these responsibilities, the discussion draft would provide the council access to a broad range of information from its member agencies regarding the institutions and markets that the agencies supervise and, when the necessary information is not available through that source, the authority to collect such information directly from financial institutions and markets.

The discussion draft released by Chairman Frank would provide the government with important new tools to restructure or wind down a failing firm in a way that passes on losses to shareholders and creditors of the firm while mitigating the risks to financial stability and the economy. For example, it would allow the government to sell assets, liabilities, and business units of the firm; transfer the systemically significant operations of the firm to a new bridge entity that can continue these operations with minimal disruptions; and repudiate contracts of the firm, subject to appropriate recompense.

This proposal would not guarantee the survival of any financial firm, nor is it designed to aid shareholders or creditors of a failing firm. To the contrary, the proposal would establish the expectation that shareholders and creditors of the firm will bear losses as a result of the firm's failure. And any assistance provided in the course of the resolution process to prevent severe disruptions to the financial system would be repaid by the firm or the financial services industry. Establishing credible processes for imposing losses on the shareholders and creditors of a failing firm is essential to restoring a meaningful degree of market discipline and addressing the too-big-to-fail problem. Indeed, restoring discipline through changes directed at the behavior of investors and counterparties would be an important complement to the regulatory and supervisory changes that I discussed earlier, which seek to address the too-big-to-fail problem through actions directed at the firms themselves.

Financial firms of any size should be resolved under the bankruptcy code whenever possible. Thus, this new regime should serve only as an alternative to the bankruptcy code, available when needed to address systemic concerns, and its use should be subject to high standards and checks and balances. The discussion draft would allow the new regime to be invoked with respect to a particular firm only with the approval of multiple agencies, and only upon a determination that the firm's failure and resolution under the bankruptcy code or otherwise applicable law would have serious adverse effects on financial stability and the U.S. economy. These standards, which are similar to those governing the use of the systemic risk exception to least-cost resolution in the Federal Deposit Insurance Act, appear appropriate and should help ensure that these new powers are invoked only when circumstances dictate their use.

The discussion draft provides that the ultimate costs of any assistance needed to facilitate the orderly resolution of a large, highly interconnected financial firm be recouped through the sale or dissolution of the troubled firm, supplemented by assessments on financial firms over an extended period of time if necessary. We believe this approach provides a path to resolution for financial firms in a way that both mitigates risk to the financial system and protects taxpayers. The availability of a workable resolution regime with appropriate funding 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 disorderly failure of specific failing institutions.

It is important, however, that the Federal Reserve, as the nation's central bank, retain our long-standing authority to address broader liquidity needs within the financial system under section 13(3) when necessary to maintain financial stability. During the recent crisis, our ability to establish broad-based liquidity facilities proved critical in containing the severe pressures that threatened the financial system as a whole and in reopening key financial markets. We used this authority only when the need for action was evident to both the Federal Reserve and the Treasury, a practice that could be formalized by the Congress.

Payment, clearing, and settlement arrangements

As I mentioned at the outset, in revising the financial regulatory system, we must look beyond the causes of the current crisis and seek to address areas of *potential* systemic risk in the future. Such areas include critical payment, clearing, and settlement arrangements, which 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 the decentralized activities through which financial institutions clear and settle such transactions bilaterally. While these arrangements can create significant efficiencies and promote transparency in the financial markets, they also may concentrate substantial credit, liquidity, and operational risks. In addition, many of these arrangements 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 payment, clearing, and settlement 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.

Unfortunately, the current regulatory and supervisory framework for systemically important payment, clearing, and settlement arrangements is fragmented, creating the potential for inconsistent standards to be adopted or applied. In light of the increasing integration of global financial markets, it is important that these arrangements be viewed from a systemwide perspective, and that they be subject to strong and consistent prudential standards and supervisory oversight.

The Federal Reserve has direct supervisory responsibility for some of the largest and most critical systems in the United States and has a role in overseeing several other systemically important systems. But a coherent framework for supervision of these systems does not exist, and our current authority depends to a considerable extent on the specific organizational form of these systems. Chairman Frank's discussion draft would provide the Federal Reserve with additional authorities to ensure that appropriate standards and oversight are applied to systemically important payment, clearing, and settlement arrangements.

Improving the securitization process

The financial crisis revealed a number of significant shortcomings in the securitization process that contributed importantly to the stresses experienced by the markets as well as to the outsized losses some firms faced once markets began to deteriorate. The ability of brokers and lenders to readily securitize and sell to third parties loans that they were making, regardless of their risks, contributed to the overall decline in underwriting standards in the years leading up to the crisis. Moreover, capital requirements failed to provide adequate incentives for firms to maintain capital and liquidity buffers sufficient to absorb extreme systemwide shocks without taking actions that could tend to amplify the effects of the shocks. In addition, institutional investors of all sorts – including financial institutions, pension funds, and overseas investors – put excessive reliance on the rating agencies' assessment of the risks associated with a range of structured products. In part, investors' reliance on ratings reflected the lack of transparency of many structured products, which made independent assessments of risk difficult. However, it subsequently became clear that the rating agencies had not themselves understood the extent of the risks associated with complex structured instruments, particularly those related to subprime mortgages. Once those risks were realized, the ratings of many of these securities were downgraded sharply, with investors taking very large and unexpected losses.

Addressing these weaknesses will require action on several fronts. As I noted earlier, the Basel Committee has announced improvements to bank capital standards for securitization-related exposures, thereby better aligning these standards with the risks presented by securitizations. Improved transparency regarding the individual loans backing a securitization, as well as regarding the originators of such loans, also is needed to reduce the opacity that has impeded effective discipline in the market for asset-backed securities (ABS) and encouraged undue reliance on credit rating agencies. Chairman Frank's discussion draft would advance this goal by authorizing the Securities and Exchange Commission (SEC) to

develop enhanced disclosure requirements for ABS, including loan-level information and information identifying the originators or brokers of the underlying loans.⁶ Using authority granted by the Congress in 2006, the SEC already has adopted or proposed several rules to improve the transparency, quality, and integrity of the credit rating process for securitizations and other structured finance products.⁷

Requiring that originators or securitizers of loans packaged for securitization retain some exposure to the credit risk associated with the loans also could help restore confidence in the securitization market and encourage the application of sound underwriting criteria to all loans, including those intended for securitization. The details of such a requirement are probably best left to rulemaking by the implementing agencies. Complexities are created by the broad range of assets that are, or may be, securitized, as well as by the different approaches that may be taken to securitization. A credit exposure retention requirement may thus need to be implemented somewhat differently across the full spectrum of securitizations in order to properly align the interests of originators, securitizers, and investors without unduly restricting the availability of credit or threatening the safety and soundness of financial institutions.

Charter conversions and regulatory arbitrage

Finally, I am pleased to note that one potential gap, which I know is of interest to this Committee, already has been addressed by the joint efforts of the banking agencies. The dual banking system and the existence of different federal supervisors create the opportunity for insured depository institutions to change charters or federal supervisors. While institutions may engage in charter conversions for a variety of sound business reasons, conversions that are motivated by hopes of *escaping* current or prospective supervisory actions by the institutions' existing supervisors undermine the efficacy of the prudential supervisory framework.

Accordingly, the Federal Reserve welcomed and immediately supported an initiative led by the Federal Deposit Insurance Corporation to address such regulatory arbitrage. This initiative resulted in a recent statement of the Federal Financial Institutions Examination Council reaffirming that a charter conversion or other action by an insured depository institution that would result in a change in its primary supervisor should occur only for legitimate business and strategic reasons.⁸ Importantly, this statement also provides that conversion requests should *not* be entertained by the proposed new chartering authority or supervisor while serious or material enforcement actions are pending with the institution's current chartering authority or primary federal supervisor. In addition, it provides that the examination rating of an institution and any outstanding corrective action programs should remain in place when a valid conversion or supervisory change does occur.

⁶ Encouraged by the Federal Reserve and others, the American Securitization Forum already has taken important steps along these lines, developing model disclosures for residential mortgage-backed securities that would provide investors standardized loan-level information.

⁷ Increased transparency regarding the pricing of ABS also can support enhanced market discipline by providing investors important signals regarding other market participants' assessments of the quality of individual issues. Along these lines, the Financial Industry Regulatory Authority recently proposed including ABS in its post-trade reporting system, a step that deserves the support of policymakers.

⁸ See Federal Financial Institutions Examination Council (2009), "FFIEC Issues Statement on Regulatory Conversions," press release, July 1.

Conclusion

In closing, let me reiterate the importance of moving ahead with the elements of the administrative and legislative reform agenda that I have discussed. These reforms, taken together, will enhance financial stability, increase market discipline in transactions involving large financial firms, and reduce both the probability and severity of future crises. The Federal Reserve looks forward to continuing work with the Congress and the Administration as the legislative process moves forward.