

## **Daniel K Tarullo: Derivatives regulation**

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, 12 April 2011.

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Chairman Johnson, Ranking Member Shelby, and other members of the Committee, I appreciate this opportunity to provide the Federal Reserve Board's views on the implementation of title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). The Board's responsibilities with respect to over-the-counter (OTC) derivatives fall into three broad areas: consultation and coordination with other authorities, both domestic and international; efforts to strengthen the infrastructure of derivatives markets; and supervision of many derivatives dealers and market participants.

### **Consultation and coordination**

The Dodd-Frank Act requires that the Commodity Futures Trading Commission (CFTC) and the Securities and Exchange Commission (SEC) consult with the Board on the rules they are crafting to implement several provisions of title VII. Immediately after passage of the act, the staff from the commissions and the Board met to fashion a process for this consultation; at the Board, we identified members of the staff with relevant expertise, both here and across the Federal Reserve System. Our staff have commented on proposed rules of the commissions at each stage of the development process to date. In providing feedback, we have tried to bring to bear our experience from supervising dealers and market infrastructure as well as our familiarity with markets and data sources to assist the commissions.

Important coordination activities related to derivatives regulation also are occurring within international groups. Most prominently, the Group of Twenty (G-20) leaders have set out commitments related to reform of the OTC derivatives markets that, when implemented by national authorities, will form a broadly consistent international regulatory approach. Work on the G-20 commitments is being done by numerous groups of technical and policy experts, and staff members from the Federal Reserve are actively participating in these groups.

More generally, the Board participates in many international groups that serve as vehicles for coordinating policies related to the participants and the infrastructure of derivatives markets. These groups include the Basel Committee on Banking Supervision (Basel Committee), which has recently enhanced international capital, leverage, and liquidity standards for derivatives, and the Committee on Payment and Settlement Systems, which is working with the International Organization of Securities Commissions to update international standards for systemically important clearing systems, including central counterparties that clear derivatives instruments, and trade repositories. Public consultation on these revised international standards is currently under way.

The goal of all of these efforts is to develop a consistent international approach to the regulation and supervision of derivatives products and market infrastructures as well as to the sound implementation of the agreed-upon approaches. Our aim is to promote both financial stability and fair competitive conditions to the fullest extent possible.

### **Infrastructure issues**

The Dodd-Frank Act addressed both the infrastructure of the derivatives markets and the regulation and supervision of its dealers and major participants. Central counterparties are given an expanded role in the clearing and settling of swap and security-based swap

(hereafter referred to as “swap”) transactions, and the Board believes benefits can flow from this reform. Since 2005, Federal Reserve staff members have worked with market participants to strengthen the infrastructure for OTC derivatives, including developing and broadening the use of central clearing mechanisms and trade repositories. Market participants have already established central counterparties that provide clearing services for some OTC interest rate, energy, and credit derivatives contracts. If properly designed, managed, and overseen, central counterparties offer an important tool for managing counterparty credit risk, and thus they can reduce risk to market participants and to the financial system. Both central counterparties and trade repositories also support regulatory oversight and policymaking by providing more-comprehensive data on the derivatives markets. The Board is committed to continuing to work with other authorities, both in the United States and abroad, to ensure that a largely consistent international approach is taken to central counterparties and trade repositories and that their risk-reducing benefits are realized.

Title VIII of the act complements the role of central clearing in title VII through heightened supervisory oversight of systemically important financial market utilities, including systemically important facilities that clear swaps. This heightened oversight is important because financial market utilities such as central counterparties concentrate risk and thus have the potential to transmit shocks throughout the financial markets. The Financial Stability Oversight Council is responsible for designating utilities as systemically important. Through its role on the council, the Board helped develop the designation process that was released for comment in March. Separately, the Board is also seeking comment on proposed risk-management standards that would apply to those designated utilities supervised by the Board under title VIII.<sup>1</sup> As part of title VIII, the Board was given new authority to provide designated utilities with access to Reserve Bank accounts, payment services, and emergency collateralized liquidity in unusual and exigent circumstances. We are carefully considering ways to implement this authority in a manner that protects taxpayers and limits any rise in moral hazard.

## **Supervisory issues**

Although central counterparties will provide an additional tool for managing counterparty credit risk, enhancements to the risk-management policies and procedures for individual market participants will continue to be a high priority for supervisors. As the reforms outlined in the act are implemented, the most active firms in bilateral OTC markets likely will become active clearing members of central counterparties. As such, the quality of risk management at these firms importantly affects the ability of the central counterparty to manage its risks effectively and to deliver risk-reducing benefits to the markets.

Capital and margin requirements are central to the prudential regulation of financial institutions active in derivatives markets as well as to the internal risk-management processes of such firms. Title VII requires that the CFTC, the SEC, and prudential regulators adopt capital and margin requirements for the noncleared swap activity of swap dealers and major swap participants. The Board, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Federal Housing Finance Agency, and the Farm Credit Administration are responsible for adopting capital and margin requirements for swap dealers and major swap participants that are banks or other prudentially regulated entities. The commissions are responsible for adopting capital and margin requirements for swap dealers and major swap participants that are not supervised by a prudential regulator. The

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<sup>1</sup> Board of Governors of the Federal Reserve System (2011), “Federal Reserve Seeks Comment on Proposed Rule Related to Supervision of Designated Financial Market Utilities,” press release, March 30.

prudential regulators and the commissions are consulting in developing the rules, and all agencies must, to the maximum extent practicable, adopt comparable standards.

Earlier today, the Board and the other prudential regulators released for public comment a proposed rule on capital and margin requirements. Our proposal will be open for public comment for 60 days, and we look forward to receiving the public's comments.

For capital, our proposal relies on the existing regulatory capital requirements, which already specifically address the unique risks of derivatives transactions. Beyond the current requirements, the Board and the other U.S. banking agencies played an active role in developing the recent Basel III enhancements to capital requirements agreed to by the Basel Committee in December 2010. Basel III will, among other things, strengthen the prudential framework for OTC derivatives by increasing OTC derivatives' risk-based capital and leverage requirements and by requiring banking firms to hold an additional buffer of high-quality, liquid assets to address potential liquidity needs resulting from their derivatives portfolios.

Our proposal for margin imposes initial and variation margin requirements on the noncleared swaps held by swap dealers or major swap participants that have a prudential regulator. For swaps with a nonfinancial end-user counterparty, the proposed rule would not specify a minimum margin requirement. Rather, it would allow a banking organization that is a dealer or major participant to establish a threshold, based on a credit exposure limit that is approved and monitored as part of the credit approval process, below which the end user would not have to post margin. For swaps with other counterparties, the proposal would cap the allowable threshold for unsecured credit exposure on noncleared swaps. In addition, the proposal would only apply a margin requirement to contracts entered into after the new requirement becomes effective.

A much discussed part of the act is the requirement that banks push portions of their swap activity into affiliates or face restrictions on their access to the discount window or deposit insurance. Under the push-out provisions, banking organizations with deposit insurance or access to the Federal Reserve's discount window will have to reorganize some of their derivatives activity, pushing certain types of swaps out of subsidiary banks and into distinct legal entities that will require their own capitalization and separate documentation of trades with existing customers. The act permits domestic banks to continue to engage in derivatives activities that have been a traditional focus of banks, including hedging activities and dealing in interest rate swaps, currency swaps, certain cleared credit default swaps, and other swaps that reference assets that banks are eligible to hold. However, because of the specific language contained in the act, this exemption for traditional bank derivatives activities does not apply to U.S. branches of foreign banking firms that by law have access to the Federal Reserve's discount window. A possibly unintended effect of the act's push-out provision may be to require some foreign firms to reorganize their existing U.S. derivatives activities to a greater extent than U.S. firms. Proposed rules to implement this section are still under development by the banking agencies.

## **Conclusion**

As the implementation process for the act continues, the challenge facing the Board is to enhance supervision, oversight, and prudential standards of major derivatives market participants in a manner that promotes more-effective risk management and reduces systemic risk, yet retain the significant benefits of derivatives to the businesses and investors who use them to manage financial market risks. The Board is working diligently to achieve these goals.