

Daniel K Tarullo: Regulatory reform

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, 22 March 2012.

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Chairman Johnson, Ranking Member Shelby, and other members of the Committee, thank you for the opportunity to testify on implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act) and its international implications.

Although banking regulation has long included an important international dimension, the recent financial crisis has brought renewed attention, both in the United States and abroad, to the interconnectedness among national financial markets and, consequently, the importance of international cooperation in safeguarding those markets. In recognition of the fact that financial distress can quickly and dramatically cross national borders, we seek to protect our own financial system by promoting the global adoption of strong, common regulatory standards and effective supervisory practices. Such common standards and practices should also help prevent major competitive disadvantages for U.S. firms.

Today I will touch on several aspects of the implementation of the Dodd-Frank Act that have significant international implications: regulation of systemically important financial institutions (SIFIs), reform of the over-the-counter (OTC) derivatives market, and a number of discrete issues that are arising as we work to implement the Dodd-Frank Act.

Regulation of SIFIs

The Dodd-Frank Act and post-crisis international regulatory reform efforts both place great emphasis on containing the systemic risk potentially posed by major financial institutions. The most important points of intersection include efforts to strengthen capital requirements, to develop international quantitative liquidity standards, and to put in place mechanisms for the orderly resolution of these firms.

Capital regulation

Strong capital requirements remain the cornerstone of prudential regulation because capital can provide a buffer against losses at financial firms from any source or activity. The best way to safeguard against taxpayer-funded bailouts in the future is for our large financial institutions to have adequate capital buffers, sized to reflect their own risk profiles and the damage that would be done to the financial system were such institutions to fail. Achievement of this aim requires both improvement of the traditional, firm-based approach to capital regulation and creation of a more systemic, or macroprudential, component of capital regulation.

With respect to improving the traditional approach to capital regulation, international work on common, global standards was already quite advanced by the time the Dodd-Frank Act was enacted in July 2010. The so-called Basel 2.5 agreement, which strengthened the market risk capital requirements of Basel II, had already been finished. Just a few months after the Dodd-Frank Act was enacted, agreement was reached on the Basel III reforms, which require improvement of the quality of regulatory capital, an increase in the quantity of minimum required capital, maintenance of a capital conservation buffer, and – for the first time internationally – compliance with a minimum leverage ratio. In the coming months, the banking agencies will be finalizing regulations to implement Basel 2.5 in the United States and will be proposing regulations to implement Basel III in the United States.

With respect to macroprudential capital regulation, section 165 of the Dodd-Frank Act mandated that the Board establish enhanced risk-based capital standards for large bank holding companies that would be graduated based on the relative systemic importance of those companies. Consistent with this requirement, we espoused proposals in the Basel Committee for capital surcharges on the world's largest, most interconnected banking organizations based on their global systemic importance. Last year, agreement was reached on a framework for such surcharges, to be implemented during the same transition period applicable to Basel III. The Board's aim has been to fashion the enhanced capital requirements of section 165 and the associated international framework in a simultaneous and congruent manner. Both the Dodd-Frank Act provision and the Basel systemic surcharge framework are motivated by the fact that the failure of a systemically important firm would have dramatically greater negative consequences on the financial system and the economy than the failure of other firms. Stricter capital requirements on systemically important firms should also have the benefit of helping offset any funding advantage these firms derive from their perceived status as too-big-to-fail and providing an incentive for such firms to reduce their systemic footprint.

If the benefits of all these improvements to existing capital requirements are to be realized, it is crucial that capital standards be not only agreed upon globally, but also implemented consistently across jurisdictional boundaries. We have strongly supported efforts within the Basel Committee to monitor implementation – not only in the laws and regulations of member countries, but also at the level of individual large banking organizations, including an assessment of the consistency of risk-weighting practices by banks. We look forward to the evolution of the Basel Committee's new plans for conducting this monitoring exercise, which are considerably more ambitious than any pursued in the past.

Liquidity standards

In recognition of the fact that liquidity squeezes at some financial institutions played a key role in the financial crisis, the Basel III agreements also introduced, for the first time, quantitative liquidity requirements for application to internationally active banks. One standard, the Liquidity Coverage Ratio (LCR), is designed to ensure a firm's ability to withstand short-term liquidity shocks through adequate holdings of highly liquid assets. The other standard, the Net Stable Funding Ratio (NSFR), is intended to avoid significant maturity mismatches over longer-term horizons. Again, there is a parallel to this international initiative in section 165 of the Dodd-Frank Act, which calls for enhanced, graduated liquidity standards for large bank holding companies.

Precisely because this was the first effort on quantitative liquidity regulation by the Basel Committee, there were some questions about potential unintended consequences, as well as a desire to ensure that the new standards reflected actual experience with the stability of various funding sources and the relative liquidity of different financial instruments during the financial crisis. For these reasons, the Federal Reserve, with support from a number of other central banks and supervisors, suggested at the time of adoption of Basel III in 2010 a multiyear study period before the rules take effect. Since then, the U.S. banking agencies and a Basel Committee working group have been collecting data, analyzing the potential effects of the LCR on financial markets and the broader economy, and considering what amendments might be warranted. The Basel Committee will likely suggest a set of changes to the LCR later this year, with a goal of introducing the LCR in 2015. Work on the NSFR is on a considerably slower track; the current plan is for implementation in 2018.

Resolution of SIFIs

A third core regulatory reform goal of both the Dodd-Frank Act and international policymakers is to enhance the ability of regulators to resolve failing SIFIs. The Basel Committee and the Financial Stability Board (FSB) have set forth standards for national

resolution regimes that will allow resolution of SIFIs in an orderly fashion, without taxpayer exposure to losses through solvency support. Here in the United States, the Dodd-Frank Act provides for an orderly resolution process to be administered by the Federal Deposit Insurance Corporation (FDIC), and resolution planning by SIFIs to be overseen by the FDIC and the Federal Reserve. Together these provisions of the Dodd-Frank Act are fully consistent with the Basel Committee and FSB standards.

In developing the orderly liquidation authority established by Title II of the Dodd-Frank Act, the FDIC has recently expressed a preference for resolving a failed SIFI under a single receivership and internal recapitalization model. Under this model, the parent company of the failed SIFI is placed into receivership; all, or substantially all, of the assets of the parent company are transferred to a bridge entity; the parent company and its residual assets are liquidated; and the bridge entity is capitalized, in part, by converting the holders of long-term unsecured debt of the parent company into equity holders in the bridge. Under the single receivership model, the major subsidiaries of the SIFI continue to operate as going concerns. This approach holds great promise, but ensuring its viability as a resolution option requires, among other things, that each SIFI maintain an amount of long-term unsecured debt that is sufficient to absorb very significant losses at the firm.

Some other jurisdictions have, or are planning to, put in place special resolution mechanisms that conform to the emerging international standards. But even continued progress along this path may not solve all the possible problems associated with failure of a SIFI. The coexistence of internationally active firms with nationally based insolvency regimes means that there could be important cross-border legal complications when a home jurisdiction places into receivership a firm with significant assets, subsidiaries, and contractual arrangements in other countries. A comprehensive, treaty-like instrument for a global bank resolution regime to address these issues is surely an unrealistic prospect for the foreseeable future. The Federal Reserve and the FDIC are working together with counterparts from other countries to identify opportunities for more limited cooperation agreements, coordinated supervisory work on resolution plans, and other devices to make the orderly resolution of a large, internationally active firm more feasible.

OTC derivatives regulatory reforms

Another key part of the Dodd-Frank Act that involves significant international considerations is OTC derivatives reform. In the United States, administrative agencies are implementing the requirements of the Dodd-Frank Act to strengthen the infrastructure and regulation of the OTC derivatives market. This task includes enhancing the role of central counterparties, which can be an important tool for managing counterparty credit risk in the derivatives market; improving regulation and supervision of dealers and key market participants; introducing minimum margin requirements for certain derivatives transactions that are not cleared with a central counterparty; and increasing transparency.

A roughly parallel international initiative got under way in 2009, when the Group of Twenty (G-20) leaders set out commitments related to reform of the OTC derivatives markets. Since work on the G-20 commitments is being pursued in a number of international groups and foreign jurisdictions, continued attention will be required to ensure that the global convergence process continues in a timely fashion. Such attention will be particularly important in areas where international convergence is desirable to avoid a significant fracturing or regionalization of the existing global structure of the swaps market, or to prevent undue constraints on the ability of U.S. firms to compete in foreign markets. A good example of this is the introduction of margin requirements for uncleared derivatives. U.S. and foreign regulators have formed a joint working group of the Basel Committee and the International Organization of Securities Commissions (IOSCO) to develop internationally consistent margin standards that appropriately address the risks of uncleared derivatives while ensuring that U.S. and foreign firms compete on a level playing field.

Other key areas of OTC derivatives reform present similar international challenges and will demand similar levels of international collaboration. These areas include the creation and regulation of central counterparties, swap execution facilities, and swap data repositories, including mutual recognition by U.S. and foreign regulators where appropriate. Issues also arise around the treatment of governmental entities in derivatives reforms in the United States and abroad. For example, title VII of the Dodd-Frank Act generally exempts from swaps regulation any transaction to which the Federal Reserve is a party, but does not contain a similar exemption for transactions to which a foreign central bank is party. Foreign central banks have expressed concerns that the application of certain parts of title VII may interfere with the manner in which they conduct their national monetary policies.

In addition to its involvement in specific derivatives reforms related to the Dodd-Frank Act, the Federal Reserve also participates in a variety of international groups that serve as broader forums for coordinating policies related to the participants and the infrastructure of derivatives markets. These forums include the Basel Committee, which has recently enhanced international capital, leverage, and liquidity standards for derivatives, as well as the Committee on Payment and Settlement Systems, which is working with IOSCO to update international standards for systemically important clearing systems, including central counterparties that clear derivatives instruments, and trade repositories. These collaborative exercises are intended to support the development of a consistent international approach to the regulation and supervision of derivatives products, dealers, and market infrastructures. Here, as in other international contexts, our aims are to promote the financial stability of the United States and fair competitive conditions for U.S. financial institutions.

Other implementation issues

As noted in the preceding discussion, even where there is broad international consensus to adopt a particular regulatory approach, there can be discrete issues raised as countries implement that approach in the context of their own legal, financial, and political systems. This circumstance is hardly unique to the area of financial regulation; it is familiar to anyone who has worked on virtually any regulatory issues that affect international trade and investment. There are also some elements of the Dodd-Frank Act that are unlikely to be pursued internationally in any comparable form. These areas of U.S.-only regulatory reform can present particular challenges in implementation, both in terms of the potential impact that they may have on the ability of U.S. financial institutions to compete abroad and the extent to which they may affect the activities of foreign financial institutions in U.S. markets and with U.S. counterparties. In these instances of regulatory reforms being pursued only in the United States, there are not likely to be obvious answers to the resulting international complexities.

For example, there has been considerable recent attention paid to the international aspects of section 619 of the Dodd-Frank Act, more commonly known as the “Volcker Rule.” Concerns have been expressed about the Volcker Rule’s potential international implications in three principal areas. First, because the Volcker Rule applies to the worldwide operations of U.S. banking entities, but only to the U.S.-connected operations of foreign banks, concerns have been raised regarding the relative competitiveness of U.S. firms that have significant operations in overseas markets. Second, and conversely, because the Volcker Rule also applies to the activities of foreign banks unless such activities are “solely outside the United States,” several foreign banks and their supervisors have expressed concern regarding the potential extraterritorial impact that those restrictions may have on trading or fund activity of foreign banks that has both U.S. and non-U.S. characteristics. Third, because the Volcker Rule includes a statutory exemption for proprietary trading in U.S. government debt securities, but not in foreign sovereign debt securities, several constituencies have raised concerns regarding this asymmetry. In each of these areas, U.S. regulators will need to carefully consider the concerns that have been raised and the broader international implications of the Volcker Rule as we work to finalize our implementing rules.

Similarly, the swaps “push-out” requirement in section 716 of the Dodd-Frank Act also appears unlikely to be pursued internationally. Under section 716, U.S. insured depository institutions and U.S. branches and agencies of foreign banks will be required to “push out” certain types of derivatives dealing activities to affiliated entities. The global effects of the swaps push-out provision are multifaceted. On the one hand, the provision will require U.S. banking firms to restructure their global derivatives dealing activities in ways that will not be required of foreign banks abroad. At the same time, the provision may require U.S. branches and agencies of foreign banks to restructure their derivatives dealing activities in ways that will not be required of U.S. banks.

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