Daniel K Tarullo: Dodd-Frank implementation

Testimony by Mr Daniel K Tarullo, Member of the Board of Governors of the Federal Reserve System, before the Committee on Banking, Housing, and Urban Affairs, US Senate, Washington DC, 9 September 2014.

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Chairman Johnson, Ranking Member Crapo, and other members of the committee, thank you for the opportunity to testify on the Federal Reserve's activities in mitigating systemic risk and implementing the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). In testifying before this committee in February, I noted my hope and expectation that this year would be the beginning of the end of our implementation of the major provisions of the Dodd-Frank Act. Seven months later, we are on track to fulfill that expectation. The Federal Reserve and other banking supervisors have continued to make progress in implementing the congressional mandates in the Dodd-Frank Act, promoting a stable financial system, and strengthening the resilience of banking organizations. In today's testimony, I will provide an update on the Federal Reserve's implementation of the Dodd-Frank Act and describe key upcoming regulatory and supervisory priorities to address the problems of "too big to fail" and systemic risk. The Federal Reserve is committed to continuing to work with our fellow banking agencies and with the market regulators to help ensure that the organizations we supervise operate in a safe and sound manner and are able to support activity in other sectors of the economy.

As we complete our revisions to the financial regulatory architecture, we are cognizant that regulatory compliance can impose a disproportionate burden on smaller financial institutions. In addition to overseeing large banking firms, the Federal Reserve supervises approximately 800 state-chartered community banks that are members of the Federal Reserve System, as well as several thousand small bank holding companies. In my testimony, I also will describe how the Federal Reserve is seeking to ensure that its regulations and supervisory framework are not unnecessarily burdensome for community banking organizations so they can continue their important function of safe and sound lending to local communities.

Recent Dodd-Frank Act implementation milestones

Since the passage of the Dodd-Frank Act more than four years ago, the Federal Reserve and the other agencies represented at this hearing have completed wide-ranging financial regulatory reforms that have remade the regulatory landscape for financial firms and markets. Internationally, at the Basel Committee on Banking Supervision (BCBS), we have helped develop new standards for global banks on risk-based capital, leverage, liquidity, single-counterparty credit limits, and margin requirements for over-the-counter derivatives. We have also worked with the Financial Stability Board (FSB) to reach global agreements on resolution regimes for systemic financial firms and on a set of shadow banking regulatory reforms.

Domestically, we have completed many important measures. We approved final rules implementing the Basel III capital framework, which help ensure that U.S. banking organizations maintain strong capital positions and are able to continue lending to creditworthy households and businesses even during economic downturns. We implemented the Dodd-Frank Act's stress testing requirements, which are complemented by the Federal Reserve's annual Comprehensive Capital Analysis and Review. Together, these supervisory exercises provide a forward-looking assessment of the capital adequacy of the largest U.S. banking firms. Pursuant to section 165 of the Dodd-Frank Act, we established a set of enhanced standards for large U.S. banking organizations to help increase the resiliency of their operations and thus promote financial stability. In addition, the Federal Reserve implemented a rule requiring foreign banking organizations with a significant U.S. presence to establish U.S. intermediate holding companies over their U.S. subsidiaries and subjecting such companies to substantially the same prudential standards applicable to U.S. bank holding companies. We finalized the Volcker rule to implement section 619 of the Dodd-Frank Act and prohibit banking organizations from engaging in short-term proprietary trading of certain securities and derivatives. These and other measures have already created a financial regulatory architecture that is much stronger and much more focused on financial stability than the framework in existence at the advent of the financial crisis.

More recently, the Federal Reserve, often in tandem with some or all of the other agencies represented at this hearing, has made progress on a number of other important regulatory reforms. I will discuss those steps in more detail.

Liquidity rules for large banking firms

Last week, the Federal Reserve and the other U.S. banking agencies approved a final rule, consistent with the enhanced prudential standards requirements in section 165 of the Dodd-Frank Act, which implements the first broadly applicable quantitative liquidity requirement for U.S. banking firms. Liquidity standards for large U.S. banking firms are a key contributor to financial stability, as they work in concert with capital standards, stress testing, and other enhanced prudential standards to help ensure that large banking firms manage liquidity in a manner that mitigates the risk of creditor and counterparty runs.

The rule's liquidity coverage ratio, or LCR, requires covered banking firms to hold minimum amounts of high-quality liquid assets – such as central bank reserves and high-quality government and corporate debt – that can be converted quickly and easily into cash sufficient to meet expected net cash outflows over a short-term stress period. The LCR applies to bank holding companies and savings and loan holding companies with $250 billion or more in total consolidated assets or $10 billion or more in on-balance-sheet foreign exposures. The rule also applies a less stringent, modified LCR to bank holding companies and savings and loan holding companies that are below these thresholds but with more than $50 billion in total assets. The rule does not apply to bank holding companies or savings and loan holding companies with less than $50 billion in total assets, nor to nonbank financial companies designated by the Financial Stability Oversight Council (FSOC). The Federal Reserve will apply enhanced liquidity standards to designated nonbank financial companies through a subsequently issued order or rule following an evaluation of each of their business models, capital structures, and risk profiles.

The rule's LCR is based on a liquidity standard agreed to by the BCBS but is more stringent than the BCBS standard in several areas, including the range of assets that qualify as high-quality liquid assets and the assumed rate of outflows for certain kinds of funding. In addition, the rule's transition period is shorter than that in the BCBS standard. The accelerated phase-in of the U.S. LCR reflects our objective that large U.S. banking firms maintain the improved liquidity positions they have already built following the financial crisis, in part because of our supervisory oversight. We believe the LCR will help ensure that these improved liquidity positions will not weaken as memories of the financial crisis fade.

The final rule is largely identical to the proposed rule, with a few key adjustments made in response to comments from the public. Those adjustments include changing the scope of corporate debt securities and publicly traded equities qualifying as high-quality liquid assets, phasing in reporting requirements, and modifying the stress period and reporting frequency for firms subject to the modified LCR.

Swap margin reproposal

Sections 731 and 764 of the Dodd-Frank Act require the establishment of initial and variation margin requirements for swap dealers and major swap participants (swap entities) on swaps that are not centrally cleared. These requirements are intended to ensure that the counterparty risks inherent in swaps are prudently limited and not allowed to build to unsustainable levels that could pose risks to the financial system. In addition, requiring all uncleared swaps to be subject to robust margin requirements will remove economic incentives for market participants to shift activity away from contracts that are centrally cleared.

The Federal Reserve and four other U.S. agencies originally issued a proposed rule to implement these provisions of the Dodd-Frank Act in April 2011. Following the release of the original proposal, the BCBS and the International Organization of Securities Commissions began working to establish a consistent global framework for imposing margin requirements on uncleared swaps. This global framework was finalized last September. After considering the comments that were received on the April 2011 U.S. proposal and the recently established global standards, the agencies issued a reproposal last week. Under the reproposal, swap entities would be required to collect and post initial and variation margin on uncleared swaps with another swap entity and other financial end user counterparties. The requirements are intended to result in higher initial margin requirements than would be required for cleared swaps, which is meant to reflect the more complex and less liquid nature of uncleared swaps.

In accordance with the statutory requirement to establish margin requirements regardless of counterparty type, the reproposal would require swap entities to collect and post margin in connection with any uncleared swaps they have with nonfinancial end users. These requirements, however, are quantitatively and qualitatively different from the margin requirements for swaps with financial end users. Specifically, swaps with nonfinancial end users would not be subject to specific, numerical margin requirements but would only be subject to initial and variation margin requirements at such times, in such forms, and in such amounts, if any, that the swap entity determines is necessary to address the credit risk posed by the counterparty and the transaction. There are currently cases where a swap entity does not collect initial or variation margin from nonfinancial end users because it has determined that margin is not needed to address the credit risk posed by the counterparty or the transaction. In such cases, the reproposal would not require a change in current practice. The agencies believe that these requirements are consistent with the Dodd-Frank Act and appropriately reflect the low level of risk presented by most nonfinancial end users.

The agencies in the reproposal have taken several steps to help mitigate any impact to the liquidity of the financial system that could result from the swap margin requirements. These steps include incorporating an initial margin requirement threshold below which exchanges of initial margin are not required, allowing for a wider range of assets to serve as eligible collateral, and providing smaller swap entities with an extended timeline to come into compliance. We look forward to receiving comments on the reproposal.

Modifications to the supplementary leverage ratio and adoption of the enhanced supplementary leverage ratio

Also last week, the Federal Reserve and the other U.S. banking agencies approved a final rule that modifies the denominator calculation of the supplementary leverage ratio in a manner consistent with the changes agreed to earlier this year by the BCBS. The revised supplementary leverage ratio will apply to all banking organizations subject to the advanced approaches risk-based capital rule starting in 2018. These modifications to the supplementary leverage ratio will result in a more appropriately measured set of leverage capital requirements and, in the aggregate, are expected to modestly increase the stringency of these requirements across the covered banking organizations.

This rule complements the agencies' adoption in April of a rule that strengthens the internationally agreed-upon Basel III leverage ratio as applied to U.S.-based global systemically important banks (GSIBs). This enhanced supplementary leverage ratio, which will be effective in January 2018, requires U.S. GSIBs to maintain a tier 1 capital buffer of at least 2 percent above the minimum Basel III supplementary leverage ratio of 3 percent, for a total of 5 percent, to avoid restrictions on capital distributions and discretionary bonus payments. In light of the significantly higher risk-based capital rules for GSIBs under Basel III, imposing a stricter leverage requirement on these firms is appropriate to help ensure that the leverage ratio remains a relevant backstop for these firms.

Key regulatory priorities

As we near the completion of the implementation of the major provisions of the Dodd-Frank Act, some key regulatory reforms remain unfinished. To that end, the Federal Reserve contemplates near- to medium-term measures to enhance the resiliency and resolvability of U.S. GSIBs and address the risks posed to financial stability from reliance by financial firms on short-term wholesale funding.

The financial crisis made clear that policymakers must devote significant attention to the potential threat to financial stability posed by our most systemic financial firms. Accordingly, the Federal Reserve has been working to develop regulations that are designed to reduce the probability of failure of a GSIB to levels that are meaningfully below those for less systemically important firms and to materially reduce the potential adverse impact on the broader financial system and economy in the event of a failure of a GSIB.

GSIB risk-based capital surcharges

An important remaining Federal Reserve initiative to improve GSIB resiliency is our forthcoming proposal to impose graduated common equity risk-based capital surcharges on U.S. GSIBs. The proposal will be consistent with the standard in section 165 of the Dodd-Frank Act that capital requirements be progressively more stringent as the systemic importance of a firm increases. It will build on the GSIB capital surcharge framework developed by the BCBS, under which the size of the surcharge for an individual GSIB is a function of the firm's systemic importance. By further increasing the amount of the most loss-absorbing form of capital that is required to be held by firms that potentially pose the greatest risk to financial stability, we intend to improve the resiliency of these firms. This measure might also create incentives for them to reduce their systemic footprint and risk profile.

While our proposal will use the GSIB risk-based capital surcharge framework developed by the BCBS as a starting point, it will strengthen the BCBS framework in two important respects. First, the surcharge levels for U.S. GSIBs will be higher than the levels required by the BCBS, noticeably so for some firms. Second, the surcharge formula will directly take into account each U.S. GSIB's reliance on short-term wholesale funding. We believe the case for including short-term wholesale funding in the surcharge calculation is compelling, given that reliance on this type of funding can leave firms vulnerable to runs that threaten the firm's solvency and impose externalities on the broader financial system.

Resolvability of GSIBs

Our enhanced regulation of GSIBs also includes efforts to improve their resolvability. Most recently, in August, the Federal Reserve and the Federal Deposit Insurance Corporation (FDIC) completed reviews of the second round of resolution plans submitted to the agencies in October 2013 by 11 U.S. bank holding companies and foreign banks. Section 165(d) of the Dodd-Frank Act requires banking organizations with total consolidated assets of $50 billion or more and nonbank financial companies designated by the FSOC to submit resolution plans to the Federal Reserve and the FDIC. Each plan must describe the organization's strategy for rapid and orderly resolution in the event of material financial distress or failure. In completing the second round reviews of these banking organizations' resolution plans, the FDIC and the Federal Reserve noted certain shortcomings in the resolution plans that the firms must address to improve their resolvability in bankruptcy. Both agencies also indicated the expectation that the firms make significant progress in addressing these issues in their 2015 resolution plans.

In addition, the Federal Reserve has been working with the FDIC to develop a proposal that would require the U.S. GSIBs to maintain a minimum amount of long-term unsecured debt at the parent holding company level. While minimum capital requirements are designed to cover losses up to a certain statistical probability, in the even less likely event that the equity of a financial firm is wiped out, successful resolution without taxpayer assistance would be most effectively accomplished if a firm has sufficient long-term unsecured debt to absorb additional losses and to recapitalize the business transferred to a bridge operating company. The presence of a substantial tranche of long-term unsecured debt that is subject to bail-in during a resolution and is structurally subordinated to the firm's other creditors should reduce run risk by clarifying the position of those other creditors in an orderly liquidation process. A requirement for long-term debt also should have the benefit of improving market discipline, since the holders of that debt would know they faced the prospect of loss should the firm enter resolution.

The Federal Reserve is working with global regulators, under the auspices of the FSB, to develop a proposal that would require the largest, most complex global banking firms to maintain a minimum amount of loss absorbency capacity beyond the levels mandated in the Basel III capital requirements.

Another element of our efforts to promote resolvability of large banking organizations involves the early termination rights of derivative counterparties to GSIBs. Some of the material operating subsidiaries of GSIBs are counterparties to large volumes of over-the-counter derivatives and other qualifying financial contracts that provide for an event of default based solely on the insolvency or receivership of the parent holding company. Although the Dodd-Frank Act created an orderly liquidation authority (OLA) to better enable the government to resolve a failed systemically important financial firm – and the OLA's stay and transfer provisions can prevent exercise of such contractual rights by counterparties to contracts under U.S. law – the OLA provisions may not apply to contracts under foreign law. Accordingly, counterparties of the foreign subsidiaries and branches of GSIBs may have contractual rights and substantial economic incentives to accelerate or terminate those contracts as soon as the U.S. parent GSIB enters OLA. This could render a resolution unworkable by resulting in the disorderly unwind of an otherwise viable foreign subsidiary and the disruption of critical intra-affiliate activities that rely on the failing subsidiary. The challenge would be compounded in a bankruptcy resolution because derivatives and other qualifying financial contracts are exempt from the automatic stay under bankruptcy law, regardless of whether the contracts are governed by U.S. or foreign law.

The international regulatory community is working to mitigate this risk as well. The Federal Reserve is working with the FDIC and global regulators, financial firms, and other financial market actors to develop a protocol to the International Swaps and Derivatives Association (ISDA) Master Agreement to address the impediments to resolvability generated by these early termination rights. The FSB will be reporting progress on this effort in the fall.

Short-term wholesale funding

As I have noted in prior testimony before this committee, short-term wholesale funding plays a critical role in the financial system. During normal times, it helps to satisfy investor demand for safe and liquid investments, lowers funding costs for borrowers, and supports the functioning of important markets, including those in which monetary policy is executed. During periods of stress, however, runs by providers of short-term wholesale funding and associated asset liquidations can result in large fire sale externalities and otherwise undermine financial stability. A dynamic of this type engulfed the financial system in 2008.

Since the crisis, the Federal Reserve has taken several steps to address short-term wholesale funding risks. The Basel III capital framework and the Federal Reserve's stress testing regime have significantly increased the quantity and quality of required capital in the banking system, particularly for those banking organizations that are the most active participants in short-term wholesale funding markets. Similarly, the implementation of liquidity regulations such as the LCR, together with related efforts by bank supervisors, will help to limit the amount of liquidity risk in the banking system.

We have also taken steps to reduce risks posed by the use of short-term wholesale funding by actors outside the banking system. These include leading an effort to reduce reliance by borrowers in the tri-party repo market on intraday credit from clearing banks and increasing the regulatory charges on key forms of credit and liquidity support that banks provide to shadow banks. In part because of these actions and in part because of market adjustments, there is less risk embedded in short-term wholesale funding markets today than in the period immediately preceding the financial crisis. The short-term wholesale funding markets are generally smaller, the average maturity of short-term funding arrangements is moderately greater, and collateral haircuts are more conservative. In addition, the banking organizations that are the major intermediaries in short-term wholesale funding markets are much more resilient based on the measures I discussed earlier.

Nevertheless, we believe that more needs to be done to guard against short-term wholesale funding risks. While the total amount of short-term wholesale funding is lower today than immediately before the crisis, volumes are still large relative to the size of the financial system. Furthermore, some of the factors that account for the reduction in short-term wholesale funding volumes, such as the unusually flat yield curve environment and lingering risk aversion from the crisis, are likely to prove transitory.

Federal Reserve staff is currently working on three sets of initiatives to address residual short-term wholesale funding risks. As discussed above, the first is a proposal to incorporate the use of short-term wholesale funding into the risk-based capital surcharge applicable to U.S. GSIBs. The second involves proposed modifications to the BCBS's net stable funding ratio (NSFR) standard to strengthen liquidity requirements that apply when a bank acts as a provider of short-term funding to other market participants. The third is numerical floors for collateral haircuts in securities financing transactions (SFTs) – including repos and reverse repos, securities lending and borrowing, and securities margin lending.

Modifications to the NSFR could be designed to help address the types of concerns described in my previous testimony regarding SFT matched book activity. In the classic fact pattern, a matched book dealer uses SFTs to borrow on a short-term basis from a cash investor, such as a money market mutual fund, to finance a short-term SFT loan to a client, such as a leveraged investment fund. The regulatory requirements on SFT matched books are generally low despite the fact that matched books can pose significant microprudential and macroprudential risks. Neither the BCBS LCR nor the NSFR originally finalized by the Basel Committee would have imposed a material charge on matched book activity.

In January, the BCBS proposed a revised NSFR that would require banks to hold a material amount of stable funding against short-term SFT loans, as well as other short-term credit extensions, to nonbank financial entities. By requiring banks that make short-term loans to hold stable funding, such a charge would help limit the liquidity risk that a dealer would face if it experiences a run on its SFT liabilities but is unable to liquidate corresponding SFT assets. In addition, by making it more expensive for the dealer to provide short-term credit, the charge could help lean against excessive short-term borrowing by the dealer's clients.

Turning to numerical floors for SFT haircuts, the appeal of this policy measure is that it would help address the risk that post-crisis reforms targeted at banking organizations will drive systemically risky activity toward places in the financial system where prudential standards do not apply. In its universal form, a system of numerical haircut floors for SFTs would require any entity that wants to borrow against a security to post a minimum amount of excess margin to its lender that would vary depending on the asset class of the collateral. Like minimum margin requirements for derivatives, numerical floors for SFT haircuts would serve as a mechanism for limiting the build-up of leverage at the transaction level and could mitigate the risk of procyclical margin calls.

Last August, the FSB issued a consultative document that represented an initial step toward the development of a framework of numerical floors. However, the FSB's proposal contained some significant limitations, including that its scope was limited to transactions in which a bank or broker-dealer extends credit to an unregulated entity and that the calibration of the numerical floor levels was relatively low. Since then, the FSB has been actively considering whether to strengthen the proposal along both of these dimensions.

Financial sector concentration limits

In May, the Federal Reserve proposed a rule to implement section 622 of the Dodd-Frank Act, which prohibits a financial company from combining with another company if the resulting financial company's liabilities exceed 10 percent of the aggregate consolidated liabilities of all financial companies. Under the proposal, financial companies subject to the concentration limit would include insured depository institutions, bank holding companies, savings and loan holding companies, foreign banking organizations, companies that control insured depository institutions, and nonbank financial companies designated by the FSOC for Federal Reserve supervision. Consistent with section 622, the proposal generally defines liabilities of a financial company as the difference between its risk-weighted assets, as adjusted to reflect exposures deducted from regulatory capital, and its total regulatory capital. Firms not subject to consolidated risk-based capital rules would measure liabilities using generally accepted accounting standards. We anticipate finalizing this rule in the near term.

Credit risk retention

Section 941 of the Dodd-Frank Act requires firms generally to retain credit risk in securitization transactions they sponsor. Retaining credit risk creates incentives for securitizers to monitor closely the quality of the assets underlying a securitization transaction and discourages unsafe and unsound underwriting practices by originators. In August 2013, the Federal Reserve, along with several other agencies, revised a proposal from 2011 to implement section 941. The Federal Reserve is working with the other agencies charged by the Dodd-Frank Act with implementing this rule to complete it in the coming months.

Rationalizing the regulatory framework for community banks

Before closing, I would like to discuss the Federal Reserve's ongoing efforts to minimize regulatory burden consistent with the effective implementation of our statutory responsibilities for community banks, given the important role they play within our communities. Over the past few decades, community banks have substantially reduced their presence in lines of businesses such as consumer lending in the face of competition from larger banks benefiting from economies of scale. Today, as a group, their most important forms of lending are to small- and medium-sized businesses. Smaller community banks – those with less than $1 billion in assets – account for nearly one-fourth of commercial and industrial lending, and nearly 40 percent of commercial real estate lending, to small- and medium-sized businesses, despite their having less than 10 percent of total commercial banking assets. These figures reveal the importance of community banks to local economies and the damage that could result if these banks were unable to continue operating within their communities.

Banking regulators have taken many steps to try to avoid unnecessary regulatory costs for community banks, such as fashioning more basic supervisory expectations for smaller, less complex banks and identifying which provisions of new regulations are relevant to smaller banks. In this regard, the Federal Reserve has worked to communicate clearly the extent to which new rules and policies apply to smaller banks and to tailor them as appropriate. We also work closely with our colleagues at the federal and state banking regulatory agencies to ensure that supervisory approaches and methodologies are consistently applied to community banks.

But several new statutory provisions apply explicitly to some smaller banks or, by failing to exclude any bank from coverage, apply to all banks. The Federal Reserve is supportive of considering areas where the exclusion of community banks from statutory provisions that are less relevant to community bank practice may be appropriate. For example, we believe it would be worthwhile to consider whether community banks should be excluded from the scope of the Volcker rule and from the incentive compensation requirements of section 956 of the Dodd-Frank Act. The concerns addressed by statutory provisions like these are substantially greater at larger institutions and, even where a practice at a smaller bank might raise concerns, the supervisory process remains available to address what would likely be unusual circumstances.

Another area in which the Federal Reserve has made efforts to right-size our supervisory approach with regard to community banks is to improve our off-site monitoring processes so that we can better target higher risk institutions and activities. Research conducted for a 2013 conference sponsored by the Federal Reserve System and the Conference of State Bank Supervisors addressed the resilience of the community bank model and showed how some banks performed better than others during the recent crisis. Building on this research, we are updating our off-site monitoring screens to reflect experience gained during the crisis and recalibrating our examination scoping process for community banks to focus our testing on higher-risk banks and activities, and whenever possible reduce procedures for banks of lower risk.

Recognizing the burden that the on-site presence of many examiners can place on the day-to-day business of a community bank, we are also working to increase our level of off-site supervisory activities. Responding to on-site examinations and inspections is of course a cost for community banks, but this cost must be weighed against the supervisory benefit of face-to-face interactions with bank examiners to explore and resolve institution-specific concerns. The Federal Reserve aims to strike the appropriate balance of off-site and on-site supervisory activities to ensure that the quality of community bank supervision is maintained without creating an overly burdensome process. To that end, last year we completed a pilot on conducting parts of the labor-intensive loan review off-site using electronic records from banks. Based on good results with the pilot, we are planning to continue using this approach in future reviews at banks where bank management is supportive of the process and where electronic records are available. We are also exploring whether other examination procedures can be conducted off-site without compromising the ability of examiners to accurately assess the safety and soundness of supervised banks.

Conclusion

The Federal Reserve has made significant progress in implementing the Dodd-Frank Act and other measures designed to improve the resiliency of banking organizations and reduce systemic risk. We are committed to working with the other U.S. financial regulatory agencies to promote a stable financial system in a manner that does not impose a disproportionate burden on smaller institutions. To help us achieve these goals, we will continue to seek the views of the institutions we supervise and the public as we further develop regulatory and supervisory programs to preserve financial stability at the least cost to credit availability and economic growth.

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