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Implementing financial reform regulations from the Dodd–Frank Act and Basel III

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The Chicago Fed's 47th annual Conference on Bank Structure and Competition, which took place May 4–6, 2011, focused on the implementation of new regulations mandated by the Dodd–Frank Wall Street Reform and Consumer Protection Act (DFA) and proposed by the Basel Committee on Banking Supervision (BCBS) in its Basel III framework.

More information on the conference is available at www.chicagofed.org/webpages/events/2011/bank_structure_conference.cfm.

This *Chicago Fed Letter* summarizes two key panels from this year's Bank Structure Conference—one on the DFA's implementation and the other on the Basel III liquidity rules and regulations.

Implementing Dodd–Frank

The DFA panel featured Wayne Abernathy, American Bankers Association (ABA); Mark Van Der Weide, Board of Governors of the Federal Reserve System; Scott O'Malia, U.S. Commodity Futures Trading Commission (CFTC); Richard Berner, U.S. Treasury Department; and Matthew Richardson, New York University.

Abernathy reviewed the progress made toward implementing the DFA from the perspective of the ABA. He acknowledged that the DFA rulemaking process is an unprecedented challenge, but questioned the slow implementation pace. In 2011:Q2, regulators missed all 26 implementation deadlines for rulemaking, bringing the total missed to 30. Abernathy stressed that regulators need to walk a fine line: Although the speed of implementation is important, it should not inhibit the transparency and clarity of the rulemaking process. He also emphasized the need to simplify regulatory processes by getting rid of previous rules now covered by the DFA. Eliminating redundant rules, he argued, would lead to reduced costs and greater innovation, which would benefit consumers.

Abernathy also discussed DFA policies that focus on managing the risks associated with systemically important financial institutions (SIFIs). The DFA provides regulators with the authority to close SIFIs in an organized, structured manner, which the ABA strongly supports. However, the DFA also provides regulators with the authority to keep SIFIs open. Abernathy argued that such regulatory powers might exacerbate the use of too-systemic-to-fail (TSTF) policies and place SIFIs at a distinct competitive advantage. He noted that historically, unsecured creditors of failed banks resolved by the Federal Deposit Insurance Corporation (FDIC) lost 20 or more cents on the dollar. In contrast, the FDIC recently calculated that had the resolution authority in the DFA been in place when Lehman Brothers failed in 2008, its unsecured creditors would have only lost 3 cents on the dollar.[1] With the DFA now in effect, investors will respond accordingly and provide SIFIs with a distinct funding advantage—calculated to be nearly 80 basis points on uninsured debt instruments in today's environment.[2] Overall, Abernathy said that the DFA places smaller institutions at a competitive disadvantage and institutionalizes TSTF.

Van Der Weide highlighted some of the core reforms mandated by the DFA. One of the major components of the DFA is the creation of the Financial Stability Oversight Council (FSOC), which is in charge of identifying and mitigating systemic risk. A key task of the FSOC is to identify SIFIs, which will then be subject to the supervision of the Federal Reserve. The DFA mandates all bank holding companies (BHCs) with over $50 billion in assets be designated as SIFIs. In addition, the FSOC is in the process of finalizing the criteria for designating nonbanks as SIFIs. The criteria for such designation include the institution's size, degree of interconnectedness (to other institutions), lack of substitutes, and leverage, as well as the extent to which the institution is currently regulated. Van Der Weide emphasized that significant effort was being spent to determine the relative weight of each factor. Although the weights had yet to be determined, he said he was optimistic that, with time, the FSOC would disclose more of its SIFI criteria, increasing the predictability of its designation decisions.

Once the process of identifying SIFI status is established, the DFA requires the Fed to develop and impose enhanced regulation (capital requirements, liquidity requirements, etc.) that aligns with the level of systemic risk generated by the SIFI, Van Der Weide said. Therefore, the Fed must measure firm-specific systemic risk contributions and calibrate the degree of additional regulation accordingly. This could result in a $50 billion BHC being treated quite differently than a $1 trillion financial holding company. Optimally, the Fed's enhanced framework should provide regulatory incentives for firms to shrink their systemic risk contribution, although accurately calibrating and integrating the new regulation to achieve such an outcome will be challenging.

O'Malia discussed components of the DFA pertaining to the derivatives market. In particular, the DFA brings the previously unregulated swaps market under the supervision of the CFTC. As a result, institutions designated as swap entities (swap dealers or major swap participants) will be subject to an array of new regulations and reporting requirements. While generally supporting the new regulations, O'Malia said that some firms that primarily use swaps to hedge risk could needlessly be designated as swap entities, thereby subjecting them to higher margin and capital requirements. He argued this would force some non-systemically-important firms to choose either to hedge risks and incur the associated regulatory costs or to leave the positions unhedged.

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The DFA also mandates that swaps previously traded in the over-the-counter (OTC) market move onto regulated trading platforms known as swap execution facilities (SEFs). O'Malia argued that SEFs will boost market liquidity and improve market transparency with real-time pricing for swaps. SEFs should enable the CFTC to create a credible surveillance and oversight program if the agency is willing to employ the necessary technology—something it has not always done in the past, according to O'Malia. Finally, O'Malia suggested that the CFTC create an implementation schedule for all final rules stemming from the DFA to provide market participants with more certainty and enough lead time to conform to the requirements. While doing this, the CFTC should also remain flexible in its rulemaking to allow SEFs to innovate.

Berner discussed the Office of Financial Research (OFR), which was established under the DFA and is housed within the U.S. Treasury Department. The OFR is mandated by the DFA to collect and organize financial data and to analyze the workings of the financial system. The primary function of this analysis is to assist the FSOC in monitoring systemic risk.

One goal of the OFR is to improve the quality of financial data by setting new reporting standards, said Berner. The OFR's "entity identification system" will assign unique identities to all legal entities involved in financial transactions. These identities can be used to organize a firm-specific financial company reference database, as well as a product-specific financial instrument reference database. Berner stated that the precision and standardization of these data, which will be shared with regulators, academics, and the industry, should help improve oversight of the financial system and risk-management processes. These data should also increase market discipline by promoting transparency among private firms. However, Berner warned that the financial system is dynamic (i.e., products, instruments, practices, and institutions evolve), so the OFR must stay abreast of industry changes, including those aimed at regulatory avoidance, and respond accordingly.

In conjunction with collecting high-quality data, the OFR will produce research on the financial system. Berner listed three data-intensive research projects: measuring and quantifying systemic risks; measuring the impact of changes in financial regulation on the supply of credit and economic activity; and measuring the costs and benefits of various macroprudential tools.

Richardson highlighted what he considers the major positive and negative aspects of the DFA. On the positive side, economic theory suggests that regulation should address market failures (i.e., negative externalities). He said that the DFA is well aligned with this principle as it focuses on limiting systemic risk (the externality) through the use of macroprudential tools. Moreover, the DFA plugs many regulatory loopholes that led to the recent crisis. Finally, the DFA brings systemically important markets, in particular the market for OTC derivatives, into the regulatory framework.

On the negative side, however, Richardson argued that individual firms have not been sufficiently discouraged from putting the financial system at risk. In fact, in certain instances the DFA creates perverse incentives. For example, if a SIFI fails, the surviving SIFIs must pay for the recovery costs not borne by the failed SIFI's creditors. Therefore, firms are charged ex post rather than ex ante for systemic risk. Richardson described this scenario as a classic free rider problem, where some parties do not pay for a common resource they rely on. Because the surviving SIFIs may be required to provide funding for a failed SIFI during a crisis, they may have to resort to asset fire sales, which could put those individual SIFIs and the financial system at greater risk.

Richardson also argued that the DFA did not sufficiently address government guarantees. For example, there were only minor changes to FDIC insurance premiums and to the allowable activities of government-sponsored enterprises (GSEs) like Fannie Mae and Freddie Mac. Also, even though "orderly liquidation authority" of SIFIs was granted to the FDIC, the possibility of future bailouts and guarantees remained intact.

In addition, Richardson criticized the DFA for not having created a level playing field between banks and nonbank financial firms. Investment banks, insurance companies, pension funds, and money market funds all acted like banks leading up to the crisis (e.g., they created credit); however, the DFA did not mandate that they be regulated like banks. Under the DFA, they can receive more regulatory scrutiny if they have the potential to create systemic risk, but Richardson said there should be a universal regulatory approach that treats both banks and nonbank financial firms the same.

Finally, Richardson contended that the DFA did not adequately restrain SIFIs' ability to circumvent regulations. For example, a bank can still sell a pool of mortgages to the GSEs and buy the mortgages back in the form of a mortgage-backed security (MBS), which reduces the amount of capital the bank has to hold. Alternatively, if a bank holds a highly rated MBS and buys a credit default swap on that security from a highly rated insurance company, that bank can hold the security "off balance sheet," which means it does not need to hold any capital on those assets.

Basel III liquidity rules and regulations

Another key panel featured Marc Saidenberg, Federal Reserve Bank of New York; Joe Bonocore, JPMorgan Chase & Co. (JPMC); and Jeremy Stein, Harvard University. The panelists discussed Basel III rules and regulations on liquidity—the ability of firms to meet their short-term obligations. Many financial firms faced liquidity problems during the financial crisis, when markets that had provided short-term funding suddenly dried up.

Saidenberg, the Federal Reserve System's representative to the BCBS, discussed the BCBS's efforts to strengthen liquidity buffers at internationally active financial institutions. The BCBS has two main objectives in liquidity regulation: to enhance the resilience of financial institutions to short-term funding shocks by requiring them to hold a minimum pool of liquid assets, and to alter longer-term liquidity mismatches by requiring firms to finance their operations with more stable sources of funding. To achieve these complementary goals, the BCBS developed two measures of liquidity risk to be implemented as minimum standards: a liquidity coverage ratio (LCR) and a net stable funding ratio (NSFR).

The LCR is defined as the ratio of a pool of high-quality liquid assets of a firm to its projected net cash outflows over a 30-day horizon under a stress scenario. The pool of assets should be unencumbered, liquid in crisis scenarios, and, ideally, eligible as collateral at central banks. Each asset category is assigned a weight (ranging from 0% to 100%) determining how much of each category can be considered a liquid asset for calculation of the numerator. The BCBS will require that the LCR be no lower than 1.0, ensuring that during a funding crisis banks will be able to meet cash outflows.

In addition to managing short-term liquidity needs with the LCR, the BCBS also introduced the NSFR to encourage banks to move away from excessive use of short-term funding sources toward more stable, longer-term sources. The NSFR is defined as a ratio of "available amount of stable funding" (capital and other sources thought to be committed to the bank for a minimum of one year) to a "required amount of stable funding" (based on the liquidity risk of the bank's asset and off-balance-sheet composition). Each funding category is assigned a weight, representing the assumed reliability of the funding source, for calculation of the numerator. Similarly, each asset and off-balance-sheet activity is assigned a risk-adjusted weight, representing the amount of the asset or activity that should be matched by stable funding, for calculation of the denominator. The ratio should exceed 1.0 to ensure that the bank's activities are funded with an acceptable amount of stable liabilities.[3]

Bonocore addressed the BCBS's new liquidity regulation from the financial services industry's perspective. He emphasized that JPMC fully supports the BCBS's objective of strengthening global liquidity standards. In fact, Bonocore credited weak liquidity standards as one of the key causes of the financial crisis. Ideally, financial institutions should maintain surplus liquidity and diverse funding sources in order to operate effectively in crisis scenarios. He said JPMC considers the LCR to be a well-designed standard; however, he questioned how it is calibrated.

Bonocore asserted that the current assumptions of the funding outflows (the stress scenario) and liquid asset eligibility (the regulatory weights) for the LCR are inconsistent with market realities. The assumptions instead should be calibrated to actual market history. Bonocore argued that the assumptions about funding outflows are more extreme than those actually experienced during the financial crisis. He also contended that certain asset classes should be at least partially counted as sources of liquid assets. The asset classes he

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highlighted include gold, investment-grade municipal bonds, AAA-rated asset-backed securities, and exchange-listed equities, as well as the capacity to secure Federal Home Loan Bank advances—all of which currently have a 0% weight for liquid asset eligibility. Additionally, he said that GSE debt and GSE-backed MBS—both with a current weight of 85%—should be given a 100% weight.

Bonocore's expressed concerns about the impact of the proposed liquidity regulation went beyond the banking industry. He said that as a result of the reforms, he saw the potential for higher funding costs in municipal, corporate, commercial paper, and mortgage markets. Additionally, as currently proposed, the regulation could force banks to use more expensive long-term financing, which could increase the cost of credit and stifle economic growth, he said.

Stein, taking a more macroeconomic perspective, discussed the economic principles that he believes should drive the BCBS's new liquidity regulations. He argued that maturity transformation (i.e., transforming short-term liabilities into longer-term earning assets) is the main source of fragility within the financial system. Financial intermediaries fund with short-term debt because it is less expensive. It is less expensive because it functions like money—it is liquid and flexible. Banks profit when they generate longer-term assets that yield a higher return than the rate paid for their short-term funding. Maturity transformation leads to private money creation, which is the core of the banking sector's function in the economy.

However, the private money creation process occurs not only in the banking sector, but also in the nonbank sector. Structured investment vehicles and hedge funds issue asset-backed commercial paper and use secured funding transactions (repos) to finance their operations. Money market funds invest in these instruments, thereby providing credit and leading to a form of money creation. These types of transactions involve forms of collateral that the lender can sell in the event that the borrower defaults. The combination of short-term debt and collateral makes markets for the collateral vulnerable to fire sales, which can drive down the value of the collateral. This can lead to spillovers into other markets and resulting solvency issues. Hence, excessive private money creation can generate systemic risk. Thus, Stein said that the BCBS should focus on regulating maturity transformation within all sectors of the financial system, not just the banking sector.

Conclusion

The DFA mandates and the BCBS proposals provide regulators with a well-constructed basis from which to implement regulatory reform. However, to achieve their stated purposes, financial regulations must be fully understood and properly implemented. In his keynote address, Federal Reserve Chairman Ben S. Bernanke stated, "While a great deal has been accomplished since the [DFA] was passed less than a year ago, much work remains to better understand sources of systemic risk, to develop improved monitoring tools, and to evaluate and implement policy instruments to reduce macroprudential risks." Speakers at the 47th annual Bank Structure Conference discussed how regulators can achieve these goals and where they are in the implementation process. With implementation timeframes of nearly ten years for certain aspects of the reform, a great deal of work remains ahead.[4]

1 See www.fdic.gov/bank/analytical/quarterly/2011_vol5_2/Article2.pdf.

2 Dow Jones and Company, 2011, "Still too big, still can't fail," *Wall Street Journal*, March 5, available by subscription at http://online.wsj.com/article/SB10001424052748703530504576164880968752682.html.

3 For details on the LCR and NSFR, including the weights assigned to various asset categories for each ratio, see www.bis.org/publ/bcbs165.pdf.

4 The 48th annual Bank Structure Conference will be held on May 9–11, 2012, when the discussions on regulatory reform will continue.