Implementing Dodd–Frank: Identifying and mitigating systemic risk

Mark Van Der Weide

The 2008 financial crisis revealed some basic flaws in our financial system and in our financial regulatory framework. Specifically, the crisis demonstrated that the failure or the material financial distress of some of our largest, most complex firms could pose a threat to the financial stability of the United States.

The crisis also made manifest that the existing framework for government oversight of our major financial firms and our authority for resolving those firms when they get into trouble were suboptimal. Bankruptcy proceedings, which could be quite panic-inducing, and federal government assistance were the only available options for addressing the failures of some of these large, nonbank financial firms.

As a result of these infirmities in our regulatory framework and the imprudent risk-taking of many financial firms, unprecedented government assistance was necessary to support these firms and the broader financial system to prevent an economic catastrophe. Market participants before the crisis assumed there was a nonzero probability that our most colossal firms would receive government assistance if they became troubled. But the actions taken by the federal government during the crisis, although necessary, I think, to prevent the implosion of our financial system and significant damage to the real economy, have certainly solidified this market perception.

So taking on this moral hazard problem, this "too-big-to-fail" problem, and the threats to financial stability that are imposed by our most systemic financial firms are the central goals of the Dodd–Frank Wall Street Reform and Consumer Protection Act and of the Fed's implementation of the act. That will be the focus of my remarks today.

Addressing problems with "systemically important financial institutions" (SIFIs) is a necessary condition to protecting financial stability. However, it is not a sufficient condition. Systemic risk can certainly be generated and propagated outside of our largest financial firms. It can arise in systemic herds, that is, collections of firms that individually may not be systemic but collectively are systemic. Money market mutual funds would be a great example of that. It can arise in common funding patterns across broad financial sectors, and it can arise in collective underestimations of risk by the financial sector broadly during an irrationally exuberant credit boom. So efforts to tamp down on systemic risk need to address the SIFI problem at a minimum, but they also need to pitch themselves quite a bit more broadly.

Mark Van Der Weide is senior associate director in the Division of Banking Supervision and Regulation at the Board of Governors of the Federal Reserve System. The views expressed are those of the author and may not be those of the Board of Governors of the Federal Reserve System or other members of its staff.

© 2012 Federal Reserve Bank of Chicago

Economic Perspectives is published by the Economic Research Department of the Federal Reserve Bank of Chicago. The views expressed are the authors' and do not necessarily reflect the views of the Federal Reserve Bank of Chicago or the Federal Reserve System.

Charles L. Evans, *President*; Daniel G. Sullivan, *Executive Vice President and Director of Research*; Spencer Krane, *Senior Vice President and Economic Advisor*; David Marshall, *Senior Vice President, financial markets group*; Daniel Aaronson, *Vice President, microeconomic policy research*; Jonas D. M. Fisher, *Vice President, macroeconomic policy research*; Richard Heckinger, *Vice President, markets team*; Anna L. Paulson, *Vice President, finance team*; William A. Testa, *Vice President, regional programs*; Richard D. Porter, *Vice President and Economics Editor*; Helen Koshy and Han Y. Choi, *Editors*; Rita Molloy and Julia Baker, *Production Editors*; Sheila A. Mangler, *Editorial Assistant*.

Economic Perspectives articles may be reproduced in whole or in part, provided the articles are not reproduced or distributed for commercial gain and provided the source is appropriately credited. Prior written permission must be obtained for any other reproduction, distribution, republication, or creation of derivative works of *Economic Perspectives* articles. To request permission, please contact Helen Koshy, senior editor, at 312-322-5830 or email Helen.Koshy@chi.frb.org.

ISSN 0164-0682

In this article, I will outline some of the core efforts that the Federal Reserve has been taking to implement the Dodd–Frank Act and some related reforms to improve supervision and regulation of the most systemic firms and also to promote financial stability. I will also discuss some of the key challenges the Fed faces in implementing the act. I'll start by describing some of the work we have been doing as part of the Financial Stability Oversight Council (FSOC) and then rotate pretty quickly to talk about things that we are doing independently.

Work of the Financial Stability Oversight Council

The Dodd–Frank Act created the FSOC principally to help identify and mitigate threats to the financial stability of the United States. We have made some meaningful progress as we have established the organizational structure of the FSOC, and its committee structure was designed to help us get our duties done.

We have also completed a number of studies that were required by the act on some of the important provisions in Dodd–Frank, including the Volcker rule, financial sector concentration limits, risk retention, and the macroeconomic effects of systemic risk regulation. And we are working on additional studies, including one on contingent capital instruments and secured creditor haircuts.

A key task of the FSOC in the coming months will be to finalize its conceptual framework for identifying and designating nonbank financial firms that could pose a threat to financial stability. The council has issued for public comment several advance notices of proposed rulemaking and several proposed rulemaking documents on how to get that job done. What should the substantive framework be and what should the process be for designating such firms?

Consistent with SIFI identification principles that the Financial Stability Board has articulated, the council has indicated that the core factors that we intend to look at when deciding whether a particular firm is systemic are size, interconnectedness, and availability of substitutes for the services provided by the firm. A set of secondary factors has also been identified that includes the extent of leverage, maturity transformation, and the extent of existing regulation that applies to those firms. Now, those six factors are obviously concepts—they are not formulas. It is going to take a lot of work to figure out within each of those categories how to quantify systemic importance and how to weigh the categories against each other.

Many comments on the FSOC's proposals in this area have urged us to be as transparent as possible about the standards by which firms will be designated. And we are looking for ways to increase the predictability of council decision-making in this area. It is important that we be consistent, though, with our prevailing need, I think, for an adaptive SIFI designation framework that is robust to financial innovation and to the intense heterogeneity in the U.S. financial sector. In any event, we are committed to providing very high levels of due process to any firm that the FSOC considers a potential candidate for designation and consequent oversight by the Fed.

Macroprudential regulatory policy

In addition to its role as a member of the FSOC, the Federal Reserve has other important responsibilities under the Dodd–Frank Act to help promote financial stability. As Chairman Bernanke has noted, a key element of the Dodd–Frank Act is its injunction to the Fed and other financial regulators to employ macroprudential approaches to supervision and regulation.[1] We are to oversee financial firms and to review their mergers and acquisitions activity with a view toward protecting the financial stability of the broader financial system, not just protecting the solvency of individual firms. We have a lot to do in fleshing out how precisely to implement that mandate.

I want to highlight a few points on macroprudential regulatory policy before moving on to address some of the more concrete provisions of the Dodd–Frank Act. I think the Chairman made a crucial distinction between what I consider the two major strands of macroprudential regulation. The first is the structural or spatial components of it and the second is the temporal, time-related components.

On the spatial/structural side, it is very important that we endeavor to mitigate threats to financial stability that can come from structural problems in our financial system—for example, from excessive entanglements among firms, from excessive herding behavior by financial firms, and from the high risk of contagion effects in the financial markets. But at the same time, we have to look at the time-varying element. We have to work to mitigate threats from the buildup of excessive risk during credit booms or other types of financial booms. So we have to watch for problems on the upside. At the same time, we have to pay attention to what the right tools are on the downside. You try to mitigate threats that might build up from the deleveraging or de-maturity transforming activities of financial firms that are rushing to crouch defensively as they see an economic thunderstorm approaching.

A final macroprudential comment I want to make deals with the occasional tension between microprudential and macroprudential goals. Typically, micro- and macroprudential goals reinforce each other. Strengthening capital requirements across the financial system, for example, will make individual banks safer and that will help make the broader financial system more resilient. However, they do not always reinforce each other. For example, actions by a particular firm to improve its capital adequacy, such as by selling assets or cutting back on lending, might very well serve microprudential goals and make the bank safer and sounder. But if we are in a recession, or a period of financial instability, that kind of behavior can be quite inconsistent with macroprudential goals for maintaining liquidity in the system and moving forward.

In addition to managing the potential conflicts between micro- and macroprudential goals, we also need to carefully measure the costs of macroprudential policies. These can be measured in terms of higher credit costs, lower credit availability, and slower economic growth. Those costs need to be contrasted with any systemic risk mitigation benefits we can achieve from the macroprudential policies.

Prudential standards for large bank holding companies and nonbanks

The second element of the Dodd–Frank Act that I want to discuss is the obligation of the Fed to develop more stringent prudential standards for large bank holding companies (BHCs) and nonbank financial firms that the council designates as SIFIs. This is one of the Fed's most important Dodd–Frank implementation duties and it is consuming a great deal of the blood, sweat, and tears of Fed lawyers, economists, and supervisors. Fortunately, the act gives the Fed a great deal of flexibility in how we design this framework, although it does hardwire a few parameters.

The act tells us that we have to apply the framework to bank holding companies above $50 billion in assets. We are also required to have the framework increase in proportion to what I like to call the "systemic footprint" of firms, that is, the size, interconnectedness, and complexity of firms in that set of BHCs above $50 billion.

Third, the act specifies the types of regulatory standards we need to apply in an enhanced way to the big firms. We need to calculate additional capital requirements, additional leverage requirements, and additional liquidity requirements. We have to develop single counterparty credit limits. We have to conduct stress tests, to develop living wills, and to design an early remediation framework.

The act required that we implement these enhanced standards by January 2012, although they did not have to go into effect then. Our goal with this package of standards will be to produce a well-integrated set of rules that meaningfully reduces the probability of default of our largest financial firms and at the same time minimizes the losses to the financial system and the economy if such a firm should fail.

The enhanced standards should force these firms to internalize any cost that they would pose to the financial system if they were to fail or become distressed. It should help offset the implicit subsidy that some of them enjoy due to the "too-big-to-fail" phenomenon and it should give the firms incentives to shrink their systemic footprint.

I am not in a position to give you a sneak peek as to how the Fed plans to come out on this set of enhanced standards for SIFIs. However, I can say that the included firms will not all be treated equally. They are not equally systemically important. This generates some challenges for the Fed.

I want to highlight some of the challenges in designing this new framework. The first issue deals with the proportionality of the regulatory process. I think the Dodd–Frank Act was spot-on in requiring the Fed to make sure that we do not apply a one-size-fits-all approach to every bank holding company above $50 billion. However, designing exactly how to do that gradation—how to make the regulatory framework proportional to the systemic footprint of the firms above $50 billion—is not an easy task.

We have been spending a lot of energy trying to figure out what the differences are in the systemic footprint between a Huntington Bank Shares or a Zions Bancorp sitting just north of $50 billion and the colossuses that we deal with such as Citi, JPMorgan, and Goldman Sachs. We need some way to measure how much more systemically important the largest of the firms are relative to the firms just above the threshold.

Once we develop a means to measure the proportional size, complexity, and interconnectedness of these firms, how do we adapt the regulatory apparatus to those differentials? Do we have some kind of continuous function of the systemic footprint of the firm for some or all the standards? Do we have a multi-bucket, a many-bucket approach, or do we just have a small number of buckets? We need to answer these questions realizing that there are costs and benefits to each of those approaches and they vary somewhat between capital rules, liquidity rules, single counterparty credit limits, and stress-testing. We are currently evaluating approaches to deal with that gradation/proportionality question.

A second core issue we have is calibration. This is difficult. It is one thing to say that you want SIFIs to internalize their externalities or to absorb any implicit subsidy they receive from market perceptions that they are "too-big-to-fail." It is quite another thing to actually calibrate a regulatory regime to achieve those goals with any precision. As we designed the enhanced standards framework, we have been attentive and will continue to be attentive to the cumulative, quantitative, and qualitative costs of these rules. We will do our best to consider the costs of the aggregate package that constitutes the higher regulatory standards for SIFIs.

A third challenge for the Fed is the integration issue. Importantly, we are not designing each of these standards in isolation. We have different people thinking about how to develop a capital surcharge, liquidity requirements, single counterparty credit limits, stress tests, and living wills for large, systemically important firms. At the same time, we have an overarching team of people making sure that these separate work streams link well together to produce a well-integrated set of rules that will apply to banks where the whole is more than the sum of the parts.

A fourth issue that is consuming much of our time deals with foreign banks. In the Dodd–Frank Act, Congress set the $50 billion threshold and said we had to apply that to any U.S. bank holding company, but also to any foreign bank that is treated as a bank holding company under federal law. There are a lot of foreign banks that satisfy these criteria. In fact, there are more such foreign banks than domestic banks. Here again, Congress, I think quite wisely, gave the Fed substantial discretion in how we implement our U.S. SIFI framework for foreign banks.

In determining that framework, Congress told us that we could consider national treatment, equality of competitive opportunity, and the quality of home country regulation for these firms. However, deciding on the appropriate factors and appropriate weights of those factors is a complicated process. Foreign banks operate in the United States in a complex and diverse set of ways. They have branches. They have agencies. They have subsidiary banks. They have subsidiary bank holding companies. They have subsidiary broker–dealers. We are spending a lot of time trying to determine the extent to which we should apply these standards to the parent foreign bank, or to just the U.S. operations of the firm, and how to best incorporate the adequacy of the home country regulatory framework into that calculus. I consider addressing this foreign bank adaptation issue to be one of the most difficult tasks we have in getting the SIFI framework figured out.

Resolvability of financial firms

The last issue I want to talk about on the SIFI regulatory front is how to improve the resolvability of financial firms. Under the Dodd–Frank Act, the Fed and other regulators are required to work to reduce the expected adverse impact of a SIFI failure on the financial system. There are two ways to do that. One is to reduce the probability of the firm's failure. The second is to reduce the impact on the system if the firm does fail. In Basel II-speak, there are probability-of-default-related tools (PD) and there are loss-given-default tools (LGD).

As Pat Parkinson explained here at the 2010 Conference on Bank Structure and Competition, financial regulators historically have focused almost exclusively on the PD-related tools, that is, reducing the probability of a firm's failure.[2] They have given very short shrift to any kind of tools that would reduce the impact of that failure on the financial system. For example, we have given financial firms great flexibility in how they organize their internal structures, even if those internal structures might make them difficult to resolve if they fail. This is going to have to change in the post-apocalyptic Dodd–Frank world. As macroprudential supervisors, I think we can no longer rely solely on the traditional ex ante going concern, prudential tools like capital and liquidity that are designed to reduce the probability of a firm's failure. We are going to have to incorporate ex post, resolvability-enhancing tools to reduce the loss to the financial system when these firms fail. This is a complicated endeavor and we have a lot of work to do to figure out how to get this right.

I want to touch on a few challenges concerning this resolvability issue. The first challenge is to determine the most socially efficient means to improve the resolvability of SIFIs. This could include requirements that the firms simplify their internal organizational structures by reducing the number of legal entities (and in doing so reducing the intrafirm guarantees, funding relationships, and derivative transactions). There could also be a movement toward requiring firms to operate their system-critical businesses in financially and operationally autonomous packets. I think we have a lot of work to do to try to figure out which of these tools might make sense.

A second sub-issue under this resolvability framing is to determine how aggressive we want to be on the resolution front. We need to be able to answer the question of how much going-concern costs we are willing to impose on the firms to achieve resolvability benefits. On this point, the comments made by Wayne Abernathy are certainly correct. There will be going-concern costs for firms to simplify their organizational structures. So we need to be able to strike the right balance between the benefits on the resolvability front and the costs on the going-concern front.

The final sub-issue under resolvability deals with choosing the right mix of policy tools. We have these two types of tools: the PD tools and the LGD tools. We need to strike the right balance between the two. Should the emphasis mostly be on the PD tools? On the LGD tools? What is the appropriate balance? Again, we have started to think about these issues, but I think a lot of work remains to be done.

Financial stability efforts here and abroad

I am obviously giving very short shrift to other sub-issues concerning Dodd–Frank issues that we are working on. Let me simply list some of these efforts. We are working with our U.S. regulatory colleagues at other agencies to implement financial stability-related reforms. Those include risk-retention requirements for securitization sponsors; margin requirements for non-cleared over-the-counter derivatives; incentive compensation rules; limits on the proprietary trading and private fund investment activities of banking firms; and risk-management standards for central counterparties and other financial market utilities. We are also working in close coordination with the Office of Thrift Supervision, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation as we prepare to take over supervisory authority for thrift holding companies.

Finally, in addition to the massive amount of energy being spent by regulators to implement the Dodd–Frank Act, there have also been a lot of discussions concerning how to make the international financial system safer. The Basel Committee, Financial Stability Board, and the G20 leaders have been doing a lot of work on issues such as improving capital requirements and the overall prudential framework for globally active banking firms. The Fed has played an important role in those discussions and I think there have been some pretty significant achievements in the Basel III Accord.

There is still a lot of work that will be done internationally in parallel with Dodd–Frank implementation in the United States. The key issues that remain for the international community include determining how to increase the loss-absorbency of systemic firms beyond those of other banks, the so-called SIFI capital surcharge issue. There is also the issue of assessing the potential role of contingent capital and bail-in mechanisms for addressing systemic banking firms. And there is the issue of how best to strengthen resolution regimes around the world to enable governments to minimize the costs resulting from the failure of a large, complex international bank.

Let me close by just saying the Dodd–Frank Act gives the Fed and other financial regulators new powers and new responsibilities to protect U.S. financial stability. With a few exceptions, Congress wisely chose not to micromanage the ways and means by which we get to the financial stability goals. I think that was a wise decision. We have a lot of degrees of freedom. I think that increases our obligation to get the job done correctly. We are determined to accomplish that, but I think we have a long way to go before we get to the end of the journey.

NOTES

[1]Ben S. Bernanke, 2011, "Implementing a macroprudential approach to supervision and regulation," speech delivered at the Federal Reserve Bank of Chicago's 47th Annual Conference on Bank Structure and Competition, Chicago, May 5, available at www.federalreserve.gov/newsevents/speech/bernanke20110505a.htm.

[2]Patrick M. Parkinson, 2010, "Restoring market discipline on large financial institutions," in *The Future of the Financial Services Industry—Structure, Regulation & Performance*, proceedings of the 46th Annual Conference on Bank Structure and Competition, Federal Reserve Bank of Chicago, pp. 38–43.