Statement of The Financial Service Roundtable
Subcommittee on Financial Institutions and Consumer Credit
of the
Committee on Financial Services
U.S. House of Representatives
on
The Impact of the Dodd-Frank Act:

Understanding Heightened Regulatory Capital Requirements
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Executive Summary

Four years after the global financial crisis, significant steps have been taken to strengthen the U.S. financial system and U.S. financial institutions. The Dodd-Frank legislation requires a myriad of new heightened regulatory standards for participants in the financial markets designed to avoid future financial crises of the magnitude experienced recently. Increased minimum capital levels are an important requirement of Dodd-Frank, but they are only one of many safeguards contained in the legislation. All of the new required regulations are intended to work together to both reduce the probability of a failure of a systemically important financial institution (SIFI) and, in the unlikely event of a failure, substantially reduce the potential impact spreading across the financial sector. The meaningful progress made to date toward these goals can be summarized in five areas:

First, the probability of a failure of a large firm has been significantly reduced. Dodd-Frank imposed a great variety of new requirements and restrictions regarding the size, business activities, capital, liquidity, governance and risk management practices of financial institutions. The intensity of supervision by the prudential regulators has risen substantially. Examinations of all areas of impacted financial institutions are more numerous and far more thorough than in the past. New regulatory rules and proposed rules will ensure thorough and active supervision in the future. It should be noted that the industry is currently providing constructive comments and feedback regarding the proposed rules to ensure the final outcomes are effective, make our financial system safer and stronger, and do not hinder the economy or the global competiveness of financial institutions in the U.S.

Second, there is greater oversight of the industry and the financial markets by new regulatory entities. There are several new regulatory organizations designed to monitor risks to the stability of the financial system. While still in the early stages of organizing and developing their missions, these entities have the

opportunity to play a critical role in avoiding another broad financial crisis. The Financial Stability Oversight Council (FSOC) was created by Dodd-Frank and is responsible for overseeing the level of risk throughout the financial system and for identifying and heading-off emerging trends that could grow to be a threat to financial stability. FSOC is not alone in its new risk monitoring responsibilities. The Federal Reserve also has created its own new Office of Financial Stability Policy and Research; the FDIC has created its new Office of Complex Financial Institutions; and a powerful new agency, the Office of Financial Research (OFR), has been charged with measuring and monitoring risk in the financial system.

Third, the systemic impact of a failure of a financial institution is greatly reduced if not completely eliminated under current law. Dodd-Frank gave regulators a much more robust set of tools for resolving a failed institution in an orderly manner. Title II of Dodd-Frank created a new resolution authority vested in the FDIC. This new resolution regime is designed to ensure that the failure of any financial institution deemed systemically important could be swiftly isolated and then resolved without contagion effects that could negatively impact other companies or the broader economy, which in turn could lead to a systemic crisis. Furthermore, large financial firms are now required to annually submit resolution plans, so-called "living wills," that will be approved by both the FDIC and the Federal Reserve. These plans will provide roadmaps to the FDIC for effectively resolving a failed institution, further ensuring minimal disruption to the financial markets in the remote event of a large financial institution failure.

Fourth, most institutions considered systemically important have strengthened their balance sheets, improved their capital and liquidity planning and positions, enhanced their internal governance and risk management capabilities, and upgraded their underwriting policies and practices on their own accord. These efforts started almost immediately after the crisis and well before most of the roughly 400 new Dodd-Frank rules become fully effective. Many firms have increased capital to record levels that exceed Basel III expectations. During the last four years, the largest U.S. banks have increased Tier I capital, the "safest" form of capital for a bank to have on its books, by 50 percent. Additionally, financial services investors have demanded greater transparency, more pertinent information, and higher levels of accountability from management teams, thereby instilling greater market discipline as well. As a result of these actions, large financial institutions are much stronger today, and they have reduced both their risk tolerance and their risk profile, and thus their potential systemic impact.

Fifth, Dodd-Frank expressly prohibits the use of taxpayer funds for the purpose of preventing the liquidation of a financial institution. Section 214 of

Title II of the Dodd-Frank Act clearly states this new prohibition to protect taxpayers.

The probability that a SIFI will fail is significantly diminished

The probability that a systemically important financial institution (SIFI) will fail has diminished significantly since the financial crisis. As noted above, larger financial institutions – by their own volition – have taken significant steps to de-risk their balance sheets and their businesses since 2008. Furthermore, the Dodd-Frank legislation calls for many new and enhanced regulatory rules that will provide managements and regulators with a set of standards and tools that will build additional safeguards into the financial system, allowing for potential emerging risks to be identified and managed much earlier.

These new regulatory safeguards include:

- **Increased regulatory capital**: There are multiple efforts to increase regulatory capital at both banks and nonbanks, not only to create a higher cushion for greater loss absorption in the event of a problem but also to ensure higher quality capital going forward (i.e., greater reliance on common equity as a standard). Internationally, the Basel Committee on Banking Supervision (BCBS) promulgated new guidelines for internationally active banks in 2011 after several years of debate. These guidelines call for a higher minimum level of Tier 1 common equity of 7.0 percent. These reforms also include raising risk-weightings for traded assets, creating a new capital counter-cyclical buffer on top of new minimums, and introducing a new international leverage ratio similar to the one in place in the United States before the crisis, only higher

  Meanwhile, the U.S. version of the new Basel III guidelines will be released for comment in the coming months, according to the latest statement from Federal Reserve officials. Even before these rules will be proposed, most of the largest financial firms are well on their way to meeting the new Basel III requirements on their own ahead of schedule.

- **Capital planning**: As a complement to new and higher capital standards, the Federal Reserve initiated new capital planning requirements for bank holding companies with assets of $50 billion or more in 2011. These new capital plans will be submitted annually by large financial institutions and will be subject to intense review by the Federal Reserve as part of its more holistic supervisory oversight. Moreover, they are designed to be more forward-looking and closely integrated with related new stress testing requirements, also mandated under Dodd-Frank.

These new capital plans are becoming an integral part of the Federal Reserve's supervisory arsenal and impose strict regulatory oversight of planned capital distributions. In effect, they will create a high hurdle for any firm that wishes to distribute capital (e.g., earnings in the form of dividends back to shareholders), with the Federal Reserve using severe economic scenarios upon which to base their judgment about the viability of capital distributions. In addition, firms subject to the capital planning rule are required to report significant new and detailed data, including granular information about their loan and investment portfolios on a monthly/quarterly basis to enhance Federal Reserve monitoring.

- **Stress testing**: Building on the Federal Reserve's stress tests of the 19 largest bank holding companies after the crisis, Dodd-Frank mandates a twice yearly rigorous stress testing exercise against at least three economic scenarios. These rigorous new stress testing requirements will now cover even more financial institutions with the results closely monitored by the Federal Reserve. There also is a requirement for firms to publicly disclose information regarding their results.

- **Liquidity**: For the first time, the Basel Committee and U.S. regulators are moving to impose new short-term and long-term quantitative liquidity requirements on large financial firms. The primary purpose of the new rules is to increase resiliency of the banks and lower systemic risk. As the crisis clearly demonstrated, large financial firms often become illiquid before they become insolvent, so new liquidity rules are also designed, in part, to reassure creditors.

  The Basel Committee and the Governors and Heads of Supervision (GHOS) of the G20 nations are considering two proposals and expect to have a final proposal later this year that would be coupled with its new capital guidelines. The first is the Liquidity Coverage Ratio (LCR), which is designed to ensure a more than adequate supply of liquidity for each covered firm during a 30-day period of liquidity stress. The second is the Net Stable Funding Ratio (NSFR), which is designed to ensure a better asset and liability duration match on a company's balance sheet within a one-year framework. Both of these measures are subject to further examination and possible further revision at the international level.

  In addition, the new enhanced prudential standards in the proposed rule for Sec. 165 of the Dodd-Frank Act impose stringent new requirements for liquidity risk management by both boards and management teams. Provisions included in the Federal Reserve's liquidity rules for SIFIs

include: the development of liquidity risk measurement and reporting systems; daily detailed cash flow projections; monthly liquidity stress testing; the establishment of a board approved liquidity buffer; maintenance of a board approved contingency funding plan, and; specific limits such as concentrations of funding, the amount of funding that matures in various time horizons, and off- balance sheet exposures that could create funding needs in times of crisis.

- **Single Counterparty Credit Limits:** The Dodd Frank Act calls for enhanced rules that will limit the total amount of credit exposure to any single counterparty to 25% of an institution's capital and surplus. This limit is intended to ensure that the risk of institutions in the financial markets to one another will remain at manageable levels, thereby reducing the risk of systemic problems spreading from one financial institution to other market participants.

- **Early remediation**: Building on the "prompt corrective action" provisions in law that apply to all insured banks, the Dodd-Frank Act also included a new section applying "early remediation" to bank holding companies subject to Federal Reserve oversight. The comment period has recently closed on the Federal Reserve's proposed rule, and our detailed comments about this new provision are contained in the same joint trade letter referenced above.

  In short, Sec. 166 of the Dodd-Frank Act mandates a new early intervention program by the Federal Reserve, based on a four-stage approach to surveillance, initial contact with a firm that may trip any number of pre-determined surveillance metrics, and then a staged approach to joint supervisory and company actions. This new early remediation regime is designed for swift and forceful intervention before a company gets to be a significant or unmanageable problem, with the goal of restoring the firm as a "going concern" as opposed to a "gone concern" requiring its orderly liquidation. This is another powerful supervisory tool, whose sole purpose is fast and sweeping action to mitigate the risk from a potential failure of a large or interconnected company, which in turn could threaten the stability of the financial system and the economy.

- **Concentration limits**: The Dodd-Frank Act also included new absolute size limits for a banking system that is the least concentrated one of any G20 nation. It imposed a new 10 percent cap on the domestic liabilities of banks, and mandated that the Federal Reserve issue regulations to implement this new concentration restriction and size limitation with respect to its merger and acquisitions approvals.

These heightened prudential standards will significantly reduce the risk profile of large financial services institutions. It should be noted, however, that if the requirements are carried too far, adverse economic consequences (such as decreased credit availability or increased product costs) could far outweigh the marginal benefits. These consequences have been discussed frequently by many policymakers and industry leaders over the past few years. The Financial Services Roundtable has catalogued over 100 reports and studies about the cumulative weight of new rules on the industry and economy.

There is far greater regulation and oversight of the financial industry and markets today than before the crisis

In addition to the enhanced regulatory standards, Dodd-Frank created the FSOC for the purpose of holistically monitoring the level of risk in the financial system and to watch for emerging trends that could grow to be a threat to financial stability. The members of the FSOC are the heads of the major regulatory agencies charged with overseeing the various aspects of the financial industry. This gives the FSOC both a unique and unprecedented view across all of the financial markets and the activities of institutions operating in those markets.

The FSOC has three new powers at its disposal: 1) the authority to monitor financial markets for risk through its new Office of Financial Research (OFR); 2) the ability to recommend enhanced prudential standards for all companies covered by Title I of the Dodd-Frank Act, which are "more stringent" and "increase in stringency" based on risk; and 3) the authority to designate nonbank financial institutions as systemically important and subject them to new and enhanced regulation and supervision by the Federal Reserve Board.

This past month, the FSOC published its final rule for the designation of nonbank firms that may pose a threat to the financial stability of the U.S. economy. Already, all bank holding companies (BHCs) with total assets of $50 billion or greater will be subject by law to the new enhanced prudential standards mandated in Title I, or roughly the top 34 BHCs currently operating in the United States. Treasury Secretary Timothy Geithner has publicly stated that he fully expects the FSOC to make its first batch of designations of nonbanks before the end of the year. This move will subject some still unknown number of firms to the Federal Reserve oversight for the first time under its new financial stability mandate.

The financial crisis was so severe in part because there was not a regulatory oversight body with either the mandate or capability to monitor risk in and across the broad financial system. The FSOC was designed to fill this critical void,

which should enable regulators to spot problems in the system earlier and at individual institutions sooner, before they become systemically threatening.

However, FSOC is still in its early stages. To be truly effective at reducing systemic risk, FSOC must coordinate with existing regulators and exercise greater transparency with the public.

In addition to FSOC, other agencies have also been charged with monitoring systemic risk and preventing the collapse and contagion effects of the failure of a large financial company. The Federal Reserve, the OCC, the FDIC, and the FSOC, all have similar mandates, but a variety of different policy and regulatory tools to significantly decrease the probability of large failures in the future that in turn would have a material impact on financial stability or the broader U.S. economy. Additionally, the Office of Financial Research (OFR) has broad powers to collect, analyze and standardize data with respect to systemic risk.

FSOC and the regulators are in the process of designing this new regulatory regime with new rules and processes, while the industry is actively engaged in providing constructive comments to avoid unintended consequences that would unnecessarily hamper healthy economic growth or the competiveness of U.S. financial markets. As Federal Reserve Governor Daniel K. Tarullo stated just last week: “the post-crisis regulatory reform program has been substantially directed at the too-big-to-fail problem, and more generally at enhancing the resiliency of the largest financial firms.”[1]

A failed SIFI will have significantly less systemic impact today than before the crisis

In the unlikely event that a large, systemically important firm fails, the Dodd-Frank legislation provides important new powers and tools in Title II (Orderly Liquidation Authority (OLA)) to the regulators for “resolving” the failed institution without damaging the financial system and without the contagion of significant problems spreading to other firms. Importantly, Section 214 of the Dodd-Frank Act clearly states that taxpayer money *cannot* be used to resolve a failed institution, and if there are costs incurred by the FDIC that are not recovered through resolution, then the FDIC will recover those costs from the industry through special assessments.

The Federal Reserve and the FDIC also have promulgated final rules under Sec. 165 of the Dodd-Frank Act that require large banks and any designated nonbanks

[1] Daniel K. Tarullo, Governor, Federal Reserve Board, “Regulatory Reform since the Financial Crisis,” Council on Foreign Relations, New York, New York, May 2, 2012.

to craft resolution plans that will require annual review and approval by both regulators (known as "living wills"). Both the Federal Reserve and the FDIC must approve these new plans separately. These resolution plans will provide a roadmap to the FDIC for winding up the activities of a failed company in an orderly fashion. Furthermore, the approval process for the plans will provide the regulators with an opportunity to proactively require changes in an institution's organizational structure or business model to the extent a firm's current structure would materially impede a resolution.

Key elements of the SIFI resolution plans and the new orderly liquidation powers granted to the regulators are:

- **Resolution Plans:** must be submitted annually and approved by both the Federal Reserve and the FDIC. Each annual report must contain the following extensive information:
    - Executive summary;
    - Strategic analysis, including capital needs, funding requirements, and specific actions to be taken, implementation processes;
    - Corporate governance, including internal controls, management responsibilities, data requirements, and risk management;
    - Organizational structure, including legal entities, balance sheet and off-balance sheet information, exposures, and counterparties;
    - Management information systems (MIS), including system requirements and access by regulators;
    - Interconnections and interdependencies, including foreign operations; and
    - Contacts.

- **Orderly Liquidation Authority:** The FDIC now has new orderly liquidation authority to resolve a large and failing bank holding company or other nonbank financial firm. The FDIC created a new internal Office of Complex Financial Institutions to manage both the resolution planning review and its new liquidation authority. In addition to the resolution plans submitted by individual firms, the FDIC will have its own internal plans for resolving individual firms based on those submissions.

  Title II provides for an elaborate mechanism to make the decision to put a financial firm through the orderly liquidation authority process, if normal bankruptcy is not a viable option. If the Federal Reserve Board, in consultation with the Secretary of the Treasury (who must also consult with the President), the FSOC, and the FDIC (the latter two by a two-thirds vote) find that a financial firm presents a systemic threat arising from its pending

insolvency, then the FDIC effectively can seize the institution and resolve it in an orderly manner under its new powers.

Large financial institutions are stronger, and better capitalized, with better risk management

The vast majority of large financial institutions today – banks and nonbanks – have significantly strengthened their balance sheets, bolstered their capital and liquidity positions dramatically, and instituted enhanced risk management standards including better underwriting practices. They reacted almost immediately after the financial crisis, and they moved well in advance of hundreds of rules being in place.

A new study by the Financial Services Roundtable – *Financial Services: Safer and Stronger in 2012* highlights the enhanced safety of the financial system, especially in the banking sector. This stronger balance sheet strength comes as a result of a combination of actions by individual firms on their own and the impact of the Federal Reserve's new capital planning and stress testing requirements. Compared to pre-crisis levels, banks will hold about 100 percent more capital, or roughly $500 billion to $550 billion more, under Basel III, and this will be significantly higher quality capital given the emphasis on the greater loss absorption of common equity.

A few data points on capital and other measures support the undeniable fact that our financial system is safer and stronger today than before:

- **Capital has increased significantly**: Most large financial institutions have significantly increased their capital strength to record levels since the crisis, and many actually exceed Basel III expectations.

    - From September 2007 to September 2011, FDIC-insured U.S. banks increased Tier 1 capital by 24 percent, to $1.217 trillion from $982 billion. Tier 1 is considered the "safest" form of capital for a bank to have on its books, consisting primarily of common equity;
    - The largest U.S. banks increased capital *by even more*. During the same four-year time period, U.S. banks with more than $10 billion in assets increased Tier 1 capital to $858 billion as of 2011 from $574 billion – a significant 50 percent increase;
    - By the end of 2010, the average Tier 1 capital ratio (capital to risk-weighted assets) for the largest 18 U.S. banks was 12.2 percent – well

above previous supervisory benchmarks, according to the Federal Reserve of San Francisco.

- **Risk management has been enhanced**: Most large financial institutions have significantly enhanced their enterprise-wide risk management frameworks and capabilities since the crisis, including more active board oversight, the adoption of risk appetite statements, regular use of stress testing and forward-looking capital planning, and more interactions with supervisors on risk in general.
- **Credit underwriting standards have improved**: Most large banks have completely overhauled their credit underwriting standards and practices. As a result, loan quality measures for the industry have improved dramatically over the last three years.
- **Proprietary trading has been restricted**: Most large banks have exited "pure" proprietary trading for their own account, while continuing to meet the needs of their customers and make markets. With the so-called "Volcker rule" still in the rule-making phase and not yet final, most large banks have overhauled their policies and processes in anticipation of a final rule, even though at this moment there are still significant concerns, unanswered questions, and unknown consequences for both financial institutions and their end-user customers, including especially foreign governments, about the potential impact of this proposed rule on financial markets, competitiveness, and market-making to support economic growth on a sustained basis.
- **Balance sheets have been de-leveraged**: Most large financial institutions have significantly de-leveraged their balance sheets since the crisis. As a result of the intense and priority focus of regulators on greater capital and liquidity buffers to absorb future potential losses, combined with the increased use of stress testing, most large banks in particular have much stronger and more resilient balance sheets today than they did before the crisis. Many have even collapsed off-balance sheet entities common before the crisis onto their balance sheets as part of this process of improving balance sheet strength to even stronger positioning in the markets.

Taxpayers are fully protected now, unlike before the crisis

Finally, Dodd-Frank expressly prohibits the use of taxpayer funds for the purpose of preventing the liquidation of a financial institution. Section 214 of Title II of the Dodd-Frank Act is very clear in stating this prohibition.

Furthermore, the language goes on to state that all funds used in the liquidation of

a financial institution shall be recovered from the disposition of the financial institution's assets or, alternatively, will be paid by the financial sector through assessments. These assessments would be in addition to the normal FDIC assessments that fund the deposit insurance fund and paid exclusively by the banking industry. The U.S. taxpayers do not fund the FDIC. Other portions of Title II of the Dodd-Frank Act also stipulate harsh outcomes for the shareholders, management, the Board, and certain creditors of a failed institution.

Summary

In summary, the U.S. financial system has been greatly strengthened by a combination of sweeping legislative, regulatory and industry changes.

First, the probability of any singular failure of a large, financial services firm has been reduced significantly through a combination of provisions in the Dodd-Frank Act, new actions by the financial regulators, and actions taken by financial institutions themselves.

Second, there is far greater oversight of the financial services industry by the new Financial Stability Oversight Council and the existing regulators, who have new and significantly enhanced powers of regulation, supervision, and enforcement. Moreover, there is much the FSOC can do to do a better job of coordination of rules and actions by the various regulators in addition to being far more transparency to the public about its agenda and its actions.

Third, the impact of any potential failure having a systemic impact has been greatly reduced, thanks to the provisions in Title II of the Dodd-Frank Act, which not only grant sweeping new authority to the Federal Reserve and the FDIC, but also ensure that taxpayers will never again have to pay for the failure of a large financial institution.

Fourth, most large financial institutions since the crisis have significantly strengthened their balance sheets, roughly doubled their capital and liquidity buffers, and upgraded their risk management capabilities. Moreover, they have done so before most of the more important Dodd-Frank rules have been finalized and well in advance of Basel III reforms even being introduced officially by U.S. regulators.

Finally, the Dodd-Frank Act explicitly prohibits taxpayer funds from being used in the event of the failure of a major financial institution.