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Financial Regulators Flag Systemic Concerns

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The financial services industry has closely followed regulators' efforts in the past three years to implement the sweeping reform agenda that lawmakers enacted in response to the financial crisis. Regulators' own observations about current and future vulnerabilities — drawn from their continuous monitoring of the financial system — have attracted less attention, but may inspire additional policy reforms.

The Financial Stability Oversight Council, which the Dodd-Frank Act created to monitor the financial system, released its annual report last month cataloguing systemic threats and vulnerabilities.[1] It is tempting to downplay the importance of the report: This is far from the first accounting of the financial system's vulnerabilities, and the council's own rulemaking authority is relatively narrow. But there is good reason to think the report may serve as a roadmap to regulatory action in the coming months.

The report is fundamentally a compendium of current vulnerabilities as seen from the perspective of each of the major federal financial regulators.[2] The agency heads do more than just sign off on the content of the report; they and their staffs are major contributors to it. Many of the emerging risks included in the report have champions in one of the member agencies who may have sought the council's imprimatur as an important step toward addressing these risks.

The council has reason to monitor how the agencies respond to the vulnerabilities it has identified. It has the authority under Dodd-Frank to recommend specific policy changes to supervisors upon a determination that a financial activity presents a systemic risk; supervisors have the choice of implementing the recommendations or explaining to the public why they choose not to.

The council flexed its muscle last year when it determined that money-market funds presented significant risks to the financial system and proposed related reforms. The council made it clear that it believed the Securities and Exchange Commission was in the best position to act, but said it would do so if the SEC does not. It could designate some funds as nonbank systemically important financial institutions subject to Federal Reserve supervision and enhanced prudential standards; alternatively, it could designate payment, clearing, and settlement as systemically important activities, ushering in heightened risk-management standards for the entire industry. The ultimate resolution bears watching

[1] http://www.treasury.gov/initiatives/fsoc/Documents/FSOC%202013%20Annual%20Report.pdf

[2] Voting members of the council include the Secretary of the Treasury, who chairs the council; the chairman of the Federal Reserve; the Comptroller of the Currency; the director of the Consumer Financial Protection Bureau; the chairman of the Securities and Exchange Commission; the chairman of the Federal Deposit Insurance Corporation; the chairman of the Commodity Futures Trading Commission; the director of the Federal Housing Finance Agency; the chairman of the National Credit Union Administration; and an independent member with insurance expertise appointed by the president.

EMERGING VULNERABILITIES IN FSOC ANNUAL REPORT

- **Run risk in repo markets**
- **Operational Risk**
  - **Market infrastructure/market continuity**
  - **Market infrastructure/business continuity**
  - **Cybersecurity**
  - **Money laundering**
  - **Model risk**
- **Reliance on reference rates**
- **System vulnerability to spikes in interest rates**
- **Foreign economic and financial developments**
- **Risk-taking incentives of large, complex, interconnected financial institutions**

not only for the implications for money-market funds, but also as a litmus test of the council's influence over the agencies' policy responses to emerging risks.

In the council's annual report, complexity of financial institutions and markets is a common thread in many of the emerging risks, as is the concern that the current regulatory framework may not be adequate to address them. Given these concerns and recent statements of many council members, financial institutions can expect a growing focus on the risks presented by the very largest institutions, and on the vulnerabilities created by complex and rapidly evolving technology — including complex, assumption-driven models.

Large, Complex, Interconnected Financial Institutions

The council sees some evidence that large, complex, and interconnected financial institutions are still perceived as too big to fail, which can create incentives for excessive risk-taking, confer a funding advantage, and concentrate the industry. In particular, the report noted that long-term credit ratings for the largest bank holding companies still imply a commitment by the government to act as a backstop in a crisis, although the related funding advantage has declined over the past two years.

The report did not identify which holding companies present the greatest concern with respect to risk-taking incentives, although it presented data for the six largest of the eight U.S. bank holding companies designated by the Financial Stability Board as global systemically important banks, or G-SIBs. However, some of the council's concerns likely also extend to the other U.S. G-SIBs, foreign G-SIBs that have a significant presence in the U.S., and firms that could become G-SIBs in the future — as well as any that could become nonbank SIFIs by council designation.

The report acknowledged that a number of provisions in Dodd-Frank address the TBTF issue, including the limitation on the government support to individual firms; the authority granted the Federal Deposit Insurance Corporation to resolve systemically significant institutions and the mandate to do so without recourse to taxpayers; the requirement for large banks to develop resolution plans; and the heightened prudential standards for large banks that strengthen capital and liquidity and reduce interconnections. In addition, agencies are required to take into account systemic risks when considering merger applications of financial institutions. The last element is important, because the concentration of assets in the top 10 bank holding companies increased markedly through acquisitions in the years prior to and during the financial crisis.

These measures do not appear to be sufficient to appease the council's concerns about the complexity and interconnectedness of the largest banks and bank holding companies in the U.S., and the risks this presents to U.S. financial stability. The council has for the most part sat on the sidelines of the debate about whether to break up the biggest banks, and its report provided no related policy recommendations. However, U.S. banking agency officials are increasingly discussing whether to tighten prudential requirements further. Their goal is to address the risks of the largest, most complex institutions and to provide incentives for those institutions to reduce their systemic footprint by simplifying operations and interconnections with other financial firms. This approach is often framed as an alternative to the "break up the largest banks" option, and has a directionally similar goal of reducing the size, complexity, and interconnectedness of the largest financial institutions — albeit over a more uncertain timeframe and perhaps to a lesser degree of fragmentation.

Some have called these policies a tax on systemic institutions. The notion that the tax should be designed to incent the G-SIBs, and possibly other large interconnected institutions, to shrink or become otherwise less systemic is an indication of the growing level of regulatory concern.

Providing incentives for simplification and disaggregation is a relatively new strategy. The FSB's policies for G-SIBs, and the heightened standards in Dodd-Frank, are aimed at lowering the probability of failure of large banking companies, reducing the cost of their failure, and providing regulators the tools to hold management and shareholders accountable. Some have called these policies a tax on systemic institutions. The notion that the tax should be designed to incent the G-SIBs, and possibly other large interconnected institutions, to shrink or become otherwise less systemic is an indication of the growing level of regulatory concern, and adds a new dimension to the policy debate. It also signals regulators' appetite to supplement the post-crisis legislative reforms with even more mandates aimed at the largest institutions.

The idea that seems to be getting the most traction is raising minimum leverage ratios for the largest banks. Several influential U.S. regulators have indicated support for raising leverage ratios for these banks above the 3% minimum that international regulators have supported in the Basel III capital accords. Even the U.S. Congress is weighing in; Sens. Sherrod Brown (D-OH) and David Vitter (R-LA) recently introduced legislation calling for higher leverage requirements for large bank holding companies, and steeply higher ratios for those with greater than $500 billion in assets.

The Federal Reserve is considering another alternative: requiring G-SIBs and possibly other large bank holding companies to issue unsecured long-term debt that could simplify resolution under Title II of Dodd-Frank. Federal Reserve Governor Daniel Tarullo has said that the debt would serve to counteract the moral hazard associated with the presumption of a taxpayer bailout. The debt requirement would be consistent with emerging international practice, as the European Union is debating a similar requirement and Switzerland has adopted one.

Regulators have also floated the idea of limiting reliance on short-term wholesale funding. That could ease concerns about panic in the midst of a liquidity event, but also could dampen economic growth, as well as limit the size of some financial institutions.

Operational Risk

The council cited concerns about operational risk in its 2012 report, but this year the issue has new contours due to the growing complexity of the systems used by financial institutions, and the markets in which they operate. Cybersecurity and anti-money-laundering risks both merited a mention, and model risk is an emerging concern.

Distributed denial-of-service attacks are among the fastest growing cybersecurity risks. More than a dozen financial institutions, including several of the largest, were the victims of DDoS attacks in 2012, and the council said the skill and knowledge of attackers are increasing. The council noted the financial, compliance, and reputational risks associated with them, and recommended that regulators increase their vigilance in this area. Concrete recommendations to combat operational risks included strengthening internal controls and corporate governance, as well as testing cross-sector linkages and working with cross-sector partners to promote resilience.

Comptroller of the Currency Thomas Curry said in March that operational risk has overtaken credit risk as the primary safety-and-soundness concern today.[3] He has focused his attention on anti-money-laundering concerns, noting that laundering schemes have become more sophisticated and complex, involving entities and individuals located in numerous jurisdictions worldwide. The council observed that many of the latest technologies that support consumers' use of the financial system, such as cell-phone applications, also can be used for illicit transactions.

Technological advances have also permitted more complex models for portfolio decisions, increasing the potential for errors. In the past year, high-profile trading losses and questions about market-risk and credit-exposure calculations have cast new suspicion on model reliability. The Basel Committee on Banking Supervision is completing a review of risk-weighted assets, and also is reviewing the complexity of the Basel capital framework. It is likely to impose additional constraints on the application of models, including potential floors for regulatory capital purposes.

Even as supervisors consider limiting the application of models for determining regulatory capital, they are holding internal risk models to higher standards and are increasingly scrutinizing how those models are developed, tested, and used. Council recommendations included continued monitoring of model validity, comparing alternative models, understanding model limitations, and supplementing models with other information and analysis. Supervisors expect model-governance programs that are appropriate for the complexity of the firm's operations.

Other Risks

Large, interconnected financial institutions exacerbate other threats the council identified, especially risks of fire sales and runs in short-term wholesale-funding markets. One of the largest of these is the tri-party repo market, in which collateral haircuts are volatile and prone to sharp increases if participants believe a broker-dealer or other large counterparty may fail. The largest broker-dealers are subsidiaries of bank holding companies, and it is not hard to imagine how the failure of one broker-dealer — especially a large, interconnected one — could lead to systemic problems.

In fact, Governor Tarullo in a recent speech questioned whether reforms to date — stress testing, orderly liquidation authority, more capital, and prudential oversight of the largest broker-dealers — would be sufficient to contain a run in wholesale markets.[4] He observed that the traditional supervisory framework can address the microprudential risk of whether the counterparty would get its money back, but may not be adequate for macroprudential or systemic risks. Governor Tarullo proposed a regulatory charge that would apply regardless of the borrower's legal form — whether it is a real estate

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[3] http://www.occ.gov/news-issuances/speeches/2013/pub-speech-2013-39.pdf
[4] http://www.federalreserve.gov/newsevents/speech/tarullo20130503a.htm

investment trust, hedge fund, broker-dealer, or plain-vanilla commercial bank. He also recommended consideration of higher capital and liquidity requirements at the largest, complex, interconnected banking companies.

Conclusion

Federal Reserve Chairman Ben Bernanke has described the Financial Stability Oversight Council as a body that creates among regulatory agencies a "sense of common responsibility for overall financial stability." While it is still not clear how influential the council will be, it appears to be taking shape as a constructive forum for monitoring the entire financial system, over which no one member has full authority. It also appears to be inspiring policy discussions that are likely to lead to substantive additions to the post-crisis financial regulatory architecture.

The council's recent annual report and the musings of its members offer important insight for large banking companies about the depth of the supervisory concerns, and may motivate them to address complexity and interconnections through resolution plans, internal-limit policies, and capital and liquidity stress testing.

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