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First take

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Five key points from Governor Tarullo's farewell speech

Federal Reserve (Fed) Governor Daniel Tarullo delivered a farewell address this week to assert his views on completing and protecting what he considers to be the most important regulatory reforms before leaving his position as de facto leader of Fed supervision.[1] Although his departure means he will no longer drive Fed policy-making, his speech framed the context for policy debates to come and acknowledge opportunities for improvement.

Governor Tarullo provided a recap of significant Fed supervision innovations during his eight-year tenure and strongly defended reforms such as the annual Comprehensive Capital Analysis and Review (CCAR) stress tests. He was uncompromising in his view that banks' capital levels need to stay high (or go higher) and reiterated the case that he outlined last fall for introducing the "stress capital buffer" (SCB) into the Fed's regulatory capital regime as well as including the Global Systemically Important Bank (GSIB) surcharge into the post-stress capital minimums to explicitly link the Fed's supervisory stress test results to CCAR banks' point-in-time capital requirements.[2] In deal-making fashion, he presented several options for *reducing* regulatory compliance burdens including an overhaul of the Volcker Rule and removal of the CCAR qualitative objection.

While his speech walks back some of the initiatives that have most irked bankers – such as public disclosure of the Fed's CCAR decisions – his exit from the Fed has been quietly welcomed by many in the banking community. Still, Governor Tarullo's viewpoints could remain influential throughout the months it could take to fill current vacancies.[3] We don't expect significant policy changes in the near term, but in the long run, new policy makers may accept only the reforms that scale back regulation.

1. **Pall over Volcker.** Indicating that the Volcker Rule lacks fans even at the primary agency tasked with its implementation, Governor Tarullo cited both statutory and regulatory limitations to the rule. The statutory limitations, which include the need for multiple agencies to coordinate their approach to the rule and the broad swath of institutions that the rule covers, would be difficult to remediate absent Congressional action (which we expect to move slowly).[5] The regulatory limitation that he cited, however, may be overcome by a change in Fed direction. He suggested scrapping the Fed's highly complex existing approach of attempting to discern whether banks are engaging in permissible market making or prohibited proprietary trading in favor of a simpler, capital-based approach that would create an "aging penalty" (i.e., higher risk weights for older trading inventories) to deter proprietary trading.

2. **Qualitative objection overruled?** Governor Tarullo indicated that the time may be coming for the Fed to fully eliminate the public shaming that accompanies its objection to capital plans as part of the annual CCAR qualitative assessment. He highlighted the importance of the public nature of results early on[6] in order to motivate senior management to address critical deficiencies in banks' capital planning processes, including foundational data aggregation and modelling capabilities but recognized the now marginal value of annual public objections. As an alternative, he suggested that the introduction of the SCB could refocus attention from annual submissions to year-round capital planning. With this change, the capital planning assessment would return to being part of business-as-usual supervisory activities throughout the year with the Fed providing private, confidential feedback. Importantly, the Fed would still retain the quantitative objection to capital plans to ensure the maintenance of capital levels.

3. **A peek behind the curtain.** While acknowledging the desire of industry participants to have greater information regarding the Fed's models, Governor Tarullo reiterated and expanded upon his past reasons for not releasing the Fed's supervisory stress test model - namely that it could allow banks to optimize or game the stress tests. However, he noted that Fed staff have been working to increase transparency by providing the post-stress results of the supervisory model for given hypothetical portfolios. This would enable banks to make a fairly accurate inference on the supervisory stress loss estimates for various asset classes without giving them full access to the models.

4. **Back-track the eSLR.** Governor Tarullo defended the importance of the Fed's use of both leverage and risk-based capital requirements, but offered an important tweak to the enhanced supplementary leverage ratio (eSLR) that would address the rule's incoherent outcomes for two US GSIBs that operate primarily as custody and processing banks. To avoid situations where the eSLR's buffer is asymmetrically more punitive than the risk-based GSIB surcharge, he suggested that the Fed implement a sliding scale for the eSLR's buffer (which is currently a flat 200 bps). However, he rejected the larger overhaul of the Fed's leverage requirement that many in the industry have called for, in particular the exclusion of certain low risk exposures included in the denominator (e.g., cash held at central banks).

5. **Small FR-Y relief.** The speech added to several bipartisan voices by highlighting ways in which Governor Tarullo believes post-crisis reforms have disproportionately increased compliance costs for regional and community banks. In particular, he cited both the $50 billion systemically important financial institution (SIFI) threshold that introduces many Dodd-Frank requirements and the $10 billion threshold (that requires banks to conduct their own stress tests) as being set too low. He noted specifically that the standardized risk-weighted capital requirements are too granular and complex for smaller banks to understand or comply with absent an unsustainable amount of resources. Although the Fed has already taken steps to reduce requirements for smaller banks (e.g., by removing the qualitative portion of CCAR or allowing streamlined resolution plan submissions),[7] relaxing or eliminating Dodd-Frank thresholds would require Congressional action.

Endnotes

1. Governor Tarullo stepped down on April 5th and Governor Jay Powell took over his role as chairman of the Committee on Supervision and Regulation.
2. See PwC's *First take, Ten key points from Governor Tarullo's speech on stress testing and the Fed's NPR* (October 2016).
3. The Fed currently has three vacancies, including the Vice Chair of Supervision seat that will drive future regulatory policy, and will have Chair and Vice Chair vacancies by mid-2018.
4. In her semi-annual Congressional testimony in February, Fed Chair Janet Yellen indicated that the Fed would proceed with rulemaking and particularly noted the SCB rule as an example.
5. See PwC's *First take, Ten key points from Donald Trump's victory* (November 2016).
6. CCAR results began with the experiment of the initial 2009 Supervisory Capital Assessment Program, or SCAP.
7. On January 30th, the Fed issued a final rule to exempt "large and noncomplex" bank holding companies from the qualitative portion of CCAR. See PwC's *First take, Ten key points from the Fed's 2017 CCAR instructions and supervisory scenarios* (February 2017).

Additional information

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