

Governor Tarullo Outlines Anticipated Proposals to Limit Short-Term Wholesale Funding Risks

On November 22, 2013, Federal Reserve Board Governor Daniel Tarullo delivered a speech at the Americans for Financial Reform and Economic Policy Institute outlining a potential regulatory initiative to limit short-term wholesale funding risks.¹ This proposal could increase capital requirements for and apply additional prudential standards to firms dependent on short-term funding, with a focus on securities financing transactions (“SFTs”) – repos, reverse repos, securities borrowing/lending and securities margin lending.

For some time, Federal Reserve officials have raised concerns about the systemic risk posed by disturbances in the short-term wholesale funding market. However, this speech is noteworthy for two reasons. First, it sets forth several concrete regulatory proposals, including a potential liabilities-based capital surcharge, that the Federal Reserve is evaluating to mitigate this risk.² Second, the speech makes clear that the Federal Reserve is considering measures that would apply to both regulated entities and “shadow banks” outside of the regulatory perimeter.

Governor Tarullo proposes several new regulatory requirements designed to capture the “tail risk” of SFTs, including those held in matched books. In doing so, he highlights that the potential for a run in the short-term financing market, with its attendant distressed “fire sales” and market price volatility,³ is a macroprudential risk that is not adequately addressed by existing regulation and regulatory proposals.⁴ In particular, he focuses on the perceived shortcomings of the following capital and liquidity regimes:

¹ Daniel K. Tarullo, Member, Board of Governors of the Federal Reserve System, “Shadow Banking and Systemic Risk Regulation,” Remarks at the Americans for Financial Reform and Economic Policy Institute Conference (Nov. 22, 2013) available at <http://federalreserve.gov/newsevents/speech/tarullo20131122a.htm>.

² These more definitive proposals go beyond earlier conceptual discussions, including by Governor Tarullo himself, and presage a potential finalization of the contents of an advanced notice of proposed rulemaking or a proposed rule. See, e.g., Tarullo, “Evaluating Progress in Regulatory Reforms to Promote Financial Stability,” Remarks at the Peterson Institute for International Economics (May 3, 2013) available at <http://www.federalreserve.gov/newsevents/speech/tarullo20130503a.pdf>.

³ See, e.g., Federal Reserve Bank of New York, Staff Report No. 616, “The Risk of Fire Sales in the Tri-Party Repo Market” (May 2013).

⁴ See also, e.g., Jeremy C. Stein, Member, Board of Governors of the Federal Reserve System, “The Fire-Sales Problem and Securities Financing Transactions,” Remarks at the Federal Reserve Bank of Chicago and International Monetary Fund Conference on Shadow Banking Within and Across National Borders (Nov. 7, 2013) available at <http://www.federalreserve.gov/newsevents/speech/stein20131107a.pdf>.

- The Basel III risk-based capital rules assign relatively low capital requirements to SFT assets, in light of the fact that they are short-term, over-collateralized, backed by liquid securities, subject to daily mark-to-market and re-margining requirements and exempt from an automatic stay in bankruptcy.
- While Governor Tarullo concedes that leverage ratio requirements, in contrast to risk-based capital requirements, would generally impose higher charges on SFTs, he acknowledges that they would be a blunt tool and may only be effective if the leverage ratio were a binding capital constraint. For those reasons, he expresses a concern that stronger leverage ratios will simply push SFTs into firms with more capital overhead to accommodate them without actually reducing the systemic risk they pose in a “tail event,” such as a failure of a significant SFT counterparty or a run on the shadow banking system triggered by the perceived weakness of a market participant that leads to a negative feedback loop from the fire sales of the underlying assets.
- Although the Liquidity Coverage Ratio (the “LCR”), formulated by the Basel Committee on Banking Supervision and recently proposed by U.S. regulators,⁵ would require holding high quality liquid assets against any net outflows in the pending 30-day period, it would not require a liquidity buffer against SFT liabilities that mature in more than 30 days. In addition, matched book SFT transactions will generally net to a minimal, if any, liquidity requirement and SFTs on high quality liquid assets generally can be assumed to roll over under the LCR rules.

Increased Capital and Liquidity Requirements. In the speech, Governor Tarullo indicates that the Federal Reserve is considering two policy options to address the financial stability risks associated with firms that use large amounts of short-term SFT funding. First, Governor Tarullo described a liabilities-based capital surcharge calculated by reference to a firm’s reliance on short-term funding. This approach could define short-term funding as total liabilities minus regulatory capital, insured deposits, and other long-term obligations. A firm’s funding sources could then be risk weighted based on their relative stability. A firm would then be subject to a Tier 1 common equity capital surcharge based on its reliance on short-term funding, although the speech does not indicate at what level of reliance a surcharge would be imposed. Governor Tarullo also gave no indication of how large a surcharge may be. He stated that a surcharge could be “added” to the Tier 1 common equity requirement already mandated by the minimum capital, capital conservation buffer, and G-SIB surcharge standards. However, his use of the word “added” is ambiguous and it is not clear whether Governor Tarullo intended a surcharge to be layered “above” buffers and surcharges that may otherwise apply. Governor Tarullo also specifically distinguished this potential surcharge from the much anticipated long-term debt requirement that the Federal Reserve will propose to enhance resolvability of large firms. This liabilities-based approach

⁵ See, e.g., Federal Reserve, *Liquidity Coverage Ratio: Liquidity Risk Measurement, Standards, and Monitoring* (Oct. 24, 2013), www.federalreserve.gov/FR_notice_lcr_20131024.pdf. The Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation each approved their own, substantively identical, versions of the LCR proposal on October 30, 2013.

would be a significant departure from the asset-based capital regime, and it is unclear how burdensome it would be to calculate and maintain such a buffer.

Second, Governor Tarullo discussed the possibility of further increases in the capital and liquidity requirements applicable to SFT matched books, including increasing the capital charges applicable to SFTs and requiring larger liquidity buffers for firms with large amounts of SFTs. Governor Tarullo acknowledges there is little appetite to incorporate these proposals into the LCR already vetted at the international level, so such a proposal, if adopted, would likely result in modifications to the proposed rule to implement the LCR in the United States and would represent yet another divergence in the direction of “super-equivalence”. The Net Stable Funding Ratio (the “NSFR”) in the Basel liquidity framework also does not currently include this type of approach, but, unlike the LCR, the NSFR is still under negotiation and Governor Tarullo’s speech indicates that the Federal Reserve is advocating that the Basel Committee adopt revisions to the NSFR in this direction.

Broadening Scope of Rules to Capture “Shadow Banks”. The two potential regulatory measures discussed above would apply only to regulated firms since they involve amplifications of the existing capital and liquidity frameworks for banking organizations. However, Governor Tarullo’s speech makes clear that the Federal Reserve intends to pursue regulatory reforms targeted at all participants in the short-term wholesale funding market to avoid incentivizing regulatory arbitrage by shadow banks. Noting reports that hedge funds are exploring the possibility of disintermediating dealers by lending cash against securities collateral to other market participants, Governor Tarullo emphasized that any proposal should have a broad scope of application, focusing on the transaction type rather than simply the type of firm engaging in the transaction.

Trending Toward “Super-Equivalence”. Governor Tarullo also took note of recent policy recommendations by the Financial Stability Board (the “FSB”) to impose haircuts and margin requirements for SFTs, including a system of numerical floors for SFT haircuts that would require any entity seeking to borrow to post minimum excess margin varying based on type of collateral.⁶ Governor Tarullo criticized the FSB’s policy recommendations as underinclusive because they (i) apply only to SFTs where regulated entities provide financing to unregulated entities (hence not to SFTs between unregulated entities or certain SFTs to regulated borrowers) and (ii) would not capture SFTs backed by government securities. Governor Tarullo also expressed concern that the FSB proposed floors are too low because they are below the current prevailing haircuts in the tri-party repo market.

Governor Tarullo proposed to address these perceived shortcomings by (A) applying floors to SFTs regardless of the identity of parties to the transaction and (B) recalibrating the margin floors to equal one of the following: (i) current repo market haircuts, (ii) targets for particular asset classes based on asset price volatility or haircut levels observed during times of stress, or (iii) current capital charges applicable to the underlying security if held in the inventory of a banking organization.

⁶ Financial Stability Board, *A Policy Framework for Addressing Shadow Banking Risks in Securities Lending and Repos* (Aug. 2013), available at http://www.financialstabilityboard.org/press/pr_130829a.pdf.

The speech contains no discussion of the Federal Reserve's legal authority to impose these types of haircuts on a transaction basis and did not indicate whether the Federal Reserve is working in tandem with the Securities and Exchange Commission or the Commodities Futures Trading Commission on this initiative.

Timing and Procedural Considerations. Governor Tarullo was also silent as to the prospective release date for a proposal. In July 2013, when final Basel III capital rules were adopted by the U.S. regulators, this initiative was identified by Governor Tarullo as one of three pending proposals on the Federal Reserve's regulatory agenda, which also included establishing a long-term debt requirement to facilitate the resolution of large banking organizations and implementing the Basel Committee's framework for G-SIB capital surcharges.⁷ At that time, Governor Tarullo indicated that a proposal to address short-term wholesale financing risks would be issued as an advanced notice of proposed rulemaking ("ANPR"). An ANPR is generally a more abstract set of proposals and questions—often issued without specific rule text—that is effectively two steps removed from a final rule. In this speech, Governor Tarullo made no reference to the proposal's procedural posture. However, the speech indicates that the proposal appears quite comprehensive. Accordingly, it is possible that the Federal Reserve could issue the proposal directly as a notice of proposed rulemaking, which could accelerate the adoption of a final rule.

* * *

If you have any questions, please feel free to contact [Derek Bush](#), [Katherine Carroll](#), [Hugh Conroy](#), [Allison Breault](#), [Patrick Fuller](#) or any of your regular contacts at the firm. You may also contact any of our partners and counsel listed under "[Banking and Financial Institutions](#)" located in the "Practices" section of our website at <http://www.cgsh.com/>.

⁷ Tarullo, Opening Statement at the July 2, 2013 Federal Reserve Board Meeting Approving Adoption of Basel III Capital Rules (July 2, 2013) *available at* <http://www.federalreserve.gov/newsevents/press/bcreg/tarullo20130702a.htm>.

Office Locations

NEW YORK

One Liberty Plaza
New York, NY 10006-1470
T: +1 212 225 2000
F: +1 212 225 3999

WASHINGTON

2000 Pennsylvania Avenue, NW
Washington, DC 20006-1801
T: +1 202 974 1500
F: +1 202 974 1999

PARIS

12, rue de Tilsitt
75008 Paris, France
T: +33 1 40 74 68 00
F: +33 1 40 74 68 88

BRUSSELS

Rue de la Loi 57
1040 Brussels, Belgium
T: +32 2 287 2000
F: +32 2 231 1661

LONDON

City Place House
55 Basinghall Street
London EC2V 5EH, England
T: +44 20 7614 2200
F: +44 20 7600 1698

MOSCOW

Cleary Gottlieb Steen & Hamilton LLC
Paveletskaya Square 2/3
Moscow, Russia 115054
T: +7 495 660 8500
F: +7 495 660 8505

FRANKFURT

Main Tower
Neue Mainzer Strasse 52
60311 Frankfurt am Main, Germany
T: +49 69 97103 0
F: +49 69 97103 199

COLOGNE

Theodor-Heuss-Ring 9
50688 Cologne, Germany
T: +49 221 80040 0
F: +49 221 80040 199

ROME

Piazza di Spagna 15
00187 Rome, Italy
T: +39 06 69 52 21
F: +39 06 69 20 06 65

MILAN

Via San Paolo 7
20121 Milan, Italy
T: +39 02 72 60 81
F: +39 02 86 98 44 40

HONG KONG

Cleary Gottlieb Steen & Hamilton (Hong Kong)
Hysan Place, 37th Floor
500 Hennessy Road
Causeway Bay
Hong Kong
T: +852 2521 4122
F: +852 2845 9026

BELJING

Twin Towers – West (23rd Floor)
12 B Jianguomen Wai Da Jie
Chaoyang District
Beijing 100022, China
T: +86 10 5920 1000
F: +86 10 5879 3902

BUENOS AIRES

CGSH International Legal Services, LLP-
Sucursal Argentina
Avda. Quintana 529, 4to piso
1129 Ciudad Autonoma de Buenos Aires
Argentina
T: +54 11 5556 8900
F: +54 11 5556 8999

SÃO PAULO

Cleary Gottlieb Steen & Hamilton
Consultores em Direito Estrangeiro
Rua Funchal, 418, 13 Andar
São Paulo, SP Brazil 04551-060
T: +55 11 2196 7200
F: +55 11 2196 7299

ABU DHABI

Al Sila Tower, 27th Floor
Sowwah Square, PO Box 29920
Abu Dhabi, United Arab Emirates
T: +971 2 412 1700
F: +971 2 412 1899

SEOUL

Cleary Gottlieb Steen & Hamilton LLP
Foreign Legal Consultant Office
19F, Ferrum Tower
19, Eulji-ro 5-gil, Jung-gu
Seoul 100-210, Korea
T: +82 2 6353 8000
F: +82 2 6353 8099