Daniel K Tarullo: Financial regulatory reform

Speech by Mr Daniel K Tarullo, Member of the Board of Governors of the Federal Reserve System, at the annual US Monetary Policy Forum, University of Chicago Booth School of Business, New York, 26 February 2010.

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It is a pleasure to participate in this year's U.S. Monetary Policy Forum. To begin the discussion of regulatory reform, I will first explain my view that the imperative for financial regulatory reform has much deeper roots than the imprudent mortgage lending, tightly wound wholesale financing channels, and other factors that were direct contributors to the recent financial crisis. Next, I will summarize the status of the reform proposals to address systemic risk, as well as the changes that are already in train, before ending with a few observations on the relationship between the scope of the systemic risk problem and the reform agenda.

The roots of the financial crisis

It is interesting and important to inquire carefully into the immediate causes of the financial crisis. But an appropriately tailored response must begin by recognizing that the crisis arose following profound changes in both the organization and regulation of financial markets that began in the 1970s.

Starting in 1933, the New Deal established a regulatory system that largely confined commercial banks to traditional lending activities within a circumscribed geographic area, with attendant limits on price competition and a federal deposit insurance backstop meant to forestall bank runs. This approach fostered a commercial banking system that was, for the better part of 40 years, quite stable and reasonably profitable, though not particularly innovative in meeting the needs of depositors and borrowers.

The turbulent macroeconomic developments of the 1970s, along with technological and business innovations, helped produce an increasingly tight squeeze on the traditional commercial banking business model. The squeeze came on both the liability side of bank balance sheets, in the form of more-attractive savings vehicles such as money market mutual funds, and on the asset side, with the growth of public capital markets and international competition. Large commercial banks reacted, among other ways, by seeking removal or relaxation of the regulations that confined bank activities, affiliations, and geographic reach – a request to which supervisory agencies and legislators were generally sympathetic because of the potential threat to the viability of the traditional commercial banking system.

The period of relative legal and industry stability that followed the New Deal legislation thus gave way in the 1970s to a nearly 30-year period during which many prevailing restrictions on banks were relaxed, both through administrative action by the bank regulatory agencies and through a series of legislative changes culminating in the Gramm-Leach-Bliley Act of 1999. By the turn of the century, the Depression-era cluster of restrictions on commercial banks had been replaced by a regulatory environment in which they could operate nationally, conduct a much broader range of activities, and affiliate with virtually any kind of financial firm.

These changes enabled a series of acquisitions that resulted in a number of very large, highly complex financial holding companies centered on large commercial banks. At the same time, independent investment banks had grown into a group of very large, complex, and highly leveraged firms. Of course, financial engineering had been rapidly changing the character of the financial services sector as a whole. Among other things, securitization and associated derivative instruments were merging capital markets and traditional lending activities, thereby fueling the growth of the shadow banking system.

The regulatory system had also evolved, notably through progressively more detailed capital requirements and increasing demands that banking organizations enhance their own risk-management systems. Supervisors counted on capital and risk management to be supple tools that could ensure stability even as financial activities changed rapidly. Truthfully, though, there was no wholesale transformation of financial regulation to match the dramatic changes in the structure and activities of the financial industry. In particular, the regulatory system did not come close to adequately accounting for the effects of securitization and other capital market activities on both traditional banking and systemic risk.

Meanwhile, as shown by the intervention of the government when Bear Stearns and American International Group were failing, and by the repercussions from the failure of Lehman Brothers, the universe of financial firms that appeared too big to fail during periods of stress included more than insured depository institutions and, indeed, reached beyond the circle of firms subject to mandatory prudential regulation. The extension of funds by the Treasury Department from the Troubled Asset Relief Program and of guarantees by the Federal Deposit Insurance Corporation (FDIC) from the Temporary Liquidity Guarantee Program to each of the nation's largest institutions revealed the government's conclusion in the fall of 2008 that a very real threat to the nation's entire financial system was best addressed by shoring up the largest financial firms.

Regulatory reform: the consensus to date

The crisis thus arose against the backdrop of a regulatory system that had not adjusted to the extensive integration of traditional lending with capital market activities, which had created new sources of systemic risk. The already significant too-big-to-fail problem was further amplified by the government's actions in 2008 to prevent a complete collapse of the financial system. The internal information and risk-management systems of many financial firms were revealed as inadequate to the task of identifying the scope of market and credit risks, much less ensuring the soundness of those firms, in a period of severe stress. Proposed reforms to counteract systemic risk should, both individually and as a whole, be evaluated by reference to these quite fundamental deficiencies in the regulatory system.

Despite substantial disagreements over some reform proposals – such as the creation of an independent consumer financial services protection agency and the possible reallocation of responsibilities among the regulatory agencies – a fair degree of consensus has been reached on some elements of a legislative reform package. Accordingly, and with full recognition that there are still important differences on the specifics of the legislation, my summary of the reform agenda as it has evolved to this point will include some proposed legislative elements, as well as various administrative measures being pursued by the regulatory agencies under existing statutory authority.

It is perhaps instructive to organize this agenda by reference to the "three pillars" of financial regulation enunciated by the Basel Committee on Banking Supervision – minimum prudential requirements, supervisory oversight, and market discipline. Although the Basel Committee formulated the three-pillar approach in the context of the Basel II arrangement for capital requirements, this frame of reference can also be applied to the broader set of reform measures.

As to *minimum prudential rules*, U.S. banking agencies are joining with our international counterparts in the Basel Committee to modify capital and liquidity requirements. Increased capital requirements for trading activities and securitization exposures have already been agreed. A consultative paper issued late last year advances additional capital proposals, including improvements in the quality of capital used to satisfy minimum capital rules, with a particular emphasis on the importance of common equity, and a first set of measures designed to reduce the traditional pro-cyclicality of capital requirements.[1] Additional work on capital requirements for market risk is also under way. Finally, the bank regulatory agencies are implementing strengthened guidance on liquidity risk management and weighing proposals for quantitative liquidity requirements.

To a considerable extent, these changes strengthen rules that existed prior to the crisis and thus build on existing approaches, even as they underscore the problems with the pre-crisis regulatory regime. Several potential regulatory devices with a more direct systemic focus have also garnered substantial interest, both here and abroad. Prominent among them are proposals to (1) impose special taxes or capital charges on firms based on their systemic importance, (2) require systemically important firms to issue or maintain contingent capital instruments that would convert to common equity in periods of stress, and (3) reduce pro-cyclical tendencies by establishing special capital buffers that would be built up in boom times and drawn down as conditions deteriorate. Each of these ideas has substantial appeal, but, as has become clear, each also presents considerable challenges in the transition from a good idea to a fully elaborated regulatory mechanism.

Many legislative proposals would extend the perimeter of regulation so that rules designed to promote financial stability would apply to firms that currently are not subject to prudential regulation because they do not own a commercial bank. The legislation passed by the House, for example, would subject any firm whose failure could have serious systemic consequences to consolidated supervision, including minimum capital and liquidity requirements.

Supervisory oversight is being reoriented in several notable ways. As I mentioned earlier, the crisis revealed the serious shortcomings in the risk-management systems of many large firms. As we found during the Supervisory Capital Assessment Program that the Federal Reserve led early last year, the risk-management prerequisite of good information management was simply lacking at many firms. Accordingly, we are placing increased emphasis on the ability of firms to assess their own capital needs, particularly in periods of stress, both to supplement minimum capital requirements and to ensure that relevant information on firm risks is readily available to supervisors.

More fundamentally, the supervisory perspective of the Federal Reserve has been refocused by modifying the scope of consolidated supervision and by coordinating much more closely the supervision of our largest financial institutions. In the years preceding the crisis, supervision of bank holding companies was principally focused on protecting the commercial banks within a holding company. Too little attention was paid to the risks faced, and created, by the entire holding company, including in affiliates principally involved in trading and other capital market activities. Supervisory attention is now focused on the risks that may develop anywhere within large holding companies, regardless of whether there is an immediate threat to the federally insured bank. Legislative proposals to remove the Gramm-Leach-Bliley constraints placed on the Federal Reserve's ability to obtain information from, and address unsafe and unsound practices in, the subsidiaries of bank holding companies would make this supervisory reorientation more effective.

We are also instituting a more closely coordinated system for supervising some of the largest holding companies that will, in effect, establish a cross-firm, horizontal perspective as an ongoing organizing supervisory principle. This new approach will have a macroprudential dimension as well. To advance both macroprudential and microprudential goals, we are instituting a quantitative surveillance mechanism (QSM) for large, complex financial organizations. The QSM will use supervisory information, firm-specific data analysis, and market-based indicators to identify developing strains and imbalances that may affect

[1] Basel Committee on Banking Supervision (2009), *Strengthening the Resilience of the Banking Sector – Consultative Document* (Basel, Switzerland: Bank for International Settlements, December).

multiple institutions, as well as emerging risks to specific firms. Periodic scenario analyses across large firms will enhance our understanding of the potential effects of adverse changes in the operating environment on individual firms and on the system as a whole.

Market discipline has been an underdeveloped policy tool despite numerous ideas put forth over the years. Yet it is hard to imagine a practical counterstrategy to the undesirable consequences of too-big-to-fail perceptions that does not include a credible alternative to the current Hobson's choice of bailout or disorderly bankruptcy. Consequently, most regulatory reform proposals have prominently featured a special resolution mechanism that would raise the real prospect of losses for investors and counterparties of even the largest failing institutions. At present, of course, the law provides the FDIC with authority to resolve failed insured depository institutions, but there is no parallel authority for the holding companies of which these banks are a part or for other systemically important financial firms.

Regulatory reform: the ongoing debate

The rough consensus around the reform elements just described has hardly meant an end to the debate for at least three reasons. First, as already noted, there is considerable continuing disagreement over the key features of some of these proposals, even when the basic idea is accepted. The significant differences over the best form of resolution mechanism provide one example. Second, as also mentioned earlier, some ideas that may be promising ideas in concept – such as special charges calibrated to the systemic importance of a firm – are not easy to develop and put into practice effectively. Until more-detailed proposals are generated, judgments on the likely efficacy of these ideas will obviously be difficult to make. Third, many participants in the public policy debate who would agree with some form of this consensus agenda nonetheless believe that it falls short of what is needed to ensure financial stability.

Those who believe that additional regulatory measures are necessary have mostly turned to structural measures, as distinguished from the prudential requirements, supervisory initiatives, and market discipline proposals that constitute the bulk of the consensus reform agenda. One approach is to reverse the 30-year trend that allowed progressively more financial activities within commercial banks and more affiliations with nonbank financial firms. The idea, promoted by former Federal Reserve Chairman Paul Volcker and now endorsed by the Administration, is to insulate insured depository institutions from proprietary trading or similar capital market activities that are thought to pose unusually high risks for institutions or, more precisely, for the federal safety net provided to insured banks.

A second approach is to directly regulate more financial products and practices, whether or not the firms involved in the transactions are subject to prudential supervision. To an extent, this approach is reflected in the House bill and other proposals that would require standardized over-the-counter derivatives to be cleared through central counterparties or traded on exchanges. Some proponents favor going beyond this market requirement to prohibit or significantly constrain the use of other products or practices.

A third approach is to attack the bigness problem head-on by limiting the size or interconnectedness of financial institutions. The more muscular forms of this approach would break up some existing institutions in a manner somewhat reminiscent of breakups of AT&T in 1982 or Standard Oil in 1911 under the antitrust laws. A somewhat less sweeping variant would prevent firms from growing beyond a certain size or in a way that would significantly increase their systemic importance, including through acquisitions. The Administration's recent proposals contain an example of the second form, with a cap on the percentage of total financial industry liabilities that could be held by any one firm. The House bill has examples of both forms, as it grants authority to a newly created council of financial regulators to dismantle a firm that poses a "grave threat" to systemic stability and to individual banking regulators to prevent acquisitions that would increase systemic risk.

Regulatory reform in perspective

Let me now offer a few observations on the overall effort to revamp our financial regulatory system. *First*, the reform process cannot be judged a success unless it substantially reduces systemic risk generally and, in particular, the too-big-to-fail problem. In using the Basel II three-pillar metaphor to classify the consensus reform agenda, I meant to underscore that this agenda is in many respects a program to build out and improve the regulatory approaches that prevailed before the crisis. The important intellectual question is whether the limitations of these approaches that have been revealed in the past can be sufficiently overcome, either within each pillar or through their combination.

The fact that support for reforms of the structural variety has been growing during the past year's policy debate suggests to me that many thoughtful people have given at least a tentative negative answer to that question. Of course, the specifics of a good number of these proposals have yet to be formulated, and judgment of the merits must await their further development, insofar as the details will determine whether a proposal is likely both to be effective and to have manageable unintended consequences. Speaking personally, however, I think that we should not become unrealistically demanding in seeking specification of such proposals, particularly when a proposal itself provides for ongoing refinement. For example, my sense is that the provision in the House bill that would empower banking regulators to prevent acquisitions that would increase systemic risk could be sensibly and effectively elaborated over time. We should also be thinking more seriously about ensuring that safety and soundness requirements for some types of activities – residential mortgage lending comes to mind – apply throughout the financial system, without regard to the regulated status of the lender.

Second, having just noted the promise of measures beyond what I have termed the consensus agenda, I also want to emphasize the importance of its elements. Without better capital requirements, a horizontal approach to supervising the largest financial institutions, and a sophisticated macroprudential complement to traditional bank and bank holding company supervision, the regulatory system is unlikely to deliver on a promise of greater financial stability. Similarly, legislative proposals to make a workable resolution mechanism and prudential regulation applicable to all systemically important firms are necessary to achieving the same goal. Indeed, the resolution mechanism is critical to strengthening market discipline sufficiently so that it can truly take its place alongside rules and supervisory oversight as a strong third pillar of the financial regulatory system.

Third, having made the case for extensive change, I want to add a cautionary note. Even as we improve and reorient regulation, we must not lose sight of the ultimate goal. Today we are all mindful of the economic devastation that can ensue when a financial system goes badly awry. But financial stability alone is not the aim of financial regulation. It is instead a stable financial system within which capital is efficiently directed to creditworthy consumers and businesses who need it, as well as a system that offers good savings and investment vehicles for individuals and organizations.

The implications of this caution are several. I will mention two. One, which we regulators have already taken to heart, is that the effect of new capital and liquidity requirements on lending, and thus on economic recovery and growth, must be carefully taken into account. This is why we urged – successfully, I am pleased to say – that the Basel Committee analyze the whole package of capital changes under consideration from a macroeconomic, as well as a microprudential, perspective before those changes are finalized. Another implication is that it will be unnecessary to apply some regulatory changes to the smaller financial institutions that are far from being able to create systemic risk on their own.

Conclusion

In closing, let me say that regulatory reform will not come to a close once we have enacted our new regulations and legislation. The work of containing systemic risk and the too-big-to-fail problem will need to be adaptive. The perspectives, ideas, and criticisms of those outside the regulatory agencies will remain essential to this work, even if they can sometimes cause some discomfort for those of us within.