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Early Observations on Improving the Effectiveness of Post-Crisis Regulation

Remarks by

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at the

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It is a pleasure to be here with you at the American Bar Association banking law committee annual meeting.[1] Thank you to Meg Tahyar, my longtime friend and colleague, for inviting me to speak today. These are still the early days of my tenure at the Federal Reserve--last weekend marked my first three months as the first Vice Chairman for Supervision. In those three months, people have had a lot of questions for me, but the most frequently asked question has been: What's next? Today I hope to give you some insights into how I am approaching the work of evaluating and improving the post-crisis regulatory regime and to outline some specific areas that are emerging as areas of focus early in my tenure. Some of those areas are closer to being ready for action, while others are topics that I believe are important and would benefit from more attention and discussion. My hope is that you will come away from our time together with a better sense of my preliminary thinking for charting a course forward on financial regulation.

Efficiency, Transparency, and Simplicity of Regulation

Before I delve into specifics, let me say a few words about the principles that are guiding my approach to evaluating changes to the current regime. The body of post-crisis financial regulation is broad in scope, complicated in detail, and extraordinarily ambitious in its objectives. Core aspects of that project have resulted in critical gains to our financial system: higher and better quality capital, an innovative stress testing regime, new liquidity regulation, and improvements in the resolvability of large firms. We undoubtedly have a stronger and more resilient financial system due in significant part to the gains from those core reforms. These achievements are consistent with the responsibility of the Federal Reserve to be a steward of a

[1] The views I express here are my own and not necessarily those of the Board of Governors of the Federal Reserve System.

safe financial system, and with the goal of maintaining the ability of banks to lend through the business cycle.

That said, the Federal Reserve and our colleagues at other agencies have now spent the better part of the past decade building out and standing up the post-crisis regulatory regime. At this point, we have completed the bulk of the work of post-crisis regulation, with an important exception being the U.S. implementation of the recently concluded Basel III “end game” agreement on bank capital standards at the Basel Committee. As such, now is an eminently natural and expected time to step back and assess those efforts. It is our responsibility to ensure that they are working as intended and--given the breadth and complexity of this new body of regulation--it is inevitable that we will be able to improve them, especially with the benefit of experience and hindsight.

In undertaking this review and assessment, in addition to ensuring that we are satisfied with the effectiveness of these regulations, I believe that we have an opportunity to improve the efficiency, transparency, and simplicity of regulation. By efficiency I mean the degree to which the net cost of regulation--whether in reduced economic growth or in increased frictions in the financial system--is outweighed by the benefits of the regulation. In other words, if we have a choice between two methods of equal effectiveness in achieving a goal, we should strive to choose the one that is less burdensome for both the system and regulators.

Efficiency of regulation can be improved through a variety of means. For example, it can mean achieving a given regulation’s objective using fewer tools. It can mean addressing unintended adverse consequences to the industry and the broader public from a regulation or eliminating perverse incentives created by a regulation. It can mean calibrating a given regulation more precisely to the risks in need of mitigation. It can also mean simpler examination procedures for bank supervisors, or less intrusive examinations for well managed firms. In our approach to assessing post-crisis regulation, we should consider all of these ways of improving efficiency.

Transparency is an objective that ought to particularly resonate with this audience. As lawyers, we were all trained to view transparency as a necessary precondition to the core democratic ideal of government accountability--the governed have a right to know the rules imposed on them by the government. In addition, as any good lawyer also recognizes, there are valuable, practical benefits to transparency around rulemaking; even good ideas can improve as a result of exposure to a variety of perspectives.

Finally, simplicity of regulation is a principle that promotes public understanding of regulation, promotes meaningful compliance by the industry with regulation, and reduces unexpected negative synergies among regulations. Confusion that results from overly complex regulation does not advance the goal of a safe system.

Common Ground Areas of Improvement

When I arrived at the Federal Reserve, the early stages of reflection on how to improve the cost-benefit balance of post-crisis regulation had already begun, mainly in a few narrow areas of focus. These were areas of low-hanging fruit in which relatively broad consensus was reached that efficiency enhancements were available with no material cost to the resiliency or resolvability of the banking system. My colleague and Chairman-nominee Jay Powell spoke about five of these areas last summer when he served as the Board’s oversight governor for supervision and regulation: small bank capital simplification, burden reduction in resolution planning, enhancements to stress testing, leverage ratio recalibration, and Volcker rule simplification.[2] I wholeheartedly support these initiatives, and I am pleased that some of them have progressed even in the months since the summer.

The banking agencies recently proposed changes to the capital rules for smaller firms, consistent with last year's Economic Growth and Regulatory Paperwork Reduction Act report, which is a positive step toward meaningful burden relief for smaller banks.[3] The Federal Reserve, along with the Federal Deposit Insurance Corporation, extended the upcoming resolution planning cycles for the eight most systemic domestic banking firms and for foreign banks with limited U.S. operations in order to allow for more time between submissions.[4] I believe we should continue to improve the resolution planning process in light of the substantial progress made by firms over the past few years, including a permanent extension of submission cycles from annual to once every two years and reduced burden for banking firms with less significant systemic footprints. And, most recently, the Federal Reserve released a package of proposed enhancements to the transparency of our stress testing program, which is currently out for comment.[5] The progress you have seen in those areas represents constructive early steps.

Leverage ratio recalibration also is among the Federal Reserve's highest-priority, near-term initiatives. We have made considerable progress on that front in the past few months, and I expect that you will see a proposal on this topic relatively soon. Finally, the relevant agencies have begun work on a proposal to streamline the Volcker rule. This project is a quite

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[2] Jerome H. Powell, "Relationship Between Regulation and Economic Growth," (testimony before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, June 22, 2017) https://www.federalreserve.gov/newsevents/testimony/powell20170622a.htm.

[3] See Board of Governors of the Federal Reserve System, "Agencies propose simplifying regulatory capital rules," news release, September 27, 2017, https://www.federalreserve.gov/newsevents/pressreleases/bcreg20170927a.htm.

[4] See Board of Governors of the Federal Reserve System, "Agencies extend next resolution plan filing deadline for certain domestic and foreign banks," news release, September 28, 2017, https://www.federalreserve.gov/newsevents/pressreleases/bcreg20170928a.htm.

[5] See Board of Governors of the Federal Reserve System, "Federal Reserve Board requests comment on package of proposals that would increase the transparency of its stress testing program," news release, December 7, 2017, https://www.federalreserve.gov/newsevents/pressreleases/bcreg20171207a.htm.

comprehensive and substantial undertaking as well as a five-agency endeavor. As such, it will naturally take a bit of work for the agencies to congeal around a thoughtful Volcker rule 2.0 proposal for public review. Volcker rule reform remains a priority in the Federal Reserve's regulatory efforts.

Emerging Areas for Review

With that update on the familiar, I will turn to my own impressions of what is next for post-crisis regulation. In my early days as the Vice Chairman for Supervision, I asked our staff to conduct a comprehensive review of the regulations in the core areas of reform that I outlined earlier--capital, stress testing, liquidity, and resolution. The objective is to consider the effect of those regulatory frameworks on resiliency and resolvability of the financial system, on credit availability and economic growth, and more broadly to evaluate their costs and benefits. This is a comprehensive and serious process, and work is still underway. I should note, however, that I have already formed views on a few areas that warrant more focus, and that I will be working with my colleagues on the Board to constructively consider.

I will start with the issue of tailoring supervision and regulation to the size, systemic footprint, risk profile, and business model of banking firms. The Federal Reserve has devoted considerable energy in its post-crisis regulatory work to incorporate the tailoring concept in its regulation and supervision across the spectrum of small, medium, and large firms. A recent example of this approach is our late 2017 proposal to simplify capital requirements for small- and medium-sized banking firms. In my view, there is further work for the Federal Reserve and the other banking agencies to do on the tailoring front.

I would emphasize that tailoring is not an objective limited in scope to a subset of the smallest firms. As my colleagues and I have said before, the character of our regulation should match the character of the risk at the institution. Accordingly, we should also be looking at additional opportunities for more tailoring for larger, non-Global Systemically Important Banks, or non-G-SIBs. In this regard, I support congressional efforts regarding tailoring, whether by raising the current $50 billion statutory threshold for application of enhanced prudential standards or by articulating a so-called factors-based threshold. Irrespective of where the legislative efforts land, I believe we at the Federal Reserve have the responsibility to ensure that we do further tailoring for the institutions that remain subject to our rules to ensure that regulation matches the risk of the firm.

Take for example large non-G-SIBs whose failure would not individually pose a risk to U.S. financial stability. Even without financial stability implications, the distress or failure of these firms still could harm the U.S. economy by, for example, significantly disrupting the flow of credit to households and businesses. In my view, this tranche of the U.S. banking system ought to be subject to regulations that are generally stricter than those that apply to small banking firms, but that are also meaningfully less strict than those that apply to the G-SIBs. The Board has effected this sort of G-SIB versus non-G-SIB tailoring among large banks in many areas of the regulatory framework. Most notably, each of the risk-based capital requirements, leverage requirements, stress testing requirements, and total loss-absorbing capacity (TLAC) requirements is calibrated substantially more strictly for G-SIBs than for large non-G-SIBs. However, in some key regulations, there is no distinction between the requirements for large non-G-SIBs and G-SIBs.

Liquidity regulation, for example, does not have a G-SIB versus non-G-SIB gradation. In particular, the full liquidity coverage ratio (LCR) requirement and internal stress testing requirements of enhanced prudential standards apply to large, non-G-SIB banks in the same way that they apply to G-SIB banks. I believe it is time to take concrete steps toward calibrating liquidity requirements differently for large, non-G-SIBs than for G-SIBs. And I see prospects for further liquidity tailoring in that the content and frequency of LCR reporting are the same for the range of firms currently subject to the modified LCR as they are for the large non-G-SIBs that are subject to the full LCR. We should also explore opportunities to apply additional tailoring for these firms in other areas, such as single counterparty credit limits and resolution planning requirements.

Another area that I think we should revisit are the “advanced approaches” thresholds that identify internationally active banks. These thresholds are significant not only for identifying which banking firms are subject to the advanced approaches risk-based capital requirements, but also for identifying which firms are subject to various other Basel Committee standards, such as the supplementary leverage ratio, the countercyclical capital buffer, and the LCR. The metrics used to identify internationally active firms--$250 billion in total assets or $10 billion in on-balance-sheet foreign exposures--were formulated well over a decade ago, were the result of a defensible but not ineluctable analysis, and have not been refined since then. We should explore ways to bring these criteria into better alignment with our objectives.

A third area in which I will be working with my Board colleagues is a meaningful simplification of our framework of loss absorbency requirements. There are different ways to count the number of loss absorbency constraints that our large banking firms face--which is perhaps in itself an indication of a surfeit of complexity if we can’t be perfectly sure of how to count them--but the number I come up with is 24 total requirements in the framework. While I do not know precisely the socially optimal number of loss absorbency requirements for large banking firms, I am reasonably certain that 24 is too many. Candidates for simplification include: elimination of the advanced approaches risk-based capital requirements; one or more ratios in stress testing; and some simplification of our TLAC rule. I am not the first Federal Reserve governor to mention some of these possibilities, and we should put them back on the table in the context of a more holistic discussion of streamlining these requirements. Let me be clear, however, that while I am advocating a simplification of large bank loss absorbency requirements, I am not advocating an enervation of the regulatory capital regime applicable to large banking firms.

Although not a post-crisis regulation, the Board's complex and occasionally opaque framework for making determinations of control under the Bank Holding Company Act (BHC Act) is another area that is ripe for re-examination through the lenses of efficiency, transparency, and simplicity. As you know, a determination of control under the BHC Act is significant because even remote entities in a controlled group can be subject to the BHC Act's restrictions on activities and a host of other regulatory requirements. Under the Board's control framework--built up piecemeal over many decades--the practical determinants of when one company is deemed to control another are now quite a bit more ornate than the basic standards set forth in the statute and in some cases cannot be discovered except through supplication to someone who has spent a long apprenticeship in the art of Fed interpretation. The process can be burdensome and time-consuming both for the requester and Federal Reserve staff. We are taking a serious look at rationalizing and recalibrating this framework.

Finally, as I mentioned earlier, an enhanced stress testing transparency package was released for public comment last month. I personally believe that our stress testing disclosures can go further. I appreciate the risks to the financial system of the industry converging on the Federal Reserve's stress testing model too completely, so I am hesitant to support complete disclosure of our models for that reason. However, I believe that the disclosure we have provided does not go far enough to provide visibility into the supervisory models that often deliver a firm's binding capital constraint. It is important in any proposal to receive comments, and I can say that I and my colleagues on the Board will be paying particularly close attention to your comments on how we might improve this current proposal.

Concluding Remarks

To conclude, I hope that these remarks give you a sense of our approach to analyzing and improving post-crisis regulation. As I mentioned earlier, the areas of core reform--capital, liquidity, stress testing, and resolution--have produced a stronger and more resilient system and should be preserved. We have made great progress, but there is further work to do. Some clear improvements are in the offing in the relatively near future. Other areas will benefit from longer term discussion. I look forward to engaging with you and the public more broadly as I help to chart a course for the important work ahead.