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The Fed's View of the Future of Bank Regulation

For better or worse, the Fed now has a Governor, Governor Daniel Tarullo, who is taking the laboring oar on bank regulation. For most of recent memory, Fed Governors were not particularly involved with regulatory developments and new rules were largely the work of the staff with some passing interest at the Board level. Because of the focus on regulatory matters, Governor Tarullo has been in the forefront of the Fed's thinking on regulatory matters and has been particularly in the lead on regulation of foreign banking.

Yesterday he gave a talk at the Fed in Chicago on "Rethinking the Aims of Prudential Regulation". While he completely ignored foreign banks in his remarks some of his comments presage where the Fed will be going on regulatory matters in the near term.

He is a believer that financial regulation by the Fed must be expanded beyond just banks to "certain nonbank financial institutions and to certain activities by all financial actors". While not everybody believes this is a good idea, the broad scope of Dodd-Frank has given the Fed some leeway to tackle regulating where they think there may be substantial risks, even in businesses far removed from the Fed's traditional purview. As Tarullo noted, "a concern with financial stability and an increased emphasis on macroprudential regulation have informed major changes in both banking law and supervision". He views this as a good thing and while that remains to be seen, he also has views on how regulating the existing banks that the Fed supervises.

Tarullo views the existing bank regulatory scheme as one that is a one size fits all scheme where by the rules for the biggest banks apply equally to the smallest as well. He calls this the "unitary" system for regulation. He saw "little hint that the purposes and principles of bank regulation might vary across the bank population "based on reasons such as "size, business model, and affiliations". He also observes that the totem of protecting the deposit insurance fund was a rationale for many of the regulatory restrictions such as "capital requirements to limitations on banks getting into nonbanking businesses".

In his view, the financial crisis revealed that system as both "too broad and too narrow'. It was too broad because it was unitary, although he notes that the regulators, smartly, implemented the rules differently depending on the complexity of the banks they were dealing with. It was too narrow because it did not cover the organizations, like Lehman, that were a threat to financial stability and he suggested that Lehman should have been subject to regulation like a bank holding company.

Governor Tarullo summarizes the 30 years of banking regulation leading up to the financial crisis as “30 years of largely deregulatory measures”. While there was some easing of regulatory burdens, the list of new banking laws adopted from 1978 through 2008 would certainly be an impressive collection. From his perspective, the crisis had the positive development of broadening financial regulation to better safeguard the financial system as a whole.

Because of Dodd-Frank’s focus on banks of different asset size and complexity and because the law requires that the regulators adopt different rules for these very different institutions, the Governor believes that the “unitary approach of the pre-crisis period has been abandoned” and this “is an important move in the right direction”.

For the very largest banks (there is only 8 of these), he sees the direction as relatively straightforward. Because the largest banks could “threaten the entire financial system”, they “must be subject to a stricter regulatory regime”. He believes in the domino effect and thus such banks need regulation that would reduce the chances of distress or failure at such firms, take into account the correlations and inter-dependencies, offset the perception of too-big-to-fail status.

For the roughly 6,000 banks with less than $10 billion in assets, that in aggregate hold only 20% of the total bank assets in the U.S., they need only be subject to the traditional ‘unitary” system.

This leaves about 80 banks between the largest and smallest. These 80 hold one third of all US bank assets, but as a group they vary dramatically and this is the hardest group to regulate in a logical way because of these differences.

Small banks. The Governor recognizes that “any regulatory requirement is likely to be disproportionately costly for community banks”. Small banks have reduced their presence in lines of business such as consumer lending. Yet their most important business is small business lending. He would like to see the burden be reduced for such banks and get exemptions from rules like the Volcker rule. While he is in favor of *some* compliance effort he seems to be in favor of a redo for these smaller banks

Top 100 banks. The Governor notes that “few of these banks have the kind of systemic footprint that would warrant extensive special regulation for financial stability purposes”. He notes, “requirements such as resolution planning and the quite elaborate requirements of our supervisory stress testing process do not seem to me to be necessary for banks between $50 billion and $100 billion in assets”.

Top 10 banks. There is not enough regulation here. The Governor notes, “there are additional requirements needed to implement prudential aims associated with financial stability. These include capital surcharges and minimum amounts of "gone” [sic] should be “going” concern" loss absorbing capacity, among others”. The regulatory response will likely require some combination of measures directed at capital, liquidity requirements, and resolution procedures. The governor is not a fan of the internal ratings based approach to capital computations and would be glad to phase that approach out.

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