Regulatory Reform: The New Face of Bank Regulation

These conventions are an ideal time to take a step back, look at the bigger picture, and cast an eye toward the future. In particular, with the passage of the Dodd-Frank Act, it is extremely important that all of us take the time to think about the likely impact of the new legislation.

Like any other major piece of legislation, the devil will be in the details and, given the scale of the legislation, many of the details of this new law remain to be worked out. While much of the push for financial reform resulted from what happened in some of the country’s largest financial firms, this legislation will affect all participants in the financial system—both large and small; both banks and non-banks. The Federal Reserve is also facing changes. We have some extra responsibilities, thanks to much work by bankers.

Many of you were involved in trying to shape the legislation, and I know that many of you remain concerned about the potential regulatory burdens this legislation may pose, particularly on community banks.

At this point, it is too early to speculate on exactly what will come a year from now, or even two years down the road, but let me offer my perspective on some of the broad themes of the new legislation as it stands today. First, I will discuss how the legislation addresses gaps in the regulatory and supervisory framework that became apparent during the financial crisis. Then I will discuss how the reform process should strengthen the core banking elements of trust and stability. Finally, I will explain why it will be so important for the regulatory and supervisory framework to distinguish between firms that pose significant risk to the financial system and those that do not.

Let me begin by offering my perspective on how the legislation addresses the oversight gaps in our financial system. We all know that the recent crisis revealed a number of gaps in regulatory, supervisory, and industry practices. The call for new legislation was a natural response. Indeed, many of the provisions of the Dodd-Frank Act are designed to catch up with the evolution that has occurred in the industry as a result of technological and financial innovations over the past couple of decades.

In my mind, these innovations may have led to a sense of greater transparency in the financial markets than actually existed. Ultimately, it became difficult for regulators, supervisors, and market participants alike to identify and quantify some of the true underlying risks behind these innovations. The new law attempts to address the gaps between the rapid evolution of the market and a
static regulatory structure.

From the early days of the financial crisis, there was a clear sense that legislative changes would be necessary to help shield against future crises. In addition to the important work you have conducted within your organizations, many policymakers—including myself—offered ideas and proposals to address the gaps that became apparent during the crisis.

At last year’s Ohio Bankers’ Day Conference in Columbus, I outlined several principles that I believed should be included in financial reform. First, I stressed that we needed to create an entity with responsibility for overall financial stability and with the appropriate authority to carry out those responsibilities. Second, I endorsed the concept of consolidated supervision. This means that a single supervisor would have the responsibility to identify the risk to an organization as a whole and the authority to take action in any part of the organization where necessary. And, third, I supported the creation of a resolution authority that would enable the orderly failure of systemically important nonbank firms.

I am pleased that the final legislation includes each of these significant principles. A financial stability oversight council that is created by the legislation will help ensure that supervisors work to protect the integrity of the financial system as a whole, rather than just focusing on the condition of individual firms. A stronger consolidated supervision approach laid out in the legislation means that supervisors can identify aggregate risk in an organization, and be better equipped to mitigate that risk, in a more timely way. Finally, the legislation calls for a resolution process for systemically important nonbank firms, and requires organizational “living wills.” This will help to prevent some firms from being too big or too interconnected to fail.

Of course, the legislation does not address every aspect of financial reform that will be needed in the future. As many have pointed out, housing finance issues have yet to be sorted out. But with the Act, we have a broad framework for reform. I think of it much like the frame for a new house that has just been built from the initial blueprints. We can see the massive wood beams in place—the broad contours of the house—but the quality of the structure and the amenities of the house depend on how the finishing takes place. If the house is finished with care by seasoned professionals who work closely together and use high-quality materials, then the house will stand the test of time. Every house must provide the core elements of shelter and comfort, but it is only through this attention to detail during the finishing process that the architects’ vision of the home will be realized.

So, just as the core elements of a house are shelter and comfort, I will be looking for certain core elements as we build out the details of the new legislation. The Dodd-Frank Act provides the frame of our new house, but it is up to all of us to ensure the finished product preserves and strengthens what I consider to be the core elements of the banking system—trust and stability.

The first and most fundamental element is that public trust and confidence must be maintained in our financial institutions. In the broadest sense of the term, banks have long enjoyed the trust and confidence of the public. Today, banks are a “safe haven,” but that was not always so. The panics, bank runs, and bank failures of earlier eras ruined families, businesses, and communities. Our impressions of those uncertain times have been clearly shaped by family stories, popular histories, and even the old Bailey Building and Loan that Jimmy Stewart ran in “It’s A Wonderful Life.”
The regulatory framework that was built in the decades since those times has instilled a deep sense of trust and confidence in the American banking system, even during economic downturns and periods of financial distress. Since the creation of the FDIC and introduction of deposit insurance in 1934, not a single depositor has lost a penny of insured funds as a result of the failure of an FDIC-insured institution. While the backing of “the full faith and credit of the U.S. government” for insured deposits has helped inspire public trust in our banking system, the financial crisis of the past two years has also revealed that trust is not something that can be taken for granted.

One prominent goal of the Dodd-Frank Act is to maintain public trust and confidence in insured depository institutions by insulating them from certain risky activities. For example, the provisions of what has become known as the “Volcker Rule” limit insured banks and their affiliates from engaging in proprietary trading or having certain business relationships with hedge funds or private equity funds. The law also places restrictions on some activities related to derivatives. Ultimately, these provisions reconfirm the principle that there will be a solid safety net under all insured deposits, and reinforce the sense that public funds will not be put at undue risk. Public trust has been a cornerstone of the banking industry, and these provisions help to prevent certain risky activities from eroding this foundation.

The second core element reinforced by this legislation is the importance of preserving the stability of our financial system. In the past, the stability of our financial system was preserved through the oversight of individual firms by their financial supervisors. In the wake of the recent financial crisis, we see that the supervisory lens was often too narrow. Financial supervisors were focused on the risks within the firms that we supervised, but in some cases, we may have failed to recognize or act on the risks that spilled over to the broader financial system.

By creating a council responsible for overall financial stability, which includes the heads of each supervisory agency, the legislation reinforces the core element of preserving stability across the entire financial system. Working collectively as a council, the heads of the supervisory agencies will be expected to share information and perspectives on the financial system as a whole. This will help to ensure that, in addition to being responsible for supervising individual firms, each member of the council is also responsible for ensuring the stability of the entire financial system.

Another important step in preserving the stability of the financial system is to allow individual firms to fail without jeopardizing the broader financial system. Currently we have laws and regulations in place for the orderly resolution of banks, and we have had guidelines, such as “prompt corrective action,” that require bank supervisors to address individual situations quickly, so that isolated problems do not fester and possibly affect the broader financial system.

While these laws and regulations were effective in addressing problem situations in banks, a significant void existed relative to nonbank financial firms. The Dodd-Frank Act provides a new mechanism for the orderly resolution of systemically important nonbank firms that fail. This will send a strong message to financial firms and market participants that no firm is too big to fail—whether a bank or a nonbank financial firm. In sending this message, I believe the legislation adds stability to the financial system.

I am especially pleased to see the legislation also calls for organizational “living wills.” These living wills are not just paper tigers. They must be carefully drawn up and updated regularly. By
ensuring that no one firm can be too big to fail, the playing field is leveled, and the perception that the very largest firms will always benefit from some implicit government guarantee against failure is addressed.

Trust and stability are the broad themes that I believe are important to take away from this historic legislation. Keeping these themes in mind will help keep the many complexities of the Act in the proper context and will help guide us as we build out the details of this new law.

So just like the house that remains to be finished, much work remains to craft the specific aspects of the regulations called for by the law. The various regulatory agencies involved in this effort are a lot like the electricians and plumbers and carpenters who must work together effectively to build a quality house. The tools and materials they use must be of the highest quality, installed properly, and in the right sequence, to prevent underlying structural problems.

In that respect, you as bankers play a critical role in making this regulatory house we are building solid and secure for the long term. I am very aware of the concerns that many of you have expressed about the potential regulatory burdens that may arise from this legislation. As we move into the rule-making phase of the process, it is essential that your input is sought, provided, and considered. As you know, a formal process exists to seek comments on proposed rulemaking, and I encourage you to take an active role in that process.

During this rule-making phase, issues of compliance, reporting, and accountability will be addressed, and as we write the rules, it will be critical to distinguish between firms that pose significant risk to the financial system and those that do not. Some of you have heard me talk about my proposal for a new regulatory and supervisory framework called “tiered parity.” In this framework, financial firms would be placed into a particular category, or tier, based on their complexity and the level of risk they pose to the overall financial system. The regulatory and supervisory approach applied to each tier would be consistent within each tier—resulting in parity of treatment for firms with similar risk profiles. However, the regulations and supervisory approach would differ between the tiers. They would become more restrictive from one tier to the next as the risk to the financial system increases.

The provisions of the Dodd-Frank Act incorporate one aspect of this tiered parity framework—that is, the most restrictive regulatory requirements are imposed on the riskiest, systemically important firms. The legislation applies this concept in a general way, in that systemically important firms are distinguished from all others. However, even greater clarification should take place during the rule-writing phase to better define the requirements for less-complex firms. I am hopeful that in this rule-writing phase, the principles of tiered parity will be more explicitly incorporated. Ultimately, I would like to see a clear distinction made between those firms that pose greater risk to the financial system versus those that pose less risk. The rules and regulations should be written accordingly to prevent overly burdensome requirements for community banks.

Following the rulemaking phase of the reform process, the next and final phase of reform will be implementation. As financial supervisors, we at the Federal Reserve will play an important role in this phase of the process. The effectiveness of the regulations will, in large part, be determined by the effectiveness of supervision. A key lesson learned from the financial crisis is that supervision must be strong enough to ensure financial stability.
But tiered parity applies here as well. The Act mandates that the riskiest firms receive the highest degree of supervisory scrutiny. In other words, there is no “one size fits all” formula for supervision. It is our job as supervisors to recognize the great diversity of financial firms, and we have to adapt our supervisory approach according to the firms’ varying degrees of complexity and according to the risk they pose to the financial system.

As an example, one of the key supervisory lessons learned from the financial crisis is the critical role that effective enterprise risk management plays in preventing excessive risk-taking by individual firms. Accordingly, financial supervisors will focus greater attention on enterprise risk management. The financial crisis revealed that a silo approach to risk identification and management does not produce good results.

The robustness of a firm’s enterprise risk management processes—their information reporting systems, their risk measurement methodologies, even their governance structures—should be matched to the nature and complexity of the firm’s activities. The risk management process for a community bank—while still necessary—does not need to be as sophisticated as that for a regional bank, and it certainly does not need to be as sophisticated as that for a money center bank with many different business lines. What financial supervisors need to keep in mind is the complexity and risk profile of the supervised firm. The expectations for review areas such as risk management or incentive compensation, for example, must be harmonized with the nature, complexity, and risk profile of the firm.

**Conclusion**

In conclusion, I think it is important to view the Dodd-Frank Act in the proper perspective. This legislation was a response to the oversight gaps that were revealed by the financial and economic crisis. Some believe that the legislation has gone too far, while others think it hasn’t gone far enough. I maintain that this new legislation, with thoughtful rule-making, provides an opportunity to strengthen the American financial industry. Together, our goals should be to reaffirm the public’s trust and confidence in their banks, and above all to help ensure the stability of the financial system.

Just like the finishing of a house, the finishing process of financial reform will be a complex and challenging task. Numerous rules and regulations will need to be written by the various regulatory agencies in the next phase, and the outcomes of this phase will benefit from the input and feedback received from the industry. We must take into consideration the varying levels of risk to the financial system posed by different tiers of firms. We want to close the gaps in our supervisory and regulatory framework without overburdening our least complex banking organizations with rules designed for the most complex financial firms. We must also find new ways to work effectively across traditional boundaries to achieve the stability we are seeking for the financial industry.

As the new rules and regulations are implemented, our financial supervisors will also need to be sensitive to this balance. We must tailor our supervisory approach in a way that ensures parity among financial firms with similar risk profiles.

An open and continuous dialogue between all stakeholders must be maintained through this next phase to prevent the outcome from tipping too far in any one direction. Again, I encourage you to raise your voices during this all-important rule-writing phase. I am optimistic that, with all of us working together, the ultimate outcome will be a strong and stable foundation for our country’s