Thoughts on Prudential Regulation of Financial Firms

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- Atlanta Fed President and CEO Dennis Lockhart, in a March 20 speech at the Georgia Law Review symposium at the University of Georgia in Athens, presents his views on prudential regulation of financial firms. He contrasts prudential regulation of banks and shadow banks, or the firms that play a role in the shadow banking system.

- Lockhart notes that the structure of the U.S. banking system is distinctive compared to other advanced countries. Our financial system has resulted in a large, growing, and opaque shadow banking system, and the money market fund industry has received particular attention.

- Lockhart says that following the financial crisis of 2008, the concept of prudential regulation broadened to encompass "macroprudential supervision" to protect the financial system's ability to support the general economy. This, he says, should be the "true north" of any expansion of the regulatory overlay on shadow banking.

- Lockhart calls for selective supervision and regulation of banking and shadow banking firms. The onus falls on regulatory policymakers to identify and respond to developments that threaten the general economy.

Thank you for including me in this symposium on financial regulation. This is an important topic. Having spent most of my career in the private-sector financial world, I am a believer in the notion of regulatory balance. Our system of financial regulation neither should tolerate practices and risk-taking that imperil public welfare, nor should it strangle innovation, initiative, and sound risk-taking under a mountain of compliance requirements. The exact right balance is, realistically, a moving target that is responsive to financial system structure and evolving circumstances.

Today I would like to explore questions related to prudential regulation as it applies to banks and nonbank financial firms. More specifically, I'll contrast prudential regulation of banks and so-called shadow banks, or firms that play a role in the shadow banking system. Banks are increasingly in competition with parties in the shadow banking system. I'll explore the logic of differential regulation between banks and shadow banks. I'll also comment on differential supervision within the banking industry per se.

My talk today anticipates a conference sponsored by the Atlanta Fed week after next titled "Central Banking in the Shadows: Monetary Policy and Financial Stability Post-Crisis." As the title suggests, we will be looking at how shadow banking interacts with monetary policy and affects financial stability. Since I expect to learn a lot at this conference, please take my comments today as work-in-process thoughts preliminary to the discussion that will take place at that conference.

Also, as always, I have to begin with a disclaimer. I will be presenting my personal views. I am not speaking for the Federal Reserve or for my colleagues on the Federal Open Market Committee.

Prudential regulation

Let me start with a few contextual observations on prudential regulation—that is, regulation focused on the safety and soundness of individual institutions.

Prudential regulation of banks in the decades leading up to the financial crisis of 2008 had, as a central aim, the protection of insured consumer deposits. This was especially the case for smaller banks. The charge to regulators was multifaceted, to be sure, but careful stewardship of the Federal Deposit Insurance Corporation—the FDIC—insurance fund was central.

The aims of prudential regulation of larger banks were broader. A substantial proportion of large bank funding came from less stable wholesale funding markets. Also, if and when these institutions faced distress, the regulators' safety net extended to nonbank subsidiaries. This became reality in the crisis.

The crisis also showed that the regulatory safety net might be used to address threats to financial stability associated with firms that were previously exempt from prudential regulation. These were firms with no real reliance on consumer deposits, but they were tightly integrated with vital money markets. Regulatory interventions in the crisis brought home the reality that substantial moral hazard accompanied exposure to such firms.

I would argue that since the crisis, there is enhanced clarity around the broad aims of prudential regulation. The concept of prudential regulations has been broadened to encompass "macroprudential supervision." The main goal of macroprudential supervision is to regulate banks—and, increasingly, some important nonbanks—to protect the financial system's ability to deliver vital services to the general economy. One could say, with little exaggeration, the goal is to protect Main Street from Wall Street.

Banks have long been among the more heavily regulated firms. However, post-crisis, regulatory oversight has been taken to another level for all sizes of banks. Minimum capital requirements are higher for all banks. Supervisors are requiring more and better internal risk management. Larger banks must now subject their portfolios to annual stress tests that assume severe recessionary conditions.

They must demonstrate an ability to absorb losses and continue lending to support the broad economy. Their capital plans must pass regulatory approval both quantitatively and qualitatively. New regulations on liquidity are now being implemented to strengthen the ability of larger banks to withstand deposit runs. There's more, but I think the point is clear enough. Banks are now even more heavily regulated.

Shadow banking

It has to be noted, though, that in the United States, banks represent only a part of the financial system. The structure of the U.S. financial industry is distinctive by comparison with other advanced countries. The financial systems of most countries—and I include those in Europe as a region—are bank-centric. The evolution of our financial system, by comparison, has resulted in a shadow banking system of considerable scale and institutional diversity.

A perfect definition of *shadow banking* is elusive. A simple and workable definition is financial services providers and credit intermediaries that operate without a bank charter. The Financial Stability Board, an international body that monitors the global financial system, uses a similar definition. It is "credit intermediation involving entities and activities outside the regular banking system." The key term in both definitions is "credit intermediaries." Credit isn't the only financial service provided by banks and nonbanks, but lending is an essential function in the economy. Credit is the lubricant of economic activity and one of the principal channels through which monetary policy has its effect.

The scale of shadow banking activity is large. The most reliable numbers focus on system liabilities. Shadow banking, as measured by liabilities, grew rapidly in the decade prior to the crisis. According to a 2013 report on shadow banking by the New York Fed, shadow liabilities peaked at $22 trillion in June 2007 and exceeded the liabilities of traditional banks. More recently, by December 2013, traditional banks had the larger share. A crude estimate would have banks at 60 percent and shadow banks at 40 percent of credit intermediation.

A wide variety of financial firms could be classified as shadow banks in part or all of their activity. The list includes money market mutual funds, broker-dealers, nonbank finance companies, business development corporations, hedge funds, pension funds to the extent they participate directly in financings, and so-called peer-to-peer online lending platforms. I would add the various functionally specialized participants in the securitization industry.

Some of these types of intermediary deserve special mention. Broker-dealers, many of which are units of bank holding companies, fund themselves independently of their associated banks in short-term funding capital markets and lend to investors against their clients' inventory of securities.

Participants in the securitization industry—the biggest component of which is home mortgages—have a share of shadow banking. In securitization, there is a chain of linked roles starting with loan origination, followed by warehousing, leading to structuring an asset-backed security or a collateralized debt obligation that is distributed in the capital markets.

Another component of the shadow banking system that has received a lot of attention is the money market mutual fund industry. Money market funds have drawn attention because of the aggregate scale of the industry and the quasi-deposit nature of shareholder investments in these funds.

The concern in the regulatory community—including the Fed—regarding money market funds relates to the industry's size and perceived vulnerability to runs in times of financial turbulence. Current regulation of money market funds by the U.S. Securities and Exchange Commission allows only a very limited range of investments and tenors. There is considerable correlation among constituent funds that results from this tight regulation.

The industry has about $2.7 trillion of liabilities. Almost 40 percent of that is in funds that hold only government and government agency securities. And almost two-thirds of the $2.7 trillion in invested assets represents investments by institutional clients.

There is some basis for concern about the industry's potential role in an episode of financial instability. In the fall of 2008, a prime fund—the Reserve Primary Fund—"broke the buck" due to holdings of Lehman Brothers commercial paper. In the week or so that followed, roughly $500 billion flowed out of prime money market funds into government money funds. Prime funds met redemptions through decreases in commercial paper holdings, prompting a crisis in that market for issuers. The Federal Reserve quickly stood up market support facilities to address the crisis in short-term markets.

The money market fund sector remains a focus of regulators because of its potential to be both contributor to and victim of financial instability.

The banks' "franchise"

Today, banks and nonbanks compete head-on to a great extent as credit intermediaries and in some other product markets. Put differently, the banking system and shadow banking system go after similar business and serve similar functions.

The banking system no longer enjoys anything resembling an exclusive "franchise" in its three key functions: deposit taking, payments, and lending.

As regards deposits, consumers and businesses have many deposit or deposit-equivalent options. They include money market accounts of various investment styles, interest-paying surplus balances on credit cards, and prepaid cards for various uses. I have a friend whose spouse keeps a substantial credit balance on her Starbucks payment card.

In payments, too, banks no longer have exclusivity. They no longer have end-to-end control of processing. Banks retain a virtual monopoly in final clearing and settling payments, but now there are legions of financial transaction specialists doing payments processing. Some of these are relative newcomers—so-called fin tech startups—while others are well established. PayPal was founded in 1998!

As I said, the lending franchise of banks is also under pressure. Some nonbank competitors have substantial balance sheets. An example is GE Capital, the seventh largest domestic financial institution.

Recently, we've seen the rise of online lending platforms that use powerful credit scoring and decision-making algorithms. The market share of these alternative lenders is small compared to banks. It's too early to assess their ultimate impact on the lending industry, but it's possible that these new nonbank lenders will become important players in some markets previously dominated by banks.

I would argue that the coexistence of bank and nonbank credit providers benefits the overall economy. Not all credit extension is appropriately *bank* business. I once worked for a nonbank finance company. We took lending risk for variable upside, performance-dependent reward where risk and loan structure was outside the appetite and competence of many banks. The risk transformation accomplished by securitization is analogous. Exposures that are individually outside the comfort zone of banks are bundled to create a portfolio with reduced default risk.

Nonetheless, banking and shadow banking *are* direct competitors along many dimensions. But most nonbanks are much less regulated than banks, and that regulation is largely not prudential in character (that is, safety- and soundness-oriented).

Aside from the obvious question of whether this constitutes a level competitive playing field, is this good macroprudential policy? Furthermore, why are banks subject to more extensive regulation? And, given the experience of the recent crisis, is the relatively light regulation of shadow banks still sufficient?

Differential regulation

Banks enjoy access to two important government programs that are designed to reduce the chances of economically damaging runs. They are the FDIC deposit insurance and the Fed's discount window—the central bank's lender-of-last-resort function. For the privilege of these two forms of support, banks submit to a process of regulation and supervision. Banks are not immunized from survival risk. The regulatory regime permits orderly bank failures and prompt resolution under procedures designed to safeguard the broader health of the economy.

If there is a case for greater prudential regulation of shadow banking institutions, it is also based on financial stability concerns. These institutions are a significant and growing source of credit in the economy. They depend greatly on wholesale funding. Many are opaque compared to banks in terms of their activities and exposures. They are part of an interconnected financial system that, in extreme circumstances, is prone to contagion. And shadow banking parties are not walled off from the banking system. They share some credit exposures with banks, and they receive funding or support for their security issuance from banks.

Heightened regulatory requirements *have* recently been imposed on some nonbanks, but the norm remains differential regulation. After the crisis, a few of the country's most significant nonbank financial firms—firms that did not own commercial banks—were pulled under the Fed's regulatory umbrella. Goldman Sachs and Morgan Stanley became bank holding companies subject to bank prudential regulation of the Federal Reserve. GE Capital has been designated a *systemically important financial institution* (SIFI), as have some large insurers.

Is market discipline sufficient?

Resistance to expanded regulatory oversight is often grounded in the view that market discipline is an effective substitute. Is market discipline sufficient to address risks residing in the shadow banking world, risks that could have systemic impact? Some comfort can be taken from the reality that liabilities of the shadow banking system come predominantly from professionally managed money sources. Also, the spread of firms and activities classified as shadow banks or shadow banking may mitigate the risk of massive concentrations of risk. That said, shadow banking activity is large, growing, and opaque. The financial crisis that began in 2007 arguably began in the shadow banking arena. It propagated to banks and became global because investors and depositors could not assess their counterparties' exposures.

At a minimum, I feel the authorities responsible for preserving financial stability must monitor the sector very closely with ever-improving techniques. A robust regime of monitoring is justified, in my opinion, because of the natural tendency in our economic system for activity to migrate to where it is least regulated. I also do not believe we have to choose between complete exemption from prudential regulation and a wholesale extension of the existing framework of regulation developed for banks.

If we anchor calibration of regulatory oversight of firms, classes of firms, and markets in potential risk to the broad economy, then it seems to me we should variably monitor and supervise institutions and activities in the banking system that may have financial stability implications, and do the same in the shadow banking world. This does not mean we should undertake full-spectrum prudential supervision and regulation of everything in either sector.

Selective supervision and regulation is both possible and desirable. The onus falls on regulatory policymakers to identify and respond to developments that threaten the general economy. Too much regulation can threaten the vibrancy of the U.S. economy—although, to be sober about it, not as catastrophically as too little.

The concept of differential supervision also is applicable among banks of varying size, scope, and complexity. The Federal Reserve is implementing differentiated supervision of individual banks based on a bank's size, complexity, risk profile, and systemic importance. We're calling this approach two-tiered regulation. The approach recognizes significant distinctions between larger banks and community banks. I expect continuing refinement of supervisory methods along this line.

The true north of shadow banking regulation

The current orientation of prudential regulation reflects learnings from the recent financial crisis. We learned about concentrations of risk across firms that may not be identified as excessive in individual firms. We learned about interconnectivity within the financial system and the threat of contagion in periods of financial stress. We learned about the role of opaque firms, markets, and vehicle structures, and how they can contribute to cascading illiquidity and market shutdown. At the beginning of my remarks, I argued that the experience of recent years has made the primary aim of prudential regulation to protect the financial system's ability to support the general economy. In my view, this should be the "true north" of any expansion of the regulatory overlay on shadow banking.