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Rebuilding the Global Economy
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MEMORANDUM ON

STRENGTHENING FINANCIAL SYSTEMS AGAINST FUTURE SHOCKS

To: The Vice Chair for Supervision of the Federal Reserve Board
From: Anna Gelpern
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Background: Financial regulators' challenge today is to fortify financial systems against future climate and public health shocks and financial crises and to prevent finance from amplifying inequality and social conflict. These risks are by their nature systemic. Prevention and resolution strategies limited to individual institutions are bound to fall short. The Dodd-Frank Wall Street Reform and Consumer Protection Act created the Vice Chair for Supervision position at the Federal Reserve[1] in 2010 as part of a far-reaching postcrisis financial reform program explicitly concerned with systemic risk. These reforms on balance expanded the Fed's regulatory and supervisory remit but also limited its scope for emergency intervention in crises.

Policy responses to COVID-19 reaffirm the central importance of the Federal Reserve to the stability of the US and global financial systems.

Ahead of the next shock, it is essential on both economic and political grounds for the Fed to prioritize building up financial system resilience and to identify and preempt new sources of instability. During the transition and the pandemic, the Vice Chair is the one sitting US official with the mandate to implement supervisory measures to bolster resilience across institutions and the bandwidth to focus on financial stability.

PRIORITY 1: Reassess Regulatory Relief Efforts in Light of the Pandemic Experience

The pandemic experience of 2020 is an opportunity to pause, review, and reconsider recent supervisory initiatives in light of new evidence without signaling regulatory instability. In the consensus view, US commercial banks have proved resilient in the face of an unprecedented economic shock. Banks' resilience so far validates domestic and international reforms that began after the global financial crisis of 2007–09. Since 2017, however, US regulators have rolled back many of these reforms. Most of the rollbacks were in the name of reducing administrative burdens on small community banks, but some

1 The Board of Governors of the Federal Reserve System, referred to as the "Federal Reserve" or the "Fed."

extended to very large regional and national institutions. Regulatory relief legislation in 2018 accelerated the reversal. Capital stress tests, resolution planning, and minimum liquidity requirements have been reduced in scope and intensity for banking organizations with less than $700 billion in assets and have been eliminated for banks with less than $100 billion in assets. The remaining stress tests have become more transparent for the banks, but less so for the public, at least during the pandemic. Volcker Rule prohibitions on banks' proprietary trading have been relaxed. According to the International Monetary Fund's (IMF) 2020 financial sector assessment of the United States, recent measures could meaningfully reduce capital and liquidity buffers for all but the biggest global financial conglomerates.

The likely total impact of many disparate regulatory relief initiatives was hard to quantify even before COVID-19, IMF warnings notwithstanding. Ascertaining it has become more urgent since. According to the Fed's November 2020 Financial Stability Report, firm and household debts have been rising sharply since the onset of the pandemic, with risks concentrated in certain sectors and regions. The full effects of recent business disruptions, including those following a new spike in COVID-19 cases since November, would take time to appear on institutions' balance sheets. The presumption that significant cumulative regulatory rollback would produce a safe recalibration in the face of these risks is questionable and potentially dangerous.

PRIORITY 2: Develop a Comprehensive Oversight Framework for Nonbank Financial Intermediation, Including Enhanced Supervision of Both Entities *and* Activities

US policymakers stopped using the term "shadow banking" in 2017; financial regulators elsewhere quickly followed suit. Yet, nonbank financial intermediation has been growing rapidly in the United States and around the world, with a variety of structures using short-term debt to fund illiquid assets. The Fed's crisis management success early in the pandemic should not obscure the underlying regulatory failure that required yet another Fed intervention in entities and markets it did not regulate. The crisis revealed continued fragility in money market funds, short-term funding markets, and other parts of the nonbank financial ecosystem.

While the Fed should collaborate with functional regulators on targeted reforms, a fragmented functional approach is not enough in a world increasingly prone to large-scale exogenous shocks. Without a comprehensive framework for financial stability oversight across both institutions and markets, regulators are doomed to play whack-a-mole with Fed emergency lending on standby.

The Trump administration committed to "activities-based" financial stability oversight as an alternative to designation and enhanced supervision of systemically important financial institutions. Guidance by the Financial Stability Oversight Council (FSOC) in 2019 on the activities-based approach expressly defers to functional regulators, such as the Securities and Exchange Commission (SEC). Apart from the Fed, however, these functional regulators have limited experience in, and limited commitment to, financial stability regulation—by mandate, they do not see the big picture and are bound to miss potentially correlated amplification of shocks. The Trump administration has not implemented any new activities-based systemic risk regulations since issuing the guidance.

Despite the flaws of this approach to activities regulation, simply returning to systemic entity designations would be a bad idea. First, critics of the entity-based approach are right to point out that it fails to capture vast amounts of financial market activity untethered from institutional balance sheets. Second, entity designation has gravitated to bank-style capital and liquidity regulation, which can be a poor fit for a diverse bunch of nonbanks. Third, by 2017, entity designation had become mired in legal challenges. While the US government might eventually win all the lawsuits, a regulatory approach that gets gummed up in court for years would cost precious time as risks build up.

Financial stability requires both entity and activity regulation. These are no more mutually exclusive than traffic lights and licensing drivers. With access to its emergency lending on the line, the Fed should press for a more holistic approach to managing systemic risk in the financial markets—even where it does not have direct supervisory authority. FSOC should coordinate the development of a comprehensive analytical framework, instead of leaving it to functional regulators and their limited tools. The Fed's intellectual leadership can be critical in this area.[2]

If FSOC does not have the wherewithal to reverse its posture of deference to functional regulators, the Fed should take the initiative to design a more holistic approach to financial stability oversight. It has ample data and analytical capacity to do so, along with tools such as margin requirements to affect the supply of credit in the financial markets, oversight and operation of payment systems, and supervisory authority over the largest diversified financial conglomerates.

PRIORITY 3: Reconsider Institutional Design to Meet New Challenges and Foster Legitimacy

The structure of financial oversight in the United States is ill-equipped to handle the challenges facing it: climate, public health, social strife, and inequality, which cuts across all others.

First, paring back stress tests, Volcker Rule trading restrictions, and public reporting puts added onus on supervisors exercising discretion to determine whether institutions are operating in unsafe and unsound ways. A rule proposed in November 2020 to reduce reliance on supervisory guidance could make the exercise of discretion less transparent, whether or not it leads to more formal rulemaking on the margins. The combined effect is to shift more prudential and financial stability oversight into the realm of confidential supervision, risking capture and courting political controversy. Supervision relies on sustained engagement between the regulators and the regulated. It is hard to make intelligible and accountable to the public; guidance is one of the few tools that can help. The Fed, last seen by the public as "bailing out the banks," is especially at risk of appearing cozy with financial institutions.

Second, FSOC and the Treasury Department's Office of Financial Research (OFR) appear increasingly adrift while the consequences of poor coordination are becoming more dire. The fact that the US Treasury Secretary chairs FSOC adds political accountability and a measure of influence—and further politicizes financial regulation. FSOC's recent

2 The Fed Chair is a voting member of FSOC; the Vice Chair has participated in council meetings by courtesy. The current Vice Chair of the Fed also serves as Chair of the Financial Stability Board, but will be replaced by the President of the Netherlands' central bank in December 2021.

interventions have made it harder for financial regulators to respond nimbly and flexibly to new risks. They have eliminated, blunted, and piled new obstacles in the way of using supervisory tools.

Third, the gap between US and international supervision practices for mid-sized banks, insurers, accounting standards, and operational risk, among others, has grown, partly thanks to all the regulatory relief. The United States has a history of selective adherence to international standards. It also has an impressive record of securing global standards in line with US domestic practice. In the wake of recent US withdrawal from international organizations and norms, as well as its poor performance in managing the pandemic, the United States may have to go to new lengths to convince other countries that it is a reliable partner, and persuade them to adopt standards close to its own.

Fourth and last, technology firms that deliver financial services outside the regulated financial sector will continue to challenge regulators, especially in areas such as payments and small-scale consumer lending. The line between retail and wholesale payments infrastructure will keep blurring. Increasingly diverse actors will demand access to payment systems, raising thorny questions of operational and counterparty risk, and prudential supervision, even when no deposit-taking is involved. Effective oversight for financial stability and consumer protection takes new skills, constant adaptation, and substantial resources—and may require public provision of some financial services.

The Federal Reserve has the motive and the capacity to take a leading role in managing these challenges. Its authority over bank holding companies, its place in the payment system, and its lender of last resort mandate together give the Fed unparalleled influence over the changing shape of the US financial system. While it would be preferable for FSOC to play a robust role, the Fed can perform many of its analytical and coordination tasks. If the OFR does not regain its footing quickly, merging the financial stability research function into the Federal Reserve should be on the table. Meanwhile, the Fed must place a new emphasis on public outreach and creative communication to bolster the public legitimacy of its supervisory work, as it has done on the monetary policy side.