

# **Guiding Principles for Financial Regulation**



**Loretta J. Mester  
President and Chief Executive Officer  
Federal Reserve Bank of Cleveland**

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## Introduction

I thank the Brevan Howard Centre for Financial Analysis at Imperial College London and the Initiative on Central Banking and Financial Policy at Columbia University, and in particular Franklin Allen and Trish Mosser, for inviting me to speak on this panel. The views I'll provide today are my own and not necessarily those of the Federal Reserve System or my colleagues on the Federal Open Market Committee.

Some of you may be too young to remember the original Star Trek – the one with William Shatner playing Captain Kirk. But in a famous episode, Kirk, Spock, and McCoy find themselves on a planet whose society is modeled on gangsters from Prohibition-era Chicago.<sup>1</sup> At one point, Kirk creates a diversion by engaging the gangsters in a card game called “fizzbin,” making up the rules as he goes along. Each player gets six cards, except for the dealer and the player to his right, who each get a seventh card. The second card is turned up, except on Tuesday. If you get two Jacks, you have a half fizzbin, which is good, but if you get a third Jack, you have a shronk, which is bad. A King and a two are good, except at night, when you want to get a Queen and a four instead. The aim of the game is to get a royal fizzbin, but the odds are astronomically against that. I think you get the idea.

At times, the regulatory framework that has arisen since the global financial crisis can seem like the game of fizzbin – very complicated, seemingly without rationale, and constantly changing. In such an environment, sometimes it helps to take a step back and focus on some underlying principles that should serve as a foundation for any financial regulatory framework, and that can help guide any potential changes to strengthen the framework and promote cross-country harmonization.<sup>2</sup>

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<sup>1</sup> The Star Trek episode was “A Piece of the Action,” season 2, episode 17, January 12, 1968.

<sup>2</sup> A similar tack was taken in the U.S. Treasury's recent report outlining proposed changes to financial regulations to promote the Administration's core principles for the financial system. However, the principles I discuss are somewhat different. (See U.S. Department of Treasury, “A Financial System That Creates Economic Opportunities:

My **first principle**, similar to Star Trek's prime directive, is that financial system regulation should be tailored to the risks imposed on the system, thereby fostering systemic resiliency. By resiliency I mean a system in which financial institutions remain strong enough to continue to lend and offer other valuable financial services throughout the ups and downs of the business cycle. The corollary is that if current regulations are not furthering this principle, they should be rethought. Similarly, if a portion of the financial system is prone to systemic problems but doesn't have adequate oversight, this situation should be rethought, too.

This principle recognizes that financial services firms provide value. Indeed, the fact that the crisis and its aftermath were very dark times for households, businesses, banks, and policymakers and that the financial system was at the heart of the crisis attests to the vital role a sound financial system plays in supporting a vibrant economy. This principle also recognizes that bank regulation and supervision should concern itself not only with the safety and soundness of individual institutions but also with the risk of the system overall. The absence of such a focus prior to the financial crisis contributed to a buildup in financial imbalances and systemic risk. The post-crisis changes made to the regulatory framework aim to strengthen resiliency by lowering the probability of another financial crisis, and by reducing the costs imposed on the rest of the economy when a large shock hits the financial system. Important components include capital requirements, liquidity requirements, stress tests, living will resolution plans, and resolution methods that allow systemically important institutions to fail without causing problems for the entire financial system. As a result of the financial crisis and these regulatory changes, banks themselves have also altered how they monitor risks and run their businesses.

Focusing on risk management makes it clear that institutions posing the most systemic risk should face enhanced prudential standards and supervisory attention, while institutions not imposing costs on the rest of the financial system or creating the kinds of contagion that can put the entire financial system at risk should face a different type of oversight. Institutions should not be burdened by rules that make it more costly for them to serve their customers but do little to further the goal of a healthy and resilient financial system. For large banks, the combination of risk-based capital requirements, a leverage ratio requirement as a backstop, liquidity requirements, and annual stress testing is appropriate. But there is now some recognition that there may be opportunities to reduce regulatory burden without increasing systemic risk. In the U.S., some increase in the thresholds at which some of the enhanced requirements kick in would be reasonable, as would a reduction in the regulatory burden that has been placed on community banks.<sup>3</sup> Some steps are already being taken. For example, in late September, the federal banking agencies issued for public comment proposed changes to the capital rules for community banks intended to simplify and reduce the burden of rules imposed by Dodd-Frank.<sup>4</sup>

At the same time, it's important not to throw the baby out with the bathwater. We learned during the financial crisis that bank capital standards were too low, that some forms of capital considered to be Tier 1 by the regulators did not protect the banks when there was a severe shock, and that neither the market nor central bank lender-of-last-resort functions were adequate to address severe liquidity problems when collateral values could not be determined. Any changes to the regulatory framework will need to heed the

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<sup>3</sup> Dodd-Frank requires that banks with assets between \$10 billion and \$50 billion be subject to company-run stress tests and that banks with assets of \$50 billion or more be subject to annual supervisor-administered stress tests, capital planning, living will, and other enhanced prudential requirements. The Fed has already exempted nonsystemic banks with less than \$250 billion in assets and less than \$75 billion in nonbank activities from the qualitative capital planning part of the stress-testing process. See "Federal Reserve Board Announces Finalized Stress Testing Rules Removing Noncomplex Firms from Qualitative Aspect of CCAR Effective for 2017," Board of Governors of the Federal Reserve System press release, January 30, 2017 (<https://www.federalreserve.gov/newsevents/pressreleases/bcreg20170130a.htm>).

<sup>4</sup> See "Agencies Propose Simplifying Regulatory Capital Rules," joint press release of the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency, September 27, 2017 (<https://www.federalreserve.gov/newsevents/pressreleases/bcreg20170927a.htm>).

first principle and preserve the strength and resiliency of the financial system, which benefit the economy.

It will be an ongoing challenge to strike the right balance between enhanced financial system resiliency and maintaining the system's ability to deliver economic value by innovating and taking on risk.

My **second principle** is that the regulatory framework must recognize that it creates incentives for financial institutions, their customers, and the regulators themselves and that market forces are always at work. A corollary is that regulations that align incentives with financial stability and that work with market forces rather than against them will likely be more effective than those that don't.

Unless the incentive effects are taken into account, even well-intentioned regulations can create unintended consequences. For example, before the crisis, some part of the strong growth in financial intermediation that occurred outside of the regulated banking system was driven by the desire to avoid regulation. Regulatory requirements that differ across sectors can create distortions and undesirable outcomes, especially when activity can easily be shifted from a sector that is monitored to a sector that is difficult to monitor. Even within a regulated sector, distortions can creep in. The asset thresholds that trigger increased regulatory requirements create incentives to remain below the thresholds. To the extent that these thresholds are a good measure of systemic risk, creating such incentives can be productive. For example, some banks have taken steps to decrease the complexity of their organizations. However, if the thresholds are only loosely connected to risk, efforts to remain slightly below the thresholds and regulatory attention on these triggers are not useful.

Regulatory requirements that differ across countries are perhaps even more problematic, as they can result in cross-country regulatory arbitrage and put institutions in some countries at a competitive disadvantage. For example, a growing body of research has documented that there are significant scale economies in

banking that are driven by technological advantages and not by safety-net subsidies.<sup>5</sup> Suppose policymakers in one country decide to put a limit on firm size because they believe that the potential costs of systemic risk posed by large institutions outweigh the efficiency gains. This would put the country's large banks at a competitive disadvantage in global markets unless other countries implemented similar constraints. Because the restrictions would be working against market forces given the scale economies, it is unlikely that size restrictions would be effective in the country imposing them. They would create great incentives for firms to try to evade them by moving activities outside of the more regulated sector but they would not necessarily reduce systemic risk. Risk would migrate but not be eliminated. There would need to be more intensive monitoring of both the regulated and the less-regulated sectors.

This example suggests that it is desirable to have international agreements on capital and liquidity requirements for systemically important institutions, and coordination when a cross-border institution gets into trouble. The Basel III rules have taken some aspects of capital regimes that were used only in a subset of countries and have applied them more broadly. For example, the rules include a leverage requirement, which was used in the U.S. but not in Europe prior to the crisis, and they include a liquidity requirement, which was used in a few but not many countries prior to the crisis. The hope is that international coordination leads to more effective regulatory regimes rather than forces movement to the lowest common denominator.

The example also suggests that if regulation could benefit from understanding market forces, there may also be benefits from harnessing market discipline to promote financial stability. A prerequisite for this would be increased disclosure from financial firms so that their creditors and other market participants are in a position to exert such discipline.

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<sup>5</sup> For a discussion of this research and the policy implications, see Joseph P. Hughes and Loretta J. Mester, "The Future of Large, Internationally Active Banks: Does Scale Define the Winners?" Chapter 6 in *The Future of Large, Internationally Active Banks*, World Scientific, Hackensack, NJ, Asli Demirgüç-Kunt, Douglas D. Evanoff, and George G. Kaufman, eds., 2017, pp. 77-96.

Perhaps most important to remember is that regulators also face incentives. During the financial crisis, regulators and policymakers faced significant time-inconsistency problems when confronting systemically important financial institutions on the brink of failure. They faced a classic dilemma: either rescue the insolvent firm and create future moral hazard problems or let the firm fail and risk causing a cascade of other failures. As Ben Bernanke reportedly said: “There are no atheists in foxholes or ideologues in financial crises.”<sup>6</sup> Without a credible resolution method, it is reasonable to expect that well-intentioned policymakers will be biased toward bailouts. Said simply, policymakers and regulators are people, too. Recognizing regulatory incentives should guide the design of the regulatory regime. This underscores the need for credible methods of resolving insolvent firms and of well-designed lender-of-last-resort functions that reduce perceived stigma.

My **final principle** is that the regulatory framework needs to be designed so that institutions, regulators, and policymakers can be held accountable for the responsibilities assigned to them. There has been a rise in skepticism about institutions since the financial crisis. This is understandable given the depth and breadth of the crisis and its aftermath, but it also suggests there is some urgency to considering how to increase accountability in productive ways. A framework that encourages regulators to be more systematic and less discretionary in how they implement regulations can help, as it sets up appropriate expectations.

In addition, while the regulatory framework needs to acknowledge that the financial structure is complex, the framework itself should only be as complex as necessary to be effective.<sup>7</sup> The notion that

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<sup>6</sup> See Peter Baker, “A Professor and a Banker Bury Old Dogma on Markets,” New York Times, September 20, 2008 (<http://www.nytimes.com/2008/09/21/business/21paulson.html>).

<sup>7</sup> Haldane and Madouros (2012) discuss the benefits of a less complex financial regulatory structure and argue that the complexity of the financial landscape does not call for a complex financial regulatory structure, but just the opposite (see Andrew G. Haldane and Vasileios Madouros, “The Dog and the Frisbee,” speech at the Federal

“everything should be made as simple as possible, but not simpler” is often (perhaps erroneously) attributed to Albert Einstein. But it applies to regulatory regimes. A sometimes overlooked lesson from the crisis is that regulatory complexity can complicate supervision, risk monitoring, compliance, and enforcement. Too much complexity can make it harder for regulators to assess compliance and identify risk-shifting behavior, which means it is difficult to impose consequences for firms that fail to meet the standards.

Equally important, complexity also makes it difficult to monitor the regulators and align their incentives to carry out effective supervision and regulation. We should always be assessing whether we would be better off with a simpler regulatory structure that is easier to implement and govern, and that is approximately right across various states of the world, even if it is never optimal in any particular state or in any particular model of the economy.

If the system is too complex to evaluate, it will be difficult for the public and their representatives to hold regulators accountable. Either there will be no accountability or the regulators and policymakers will be held accountable for every bad outcome, regardless of whether the outcome stems from poor performance on their part or not. A simpler system allows for more effective accountability.



At the same time, we should not be seduced by regulations that appear to be simple but would, in fact, be ineffective and result in unintended consequences. Because the financial system is complex and ever-changing, there will need to be some complexity in the regulatory framework. As I mentioned earlier, proposals to break up the banks or set a size limit might seem appealing as a solution to the too-big-to-fail problem, but I think this would cause unintended and counterproductive consequences.

Speaking of simplicity, the three guiding principles I have discussed – aligning regulations with systemic risk, paying attention to incentives and market forces, and increasing accountability – sound simple but are, in fact, difficult to pull off. Still, I think they deserve attention as we strive for a regulatory framework that is more effective and better able to deliver the benefits of a well-functioning financial system to the public.