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Regulatory Reform: Lessons from the Front Line

The Minsky conference has long been known as a unique forum to discuss timely economic and financial issues, and this year is no different. The focus of this year's conference—"After the Crisis: Planning a New Financial Structure"—speaks to what we see every day in the headlines, as the U.S. Congress and governments around the world debate a wide variety of proposals to reform the world's financial regulatory structures.

Some say that major reforms can be enacted only following major crises—after conditions become "bad enough." History and human nature clearly confirm this view. What is less obvious is that hasty reactions following a crisis do not always solve the problem. In fact, they can often create new problems. If reforms are to be successful and enduring, they should reflect comprehensive assessments and analyses of the factors that contributed to the crises.

One need only look to the financial crisis that occurred at the turn of the last century in our own country for such an example. It was the market crash and panic of 1907 when things became "bad enough" for major reforms to be considered at that time. But it was also the findings and recommendations of the National Monetary Commission—which studied both the causes of the financial failures and structures adopted by other countries—that prompted the development of regulatory reforms and that ultimately [led to the establishment of] the Federal Reserve System.

I think it's absolutely true that "you cannot reform what you don't understand." Based on that truism, I will offer you some perspectives on financial regulatory reform based on the lessons I have learned, and do understand—lessons built on the front-line experiences we at the Federal Reserve Bank of Cleveland have lived through as banking supervisors.

At the Federal Reserve Bank of Cleveland, we have been engaged—as everyone else at this conference has been engaged—in studying the causes of the financial crisis and identifying opportunities for regulatory reform. In addition to our research and analysis, our proposals for reform have also been developed based on our front-line supervisory experience with the financial crisis. Through the thick of the crisis in 2008 and early 2009, our direct involvement in the supervision of banking organizations in the Fourth Federal Reserve District, and our knowledge of supervisory activities throughout the country, exposed gaps in the supervision of the financial sector that contributed to the crisis. Since then, we have been able to step back and examine the conditions that existed during those dark days and evaluate the circumstances behind them.

In my remarks today, I will first call attention to an important but sometimes overlooked aspect of regulatory reform: consolidated supervision. Second, I will describe the criteria we should use to define systemically important institutions and discuss a framework for ensuring that financial firms are effectively supervised based on the risk they pose to the financial system. Finally, I will explain why it is vitally important for the Federal Reserve to remain significantly involved in the supervision of banking firms of all sizes. Of course, these comments are my own and do not necessarily reflect the views of my colleagues in the Federal Reserve System.

The Importance of Consolidated Supervision

In the years leading up to the crisis, financial supervisors had been looking first and foremost at the risk profiles of the individual institutions that they had been responsible for supervising. This entity-based approach to supervision led to gaps in regulatory oversight, and the exposures within the broader financial system were underestimated as well.

As a result, many thoughtful observers have proposed that greater attention be focused on identifying a mechanism for macroprudential supervision, or what some refer to as systemic risk supervision—namely, supervision with an eye toward minimizing risk to the entire financial system. This concept has received a great deal of well-deserved attention in the regulatory reform deliberations currently taking place. I do not plan to elaborate on this concept today, other than to say I endorse it wholeheartedly.

Instead, I want to talk about another very important supervisory concept that has not received as much attention: the concept of consolidated supervision. To understand why I want to call your attention to this issue, let me first describe the banking structure in my Federal Reserve District.

In the Fourth Federal Reserve District, we are fortunate to have financial firms that vary considerably in size and structure—from small, noncomplex community banks to large, moderately complex regional firms. Of the 244 bank holding companies in our District, four are among the largest 25 domestic bank holding companies in the country. While our largest bank holding companies are not likely to be considered systemically important in their own right, their degree of complexity and risk pose considerable supervisory challenges.

These supervisory challenges became quite apparent during the crisis. Despite their smaller size compared with those firms typically considered systemically important, these regional firms were engaged in complex activities that resulted in a higher level of risk both to themselves and to the broader financial system. These regional bank holding companies and their affiliates were supervised by multiple federal and state agencies. All of these functional regulators were focused on supervising the individual entities for which they were responsible—and rightfully so. However, this entity-based approach to supervision created gaps in the oversight of the consolidated enterprise. As the various supervisors focused on the risks originated and faced by the particular part of the company for which they were responsible, it was sometimes difficult for bank holding company supervisors to identify the aggregate risk in the enterprise, and to do so in a timely way.

For example, think about the liquidity required for a particular entity in a holding company versus the liquidity needs of the overall enterprise. A liquidity level that may appear adequate for the needs of a specific entity—the bank subsidiary, let's say—may not meet the needs of the consolidated organization. Within the corporate structure, both bank and nonbank entities require funding to remain active. Consolidated supervision would provide for the ability to identify the aggregate liquidity requirements and to develop a comprehensive supervisory plan that addresses the risks to the entire organization.

The Federal Reserve has already taken steps to sharpen our focus on enterprise-wide risk supervision, but I support legislation that would remove some of the constraints we currently face to obtain information from, and address unsafe and unsound practices in, the subsidiaries of bank holding companies. In other words, we should move toward consolidated supervision to ensure that the aggregate risks of the entire firm are identified in a timely way and that appropriate supervisory action can be taken, regardless of where that risk originates in the organization. Without consolidated supervisory authority, oversight gaps will continue, making it difficult to identify cross-entity risks within a bank holding company and to take appropriate action to mitigate those risks.

Identifying Systemically Important Institutions

In addition to learning firsthand the value of clear, consolidated supervisory authority, experience has also sharpened my thinking about the identification of systemically important firms. Let me be clear here about the goal: to put an end to the "too big to fail" problem. To achieve this goal, banking supervisors must be able to identify which firms are systemically important, and why. While the size of a specific financial firm is an important factor, it is only one of several factors that should be considered. Other important factors that need to be considered are contagion, correlation, concentration, and context—what we at the Federal Reserve Bank of Cleveland refer to as "The Four Cs."

Contagion can be thought of as the "too interconnected to fail" problem. If an institution is connected to many other institutions and firms—through loans, deposits, and insurance contracts, for example—all of those firms may collapse if the first firm fails.

Correlation can be thought of as the "too many to let fail" problem. Institutions may engage in the same risky behavior as many other institutions, and the failure of one institution may result in the closure of all those institutions engaged in that same practice.

Concentration can be thought of as the "too dominant to fail" problem. In these situations, an institution has a market concentration sufficiently large that its failure could materially disrupt or lock up the market.

Context can be thought of as the "too much attention to fail" problem. Because of market conditions and other conditions that exist at the time, the closure of a particular institution may cause panic and result in the impairment of other firms.

Thinking about systemic importance in the context of these four factors results in a more reliable and comprehensive identification of firms that, in and of themselves, may be considered systemically important for reasons beyond just their size. Size is a necessary, but not sufficient, criterion upon which we should determine systemic importance. The Four Cs—contagion, correlation, concentration, and context—must also be considered.

Establishing a Framework of Tiered Parity

When people discuss the composition of our financial industry, they often refer to just two categories—the large, highly complex firms generally referred to as "systemically important institutions" and "all others." But once we've identified those firms that are systemically important—based on their size and The Four Cs—we are left with an "all others" category that I find to be too simplistic and that requires further refinement. Let me explain why.

My experience suggests that there is a middle tier of financial firms that poses a greater risk to the financial system than community banks and thus requires a higher degree of supervisory attention. So I believe that a multi-tier approach to thinking about our financial industry is very useful, and I have proposed a three-tiered framework called *tiered parity* that would have categories labeled "systemically important," "moderately complex," and "noncomplex."

The fundamental principle behind this framework is that the regulations and the approach to supervision for each tier would correspond to the degree of risk posed to the financial system by the firms within each tier. While we currently make some distinctions between firms of different sizes and complexity in terms of how we supervise, one objective of my approach is to draw even sharper distinctions than we do today. In the new framework, differences in treatment between the tiers would be based on differences in risk and complexity. Another objective of this framework is to ensure that institutions within each tier would receive the same regulatory treatment and supervisory oversight, so my approach incorporates parity of treatment within each tier.

Any institution that is identified as systemically important would be subject to stricter supervisory requirements, such as capital and liquidity standards, as well as close supervision of its risk taking, risk management, and financial condition. In addition, firms in this tier would be required to develop what some have called a "living will" that would provide for planned and orderly unwinding if necessary. The goal would be not only to limit the amount of risk these companies could pose to the financial system overall, but also to discourage the combination of size, complexity, and nature of operations that enabled them to become a systemic threat in the first place. All of these steps should help us to eliminate the specter of "too big to fail."

Firms in the first tier are systemically important by their very nature. Firms in the second tier—the moderately complex firms—can pose risk to the financial system under certain circumstances. In particular, a group of tier-two firms may exhibit common systemic risk characteristics, such as exposure to a specific type of risky asset that results in correlation among these firms, or together the firms may have a concentration in a particular activity.

Our supervisory approach to this group of moderately complex financial firms would be revised and customized to consider the risks they collectively pose to the financial system. Supervisors would conduct focused reviews of all the firms in this group at the same time to determine the degree of risk they pose and to ensure the consistent application of supervisory action, where warranted.

Last year's Supervisory Capital Assessment Program, or what some have referred to as the "large-bank stress tests," is an example of the successful application of this supervisory approach. In this process, firms with a common degree of risk were subjected to a unique supervisory approach that was considered appropriate for the degree of risk perceived at the time. What mattered most was not whether a firm was among the largest and most complex financial institutions, but whether it posed systemic risk under the circumstances. The review of incentive compensation practices currently being conducted on selected financial firms is another example of a practical application of this framework. Both of these examples illustrate that our supervisory approach has already been changing in response to identified risks.

The advantage of formally establishing the tiered parity framework is to identify the degrees of risk in financial firms before problems arise, and then to fashion regulations and supervisory approaches according to the risks posed by the institutions in each of the three tiers. Of course, the approach to supervision at any given time will need to be adapted to changes that occur in the economic and financial environment.

The result will be a more refined, proactive, and effective approach to regulating and supervising our nation's financial firms.

The Ongoing Role of the Federal Reserve

I would now like to explain how my experiences during the crisis reinforce my view that the Federal Reserve should continue to supervise banking organizations of all sizes and should take on an expanded role in supervising systemically important financial institutions. Retaining our role in the supervision of banks of all sizes is vital.
Our nation's banks serve an extremely diverse range of customers, industries, and geographies. Their health is critically important to the communities and regions they serve. During the peak periods of strains in financial markets, these institutions looked to their Federal Reserve Banks for liquidity. As banking supervisors, we had a firsthand understanding of the safety and soundness issues facing banking companies. This information was critical to us in our role as lender of last resort, as we understood the particular liquidity circumstances they faced. And as the central bank, we recognized the risks to the economy of credit markets seizing up. Our experience enabled us to respond quickly. We adapted our regular discount lending programs to create an auction facility, and we provided for longer lending terms and more collateral flexibility—not just for the largest and most complex banking organizations, but for all banking organizations.

In my Reserve Bank, the economists worked closely with banking supervisors and discount window lenders to pool information, assess situations, and make decisions. And I can tell you that the knowledge, expertise, and direct access to information that come from our supervision and lending responsibilities contributed to our effectiveness in monetary policy. During the darkest moments of the crisis, this knowledge, expertise, and direct access to information were critical and could not have been developed at a moment's notice. Even today, the intelligence I gather from my banking supervisors is extraordinarily useful to me as a monetary policymaker in helping to identify factors that may pose risks to my economic outlook.

In turn, I also find that the knowledge that the Federal Reserve has about the economy and financial markets enhances our effectiveness as a financial supervisor. This wide range of expertise also makes the Federal Reserve uniquely suited to supervise large, complex financial organizations and to address risks to the stability of the financial system. No other agency has, or could easily develop, the degree and nature of expertise that the Federal Reserve brings to the supervision of banking organizations of all sizes and the identification and analysis of systemic risks.

Conclusion

Financial reform is not a new idea—we have seen examples of it following crises, and we have seen reform proposals during periods of relative calm. This financial crisis has unfortunately provided us with compelling reasons to press on with the regulatory reform agenda. As we do so, let's act on our best understanding of economic theory and the results of solid research. But let's also act on the basis of what we have learned directly from our firsthand experiences.

Thank you very much, and I look forward to your questions.

Q&A

Q: My name's Dave Kelly. I work on Dennis Kucinich's policy and issues. Could you explain to us how the Federal Reserve might have been at fault and what you've learned from the financial meltdown—what specific mistakes may have been made along the way? I didn't hear a lot of that.

SP: We recognize, first and foremost, the interconnectedness of the financial system, and that's why in my comments I [remarked] on the importance of identifying that interconnectedness and dealing with the risk across the financial system—that we had been very focused on individual institutions and the risks within an individual institution but failed to recognize that some of those risks were being repeated in many institutions. That's why this approach that I mentioned of having these horizontal reviews of institutions and the bank stress test was a good example of that. . . . The way we're structured now is that you have an individual set, a supervisory team, that looks at, and sometimes actually is housed within, an institution; but they don't have the benefit of seeing the activities of what's going on with other institutions. So with these horizontal reviews we're sending in teams of experts across institutions. In my district I mentioned the larger financial institutions. These teams of experts would go into each one of those, and not just be focused on the individual. So that will help us identify risks across the system. That's an important lesson learned in this process. . . .

I mentioned this too-big-to-fail issue, which absolutely has to be dealt with, . . . and so setting up a systemic risk or macroprudential supervisor that can be effectively supervising these more complex institutions—and I've laid out a framework for how we could identify those institutions—is another important lesson learned in this process, [that of] having the resolution authority in place to deal with these nonbank financial institutions that are systemically important.

So those are a couple of lessons learned.

Q: Nick Perna from Yale. Why is it so politically difficult to consolidate the regulators? We've got the Federal Reserve, the OCC, the OTS, plus all the state regulators—and that's just for the banking system. It's hard for me to think that the OTS and the OCC have big constituencies in Congress. Do you care to comment on it? Because it seems to me that that's a complement to your consolidated regulation of entities.

SP: I can't comment on why Congress finds it difficult. I can't put myself in their shoes. But my comment around consolidated supervision was not to say that we need only one regulator in an entity, because in an entity like even these regional banking firms that we supervise, they do have affiliates that are nonbanking; they do some investment banking, they do venture capital. So it's fine to have functional supervisors of those activities, where they have more expertise; but my consolidated supervisory approach would provide—and the Federal Reserve is the umbrella supervisor for bank holding companies currently—more authority to act over the whole enterprise than we currently have. We currently rely on information from those functional regulators, and we do then also rely on enforcement of the action that we believe an institution should take by those individual regulators. There's a lot of negotiation that often goes on among the regulators when you're supervising a bank holding company, and having clearer authority to work with the functional regulator would make this consolidated supervision approach more effective.

The current structure of many regulators is not what I was trying to achieve with my consolidated supervisor approach. It was more [about] making sure that the appropriate regulator has the authority to take the enforcement action that's necessary. We have a dual banking system in this country [that] has served us well, and so you need a regulatory structure to meet the structure of the banking industry that we have.

Q: Ann Lee from New York University. Why even bother having three tiers? Why not just make them all simple institutions, and you would eliminate this problem. From what I understand, most of the supervisors missed this, because the large institutions just simply had too complex balance sheets, and even if you had more supervision, they might still not catch all these problems. So if you want to get rid of too-big-to-fail, then just break them up now.

SP: We have a complex financial industry to meet the complex financial needs of the type of economy we have, so we need to be careful to not overregulate and remove market discipline from this situation.

You can be very prescriptive on regulations, and regulations are static. But businesses are dynamic, and we've learned over the years that when you put in place very strict regulatory requirements, individual institutions or individuals figure out a way around those requirements. It's not as simple as just [setting] up a set of standards that everyone has to meet, because when you do that, individuals will figure out a way around it. So you do need a flexible supervisory approach, a more flexible supervisory approach.

Having said that, you don't want the same requirements, perhaps—capital requirements, liquidity requirements, concentration requirements—for these very large institutions as well as these small community banks. We have thousands of community banks throughout this country, and they meet the needs of the communities they serve—small businesses, and consumers. So if you would place the same supervisory requirements on those very small institutions, the regulatory burden [would be too] great, and they don't require those types of supervisory requirements. That's why I'm proposing a more flexible, tiered approach to supervising these institutions, and the supervisory requirements within those tiers would be based on the risks that those institutions pose on the financial system. We need to be careful to not create a structure that is so rigid that individuals will figure out how to get around.

Q: Yildiray Yildirim, from Syracuse University. You mentioned consolidated supervision. I agree with that statement, and I'd call it consolidated risk management, which is [approaching it] from the bottom up, basically. And all these things, the four Cs that [you] mentioned, bits and pieces of those are really in Basel II also. So do you think that if we had already implemented Basel II [we] could have prevented us being in this crisis?

SP: There are a lot of issues. I don't want to speculate on what would have been if something else had been in place. I think this crisis does provide us an opportunity to learn from what happened and to move ahead with some of these more global efforts to address supervisory approaches.

We obviously had some challenges in agreeing on some of those issues, and hopefully this crisis, which ended up being a global financial crisis, will bring us back to the table to look at some of these issues. As a Reserve Bank president, I'm not involved in those conversations and those negotiations, so I can't speak to some of those specific issues. I'm just hopeful that, just as I've been saying here today, that this crisis has provided us a lot of lessons, and we can build on those lessons as we move forward—not only in developing a regulatory reform package for our own country, but also [in looking] at these issues on a more global basis.

Q: My name's Bruce Sansom. I'm with a company in Edmonton, Alberta, called Global Wealth Builders. I'm sort of where the rubber hits the road, you might say. We do portfolio management work.

I have to tell you that we outside of your country who are looking at what's going on find it really quite frustrating, because we're now entering almost two full years since the debacle, and there seem to be no changes occurring to stop a repeat. From what we've read in the media and so forth, it appears as though the bank lobby is sufficiently strong to avoid [your] taking any real bitter pills to deal with the issues. I know that the typical investor out there who's buying stocks and bonds has lost his trust in the system. They're killing the goose. I guess I'm making a statement more than a question.

But what I wanted to ask you was, what about the hedge funds and the speculation that still continues on, for example, in the commodity markets? I think unquestionably you know the price of copper and zinc and nickel are now the focus of the hedge funds and the investment banks in the commodities markets, which don't appear to be set up to handle the volumes of money that's being concentrated there. I'm not too sure it isn't pure manipulation, because it was only about 18 months ago we were paying in Canada six dollars a gallon for gas. We found out subsequently that it was manipulation, but there's been no change to the rules or the margin requirements. A little frustration from somebody that's investing money. . . .

SP: Again, I'm not a supervisor of some of the entities that you're referring to. I will say that the conversation and the reform proposals that have been put forth by various entities—Dimitri mentioned many of them—do recognize that this is not just a banking issue, and that this reform has to be broader, so that recognition and that learning [have] taken place.

Your comment about its taking a while leads me back to some of the comments I was making. It's important that we understand what we're trying to reform more fully before we put into place broad reforms, because we've learned from past experience that when you put into place very broad reforms hastily, you don't necessarily address the problems that you're trying to address, and often you spend years unwinding those reforms because you recognize that they were the wrong reforms to make. So taking some time to understand what we're trying to reform, I think, is useful. Having said that, I understand that we also need to make sure that we have a healthy financial system, and that we not cause or allow further crises and concerns to take place.

Q: I have a question and a quick comment. In your proposed consolidated supervision, do you also propose to supervise off-balance-sheet activities, or even better, forbid them? Because securitization and derivatives, these are things that contributed to the current crisis, and they're largely off balance sheet.

My comment is that, even if the Fed is in the position to supervise and regulate the financial system, the question is whether it has the willingness to do so, because it had all the powers prior to this crisis, and many things could have been prevented had it used its powers. So the question is whether the Fed has the willingness to regulate the financial system. Thank you.

SP: Your first question, about off-balance-sheet [activities—and I'm speaking from the banking perspective—a lot of those activities, as a result of what has occurred in this crisis, . . . have had to be brought back on balance sheet. So, yes, that was a lesson learned for us—that, as supervisors, we were focusing on the balance sheet of the bank holding companies and the entities we were supervising, and we needed to recognize some of the risks that were taking place off balance sheet.

Your comment about the Federal Reserve taking on more supervisory responsibility, or do we have the will to perform the supervisory role, my answer is absolutely yes, we do. You say that we had the authority and we didn't use it. Many of the causes of what occurred, that brought on the financial crisis and that rippled throughout the financial markets, were taking place in the so-called "shadow banking" world, and we did not have authority over that world. So stepping back as supervisors and recognizing that there was activity off balance sheet for banks, that there was this shadow banking industry evolving, that's a lesson learned, and we need to focus on it.

[Regarding your] comments about the bank holding companies that we did have authority, as the bank holding company supervisor, to address, there are limitations to what we can do even within that bank holding company structure as the umbrella supervisor. So I'm recommending more authority to serve as the consolidated supervisor within this umbrella banking supervisor concept that's currently in place.

Q: My name is Robert Prasch. I teach economics up at Middlebury College in Vermont. My question is this: all of us in the room, I'm sure, have read all the various proposals kicking around the Senate and Congress, [or learned about them in] the media and so forth, and from listening to your comments today also. One of the concerns I have is that the Federal Reserve itself, at least from what I can tell, hasn't taken much public responsibility for what has occurred. The mandate of 1913 that you described before is to stabilize our financial system, and that didn't happen. In fact, the failure was . . . a *catastrophic* failure. At the same time, the Fed would like to retain its independence, yet transparency disappeared the moment the crisis started, and there doesn't seem to be any accountability in a sense. I don't see dozens of senior supervisors who have resigned, or taken prolonged leaves, or whatever, on account of this. And I'm not trying to be rude here, but as a citizen of the nation and echoing a little bit the gentleman from Alberta, there's a frustration here. It's like, where's the accountability here?

SP: Let me start with the supervisory comment. The institutions that we supervised—and I can speak from my perspective—I mentioned some lessons learned from that process. But a lot of the institutions that we needed to step in to assist during the crisis, such as Fannie and Freddie, Bear Stearns, and AIG, were not institutions that we had supervisory authority over. So that's an issue that I would like to comment on.

In response to [your comment that] we have responsibility, a mandate for financial stability, as we saw the financial markets freeze up—again, not because of institutions that we supervise—we stepped in immediately and did unprecedented things. We used our emergency authority not only to assist in preventing failures of some systemically important institutions; but we [also] created facilities to get credit moving, to get credit markets working again, such as providing a facility for the money market funds where the commercial paper market had completely dried up and would have caused an even worse disaster than we were facing. We created liquidity facilities for banks; we created facilities for other types of credit markets. So I believe we took actions to stabilize the financial markets as we saw markets freezing up.

From a monetary policy perspective, again, we were very aggressive. We brought interest rates down to historic low levels, where they are today—essentially, zero. In addition, again, we took some unprecedented actions to expand our balance sheet to make sure we were providing the credit that was needed in the economy through our purchases of mortgage-backed securities and purchasing government agency debt. Those were all unusual, unprecedented, and historic steps that the central bank took to address the financial crisis that we were facing. I do believe that if we had not taken those types of actions that we might have seen a second Depression.

Q: My name is Bert Ely. I'm a banking consultant down in Washington. You're living in a city that's just a few miles south of the border of a country that has actually come through the financial crisis quite well, and whose five large banks, in particular, have done very well. Of course, obviously I'm referring to Canada. My question for you is, what lessons can we learn from Canada?

I have two specific questions in that regard: first of all, Canada has consolidated banking supervision in what they call OSFI, the Office of, I believe it's called, Superintendent of Financial Institutions, which is independent of the central bank. Second of all, they don't have a holding company structure for their banking companies the way we do in the United States.

I was at a conference last week where a couple of folks from Canada were there, and they made the argument that their structure of their banking companies is better because the traditional retail banking aspect of the company is kind of on top, and therefore the supervisors who are looking at the retail side of the bank and deposit relationships and so forth are well positioned to also monitor other activities within the bank, such as investment banking activities.

I'd be interested in what your thoughts are, number one, about Canada and how it supervises its large financial institutions; and number two, has the time possibly arrived when we ought to simplify the structure of banking companies in this country by collapsing the holding company structure down into the chartered bank?

SP: Your comments about Canada are interesting, but we always have to remember . . . that [the United States is] the world's largest economy, and we do have a more complex financial structure. We have more than 8,000 banks in our country; Canada, as you mentioned, has five large banks and some smaller thrift types of institutions, I believe. You know that structure better—you're nodding. But we have a more complex banking and financial structure, [and] we shouldn't just focus on banking. It's a much more complex financial structure. Therefore, we can always learn from other countries and how they regulate and supervise their financial institutions, but it's very difficult to find a country that has a structure that's similar to ours. So what works in a smaller economy in a country where it's less complex is not as easily transferrable to an economy the size of ours that has financial institutions that are world players, that are playing on the global markets. So that's one reaction. We can always learn and look at [other financial systems], and we are studying various proposals; but we have such a more complex financial system than even a country like Canada.

Your comment about changing the structure of banks: you know, this complex system of banking and finance has worked for our economy. You can say that this financial crisis showed us that it may have become too complex in some institutions; but in terms of our banking institutions, I don't think that this crisis showed me where we needed a change in charters or the structure of these organizations.

Q: I have a two-part question regarding your tiering of the regulatory system and how transparent that would be, specifically, whether you have concerns about those classifications setting off a few of your Cs—specifically, contagion or correlation—and also how you would deal with banks moving between those categories, because they went from being safe to innovating or offering increasingly risky financial products.

SP: I don't see problems with moving financial institutions into various categories, because . . . the reasons for some of these institutions being in that middle tier might change as circumstances change. We're going to have the same set of issues if we use what I'm currently hearing in some of these proposals that are out there, [the categories] of systemically important, and then all others. There are going to be, in the various proposals there are, either councils set up or . . . the Federal Reserve would be the systemic risk supervisor. But in the proposals that are both in the House bill and the Senate bill right now, there is a council that would determine the criteria for where a bank falls—whether an institution becomes systemically important. And it may be that it doesn't mean that once you are determined to be systemically important you are always going to be systemically important; [nor does it] mean that others can't be added. So the important part of this is setting the criteria, and then determining who meets that criteria.

I'm saying that we also need that type of look at this middle tier, where there are going to be some circumstances where these institutions could, as a group, pose a risk to the entire financial system. So making sure that we're looking at risks *across* these institutions through these horizontal reviews would prevent some of these problems that we saw during this financial crisis.

The other point I want to leave you with, as I mentioned in my remarks on this tiering, is parity across these institutions. Because if we adopt this framework within the Federal Reserve system . . . we have some flexibility in how we supervise the institutions that we have authority over; that's one thing. But there are going to be institutions that fall into those tiers that we don't have authority over, and the supervisors of those institutions may not use the same standards or have the same concerns that we would have. So it's parity across this tiering that's also important—making sure that institutions with the same amount of complexity and risks are supervised in a similar fashion.