Fed governor details rationale for higher capital standards for “SIFIs”

By Editor Test *Sun, Jun 5, 2011*

Regulations should limit the creation or growth of giant financial institutions unless the “benefits to society are clearly significant,” said Daniel Tarullo.

In a speech on June 3, Federal Reserve Board member Daniel K. Tarullo described the ideal characteristics of enhanced capital requirements for large financial institutions and rebutted some of the financial services industries most common objections to those requirements.

Speaking at the Peter G. Peterson Institute for International Economics in Washington, Tarullo offered a report on the progress of the Dodd-Frank legislation toward its January 2012 deadline for reducing the risks of so-called “systemically important financial institutions” or SIFIs.

Tarullo listed five parameters for successful capital requirements:

1. An additional capital requirement should be calculated using a metric based upon the impact of a firm’s failure on the financial system as a whole. Size and interconnectedness of the firm with the rest of the financial system are the most important factors.
2. The metric should be transparent and replicable, reflecting a trade-off between simplicity and nuance.
3. The enhanced capital standards should be progressive in nature, “increasing in stringency” with the systemic footprint of the firm. While Dodd-Frank requires us to apply enhanced capital standards to all bank holding companies with more than $50 billion in assets, but the supplemental capital requirement for a $50 billion firm is likely to be very modest.
4. An enhanced requirement should be met with high-quality capital. Our presumption is that this means common equity, which is clearly the best buffer against loss.
5. U.S. requirements for enhanced capital standards should, to the extent possible, be congruent with international standards.

In other remarks, Tarullo said:

> The regulatory structure for SIFIs should discourage systemically consequential growth or mergers unless the benefits to society are clearly significant. There is little evidence that the size, complexity, and reach of some of today’s SIFIs are necessary in order to realize achievable economies of scale and scope. Some firms may nonetheless believe there are such economies. For them, perhaps, the highest level of an additional SIFI capital charge may be worth absorbing. Others, though, may conclude in light of the progressive form of the capital requirement that changes in the size and structure of their activities would align better with their returns.
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> The history of financial regulation over the last thirty years suggests that, when certain activities are restricted, firms will look for new areas in which to take more risk in the search for return. Capital regulation is the supplest and most dynamic tool we have to keep pace with the shifting sources of risk

taken by financial firms.

The cessation of proprietary trading and the limiting of private equity activities will directly reduce risk-weighted assets and thus capital requirements. Similarly, centrally cleared derivatives will carry lower capital charges.

Moral hazard is already undermining market discipline on firms that are perceived to be too-big-to-fail. Higher capital standards will help offset the existing funding advantage for SIFIs.

There is little if any research showing that firms need to have balance sheets with the size and composition some do in order to achieve genuine economies of scope and scale. The lower leverage that would result from higher capital requirements should lead to at least some reduction in the required return on equity.