For release on delivery
6:45 p.m. EST
March 5, 2024

Tailoring, Fidelity to the Rule of Law, and Unintended Consequences

Remarks by

Michelle W. Bowman

Member

Board of Governors of the Federal Reserve System

at the

Harvard Law School Faculty Club

Cambridge, Massachusetts

March 5, 2024

Thank you for the invitation to join you this evening at Harvard Law School.[1] It is an honor and a pleasure to speak to this distinguished group. To kick off our conversation, I would like to frame the discussion by offering my views on a key element underpinning the U.S. bank regulatory framework: the role of tailoring. While the principle itself is simple—setting regulatory priorities and allocating supervisory resources in a risk-based way—the consequences of tailoring (or not) can reverberate throughout the banking system, the broader U.S. financial system, and the economy. I see a clear nexus between tailoring and fidelity to the law, including a targeted focus within our statutorily mandated prudential responsibilities.

Tailoring as a Grounding Principle

I have long been a proponent of tailoring and continue to consider it a strong foundational principle upon which to apply bank regulation and supervision. This approach ensures a focus on the most critical risks over time, avoiding the over-allocation of resources or imposition of unnecessary costs on the banking system. When we approach rulemaking with a commitment to tailoring, and to our broader prudential mandates, the public can judge our actions by how well they serve these ends, and they should rightly be concerned when regulatory actions seem to serve other goals. In this sense, tailoring keeps policymakers grounded and facilitates appropriate prioritization. Tailoring also allows us to allocate limited supervisory resources to most effectively support safety and soundness of the banking system and U.S. financial stability.

In accordance with the law, the Federal Reserve, both in its monetary policy function and in the execution of its bank regulatory and supervisory responsibilities, is meant to operate independently and apolitically. But banking regulators have a responsibility to act in a way that

[1] The views expressed here are my own and not necessarily those of my colleagues on the Federal Open Market Committee or the Board of Governors.

proves this independence is warranted. We earn the right to operate with this independence when we consistently follow the law and achieve our prudential objectives. One of the most effective ways we accomplish this goal is through the appropriate prioritization of risks in the financial system. Regardless of the approach to bank regulation and supervision, bank regulators should be subject to oversight and accountability, to both Congress and the public.

The principles that guide the execution of prudential responsibilities matter, especially when they further efficiency and effectiveness. Congress has embedded the concept of tailoring within the Federal Reserve's regulatory mandates, including the Economic Growth, Regulatory Relief, and Consumer Protection Act, commonly referred to as S. 2155.[2] This law revised provisions of the Dodd-Frank Act, amending the *threshold* for tailored application of enhanced prudential standards on certain regulated institutions.[3] Notably, S. 2155 did not *introduce* tailoring to these standards; it merely modified tailoring thresholds and mandated the Board implement this approach. To be clear, tailoring is not a pretext for deregulation but rather a principle that allows regulators to pursue required statutory objectives in the most efficient and effective way.

Does Tailoring Need a Defender?

I suppose one could view my support for tailoring as merely setting up a straw man; surely everyone agrees with tailoring in principle? On a superficial level, it is hard to argue with the principle that regulatory tailoring—matching regulation and supervision to risk—is a prudent approach for bank regulators. And yet the rhetoric supporting tailoring and risk-based supervision often does not match regulatory reform efforts or supervisory approaches. The

---

[2] Economic Growth, Regulatory Relief, and Consumer Protection Act, Pub. L. No. 115-174, 132 Stat. 1296 (2018).

[3] Pub. L. No. 115-174, § 401(a)(1), amending 12 U.S.C. § 5365.

criticisms rarely manifest as skepticism of the principle itself. Rather, they are implicit in the approach to regulation and supervisory guidance or are disguised as a criticism of the *execution* of tailoring.

Both the pending capital reform proposals and the final climate guidance illustrate how regulatory actions can deviate from the principle of tailoring without any express recognition of this effect.

The federal banking agencies have proposed several reforms to the capital framework, among them the Basel III "endgame" and new long-term debt requirements that would apply to all banks with over $100 billion in assets. I have expressed concern with both of these proposals on the merits, in terms of striking the right balance between safety and soundness and efficiency and fairness, and out of concern for potential unintended consequences. Another concern is whether these proposals show fidelity to the law, which requires regulatory tailoring above the $100 billion asset threshold. In 2019, the Board published its regulatory tailoring rule and included a compelling visual that depicts in table form how a series of requirements—capital, single counterparty credit limits, liquidity, and the requirement to form a U.S. Intermediate Holding Company for foreign banking organizations—worked collectively to establish a tiered framework.[4]

[4] See Tailoring Rule Visual, "Requirements for Domestic and Foreign Banking Organizations," October 10, 2019, https://www.federalreserve.gov/aboutthefed/boardmeetings/files/tailoring-rule-visual-20191010.pdf.

Requirements for Domestic and Foreign Banking Organizations*

	Category I U.S. GSIBs	Category II ≥ $700b Total Assets or ≥ $75b in Cross-Jurisdictional Activity	Category III ≥ $250b Total Assets or ≥ $75b in nonbank assets, wSTWF, or off-balance sheet exposure	Category IV Other firms with $100b to $250b Total Assets	Other Firms $50b to $100b Total Assets
Capital	**TLAC/Long-term debt** **Stress Testing** • Annual company-run stress testing • Annual supervisory stress testing • Annual capital plan submission **Risk-Based Capital** • GSIB surcharge • Advanced approaches • Countercyclical Buffer • No opt-out of AOCI capital impact **Leverage capital** • Enhanced supplementary leverage ratio	**Stress Testing** • Annual company-run stress testing • Annual supervisory stress testing • Annual capital plan submission **Risk-Based Capital** • Advanced approaches • Countercyclical Buffer • No opt-out of AOCI capital impact **Leverage capital** • Supplementary leverage Ratio	**Stress Testing** • Company-run stress testing every other year • Annual supervisory stress testing • Annual capital plan submission **Risk-Based Capital** • Countercyclical Buffer • Allow opt-out of AOCI capital impact **Leverage capital** • Supplementary leverage ratio	**Stress Testing** • Supervisory stress testing (two-year cycle) • Annual capital plan submission **Risk-Based Capital** • Allow opt-out of AOCI capital impact **Leverage capital**	**Risk-Based Capital** • Allow opt-out of AOCI capital impact **Leverage capital**
SCCL	**Single-counterparty credit limits (SCCL)** • BHC/IHC level SCCL • FBOs: Meet home country requirement	**SCCL** • BHC/IHC level SCCL • FBOs: Meet home country requirement	**SCCL** • BHC/IHC level SCCL • FBOs: Meet home country requirement	**SCCL** • FBOs: Meet home country requirement if global assets≥$250B	**SCCL** • FBOs: Meet home country requirement if global assets≥$250B
Liquidity (Holding Company)	**Standardized** • Full daily LCR (100%) • Proposed full daily NSFR† (100%)	**Standardized** • Full daily LCR (100%) • Proposed full daily NSFR† (100%)	**Standardized** • If wSTWF < $75b: Reduced daily LCR and NSFR† (85%) • If wSTWF ≥ $75b: Full daily LCR and proposed NSFR† (100%)	**Standardized** • If wSTWF < $50b: No LCR • If wSTWF ≥ $50b: Reduced monthly LCR and proposed NSFR† (70%)	
Liquidity (Combined U.S. Operation)	**Reporting** • Report FR 2052a daily **Internal** • Liquidity stress tests (monthly) • Liquidity risk management	**Reporting** • Report FR 2052a daily **Internal** • Liquidity stress tests (monthly) • Liquidity risk management	**Reporting** • If wSTWF < $75b: Report FR 2052a monthly • If wSFWF ≥ $75b: Report FR 2052a daily **Internal** • Liquidity stress tests (monthly) • Liquidity risk management	**Reporting** • Report FR 2052a monthly **Internal** • Liquidity stress tests (quarterly) • Tailored liquidity risk management	
Holding Company	**U.S. IHC Requirement**	**U.S. IHC Requirement**	**U.S. IHC Requirement**	**U.S. IHC Requirement**	**U.S. IHC Requirement**

* Certain requirements for a foreign bank are determined by the risk profile of its intermediate holding company, whereas other requirements are determined by the risk profile of the firm's combined U.S. operations. Capital and standardized liquidity standards are determined by the risk profile of the intermediate holding company and other standards are determined by the risk profile of the firm's combined U.S. operations. Other foreign banks with limited U.S. presence and global assets of $100 billion or more would be subject to certain minimum standards.† The proposed net stable funding ratio (NSFR) rule will not be finalized as a result of the tailoring final rule.

Glossary: wSTWF – weighted short-term wholesale funding; HCs –bank, savings and loan, or intermediate holding company; CUSO – combined U.S. operations; AOCI – accumulated other comprehensive income; CCAR – Comprehensive Capital Analysis and Review; LCR – liquidity coverage ratio.

If you superimpose the pending capital reform proposals on the table, there is a "flattening" of requirements in the capital bucket. Of course, this simple exercise does not reflect the unknown end state of the bank regulatory framework, and the current desire among some policymakers to modify liquidity requirements. These individual efforts highlight the hazard of piecemeal reforms, especially those that are closely related in their end-state operation, like capital and long-term debt requirements. When regulators pursue reforms by creating separate rulemaking silos, we limit our capacity to not only ensure fidelity to tailoring but also fidelity to our prudential mandates. Even when proposals have concurrent comment periods, the danger is that the final regulations will be miscalibrated and not appropriately tailored.

Tailoring underpins not only effective regulation, but also effective bank supervision. The effectiveness of the interagency principles used by the Federal Reserve, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency for the management of climate-related financial risks could be evaluated as a supervisory tool through the lens of tailoring, which requires us to consider both the regulatory threshold for applicability and the content of the guidance.[5] One approach to evaluate the merit and effectiveness of these principles as a supervisory tool is through the lens of tailoring, which requires us to consider both the regulatory threshold for applicability and the content of the guidance.

On its face, it applies to banks with $100 billion or more in consolidated assets. What does this threshold mean in practice? Guidance serves the role of illuminating supervisory priorities and expectations. These informal communications help bridge the divide between regulators and regulated entities. When guidance notes that "all financial institutions, *regardless*

---

[5] Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, "Agencies Issue Principles for Climate-Related Financial Risk Management for Large Financial Institutions," news release, October 24, 2023, https://www.federalreserve.gov/newsevents/pressreleases/bcreg20231024b.htm.

of size, may have material exposures to climate-related financial risks…,"[6] my intuition is that banks will take little comfort from the nominal carveout in light of this language. Apart from the general concern with the "cliff effect" threshold at $100 billion, I question whether any size threshold will apply in practice.[7]

The content of the guidance—and its expectations for larger banks—suggests that the motivation behind the principles is neither prudential considerations nor to further regulatory tailoring, as it has a somewhat tenuous connection to core safety and soundness considerations and seems destined to trickle down to smaller firms over time. Banks have long been exposed to climate- and weather-related financial risks and have long been required to manage all of their material risks, including these. But the principles seem oriented toward contributing to a policy matter that extends well beyond prudential bank regulation—namely how the U.S. and other governments around the world should address climate change. And the principles seem focused on highly uncertain risks well outside the normal temporal horizon of a bank supervisor. One could reasonably ask, do the principles result in appropriate, risk-based prioritization of supervisory concerns? It is possible that they prioritize risks that may not be the most relevant for safety and soundness and may effectively influence credit allocation decisions through regulations that are not driven primarily by prudential considerations.

Bank regulators can acknowledge the importance of questions around climate change while also hewing to their statutory responsibilities. Promoting safety and soundness and U.S. financial stability is a weighty enough task without taking on other causes.

---

[6] 88 Fed. Reg. 74,183–184 (October 30, 2023).

[7] See Michelle W. Bowman, "Reflections on the Economy and Bank Regulation" (speech at the Florida Bankers Association Leadership Luncheon Events, Miami, Florida, February 27, 2024), https://www.federalreserve.gov/newsevents/speech/files/bowman20240227a.pdf.

The current regulatory agenda includes many other examples where similar arguments can be made that regulatory reform proposals lack sufficient attention to regulatory tailoring and thereby fail to further statutory directives to tailor certain requirements and, more importantly, to address the condition of the banking system.

Apart from substantive deviations from regulatory tailoring, there are also indirect attacks on the value of tailoring as a principle to guide bank regulatory reforms. For example, one prominent argument raised shortly after the failure of Silicon Valley Bank, and which has become a driving force in regulatory reform efforts, is that the Board's *approach* to tailoring was to blame for the bank failures and broader banking stress.[8] The argument is that a major factor contributing to the bank failures was the implementation of S. 2155, the statutory mandate to tailor regulation and an accompanying shift in supervisory policy.

As I have noted many times in the past, I find little evidence to support this claim. While couched as a critique of the *execution* of tailoring, this argument also seems to challenge the *value* of tailoring, asserting that a simple solution would be to unwind regulatory tailoring and eliminate risk-based tailoring in supervision. Taking ownership and accountability of the supervisory issues that significantly contributed to the banking system stress last spring enables us to look critically at the approach to regulation and supervision in the lead-up to these failures, and appropriately address the shortcomings.

[8] See Board of Governors of the Federal Reserve System, "Review of the Federal Reserve's Supervision and Regulation of Silicon Valley Bank," (Washington: Board of Governors, April 2023), introductory letter by Michael S. Barr, https://www.federalreserve.gov/publications/files/svb-review-20230428.pdf (concluding that "[t]he Board's tailoring approach in response to the Economic Growth, Regulatory Relief, and Consumer Protection Act (EGRRCPA) and a shift in the stance of supervisory policy impeded effective supervision by reducing standards, increasing complexity, and promoting a less assertive supervisory approach.").

Why Does Tailoring Matter?

Before thinking about tailoring for smaller, simpler firms, I think it's helpful to think about the largest, most complex firms. Additional regulation and heightened supervisory attention are warranted and necessary for larger firms, particularly global systemically important banks (GSIBs) with additional size, risk, and complexity. This principle is so well-established that it was not only a core precept of S. 2155, it was a central theme of the Dodd-Frank Act.[9] We need not rely on past views about the virtue of tailoring—what was once conventional wisdom—to believe in its ongoing relevance.

One critique of tailoring may be with what underlying "problem" it is designed to solve, particularly as it relates to the allocation of finite resources both for banks and for regulators. Are regulatory and supervisory resources actually limited, and if so, what are the practical constraints on these resources? At a basic level, the quantum of regulatory and supervisory resources is a policy decision—as regulatory and supervisory demands grow, so too can the staffs and budgets of the federal banking agencies. The U.S. financial system is expansive and regulators have the capacity to expand supervisory resources as needed (or as perceived) to address safety and soundness concerns.

Of course, there are practical constraints on an ever-expanding and stricter bank regulatory framework. First, the funding of regulatory and supervisory expansion imposes costs not only on U.S. taxpayers but also on banks, and indirectly, bank customers. While the banking system has many advantages—including the use of insured deposits as a source of financing banking activities—at some point, this structural advantage will erode under the cumulative burden of the regulatory framework and will result in a shift of activities from banks to nonbanks

[9] Pub. L. No. 111-203, 124 Stat. 1376, 1423, § 165 (July 21, 2010).

and the broader shadow-banking system. The contours of the financial system, where products and services are offered, does not exist according to the bright line of federal regulatory authority. We would be well served to recognize the limitations of a regulatory perimeter that pushes activity outside of the banking system and beyond this authority.

Unintended Consequences

As we consider the merits of tailoring, we should consider the consequences of not adhering to this principle in regulation and supervision, and related reform proposals.

As a threshold matter, a bank regulatory approach that disregards tailoring can manifest in different ways, such as uniformity in approach—failing to differentiate among institutions based on their size, risk, and complexity—or by adopting regulatory "cliffs" clustered around thresholds that insufficiently distinguish among institutions based on these factors. In both cases, deviating from tailoring could result in fundamental changes to the structure of the U.S. banking system.

One risk of uniform requirements is the consolidation pressure it creates. Apart from the shortcomings I've discussed in appropriate risk-based prioritization within the bank regulatory framework, this approach encourages consolidation, as institutions seek operational economies of scale to gain competitive advantage over their peers. In this scenario, the benefits of being large, risky, and complex become a driving force in the organization of the banking industry. I think we should consider the implications not only for regulatory efficiency, but also whether this approach represents waving the white flag in fighting against the assertion that certain institutions are "too big to fail."

Even where standards are not uniform, a lack of sufficient tailoring can reshape the banking industry, simply through the cliff effects created around particular regulatory thresholds.

For example, capital reform and climate regulation would establish $100 billion as the key regulatory threshold, lending additional gravity to the decision to cross, or even approach it, with the consequence of reducing the number of institutions around that threshold. Institutions *above* the threshold will face strong incentives to grow larger to achieve economies of scale. Institutions *below* the threshold will face strong incentives to manage their size to avoid the significant intensification of requirements that apply as they approach $100 billion in assets. This scenario also has significant implications for the too-big-to-fail issue, as well as for industry competition over the long term.

Regulatory costs that are disproportionate to a firm's risk create incentives for activities to migrate out of the banking system entirely, which we have seen as a consequence of past regulatory reform efforts. In my view, implicit in the statutory mandate to promote safety and soundness, and financial stability, is that we allow banks to continue serving their role in the U.S. financial system and in support of the economy. Fidelity to the law does not require regulators to create a bank regulatory framework that eliminates risk: banking is inherently about managing, not eliminating, risk.

Closing

Thank you, again, for the invitation to speak with you, and I look forward to our discussion.