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EDWARD R. ROYCE
Fortieth District-California

The Honorable Daniel K. Tarullo
Member
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue NW
Washington, D.C. 20551

January 2, 2013

Dear Governor Tarullo:

I was pleased to read the speech you delivered at the Brookings Institution on industrial organization and the financial industry. Like you, I have been struck by the lack of empirical research on the economies of size and scope for large financial institutions, as well as the dearth of studies on the costs and benefits of an industry that increasingly seems to be dominated by large financial institutions that appear to benefit from an implicit government guarantee because they are perceived by many to be "too big to fail." And like you, I believe that more research and more data would help policymakers—legislators and regulators alike—better understand the tradeoffs involved in balancing the benefits that large financial institutions offer to the markets and the economy against the risks they pose to financial stability. Regardless of one's view of the ideal regulatory structure for overseeing the U.S. financial sector, all parties should agree that the regulatory structure should be grounded on data. To put it simply, we should all have a better idea of what problems we are trying to solve and what additional problems those solutions may create.

As you note in your speech, a comprehensive industrial-organization analysis of the financial services industry could illuminate several relevant topics that we do not yet fully understand, including:

- the costs and benefits stemming from regulatory measures in effect and those being considered;
- industry dynamics which may play a role in financial stability regulation;
- the extent to which scale and scope economies exist in the financial sector and how "big or integrated" financial firms need to be in order to attain such economies;

- whether lower funding costs at certain firms are the result of "scale economies" or result from the belief that a given firm and its liabilities will be backed by the government in times of economic stress.

And as you suggested in your remarks, industrial organization may shed a great deal of light on the proposals that have been offered up to shrink or confine financial institutions that many have described as "too big to fail."

Yet despite the critical importance that this research would have for lawmakers and regulators, as you note in your speech—and as you've noted many times before—no one seems to be doing this research. As you put it in an interview with the *Washington Post*, "I'm frustrated by the absence of a better body of knowledge about economies of scale and scope in banking." I—and many others—share your frustration.

However, it seems the institution best situated to compile that "body of knowledge about economies of scale and scope in banking" is the Federal Reserve. As a regulator, the Federal Reserve bears an important responsibility for maintaining the stability of the financial system. As the nation's central bank, the Federal Reserve has the resources and expertise that makes it uniquely qualified to conduct the studies that you described in your speech at Brookings. As Simon Johnson put it recently, "the Fed is full of really good economists who have read everything" on the economies of scale and scope for large banks. Moreover, as a regulator and a central bank, the Federal Reserve would have access to data not available to universities, think tanks, and other researchers.

But even though it seems that the Federal Reserve is uniquely qualified to carry out this research—by virtue of its expertise, responsibilities, and its access to data as a regulator and a central bank—it seems as if the Federal Reserve has not taken up the project that you have called for. In September 2011, for example, you set out an ambitious "agenda for research" on "industrial organization and systemic risk." Yet rather than describe how the Federal Reserve would take up this agenda, you described it as a "financial regulator's wish list" and invited "journal editors to be more sympathetic" to industrial-organization research. And in your latest statement on the subject, you said that you hoped that this month's Brookings event "would be a catalyst for much more academic activity in this area."

As you may know, Senators Sherrod Brown and David Vitter have recently introduced a bill calling for the Government Accountability Office (GAO) to study the issue of "too big to fail banks." Yet, given its responsibilities, expertise, and access to data, it seems the Federal Reserve, using the approach and agenda you have outlined, would be best-suited to provide far more comprehensive analysis on the topic.

With the 398 rulemaking requirements called for in the Dodd-Frank Act, I have no doubt that the staff of the Federal Reserve have many important obligations. However, for the reasons you have given before and that have been stated above, a comprehensive industrial-organization analysis performed in a timely manner is critical in assessing whether we are on the right path and whether we need to change that path. Apart from the Federal Reserve, there are few entities—if any—that have the expertise and resources to properly undertake such a task.

I therefore request that you provide in writing the steps the Federal Reserve is taking to take up the industrial-organization research agenda that you outlined in your speech on September 15, 2011, and again in your speech on December 4, 2012. If the Federal Reserve is not following up on this agenda, I invite you to explain the factors that are preventing it from doing so. I look forward to your timely reply.

Sincerely,

EDWARD R. ROYCE