After the Crisis

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Your conference theme—“Meeting the Challenges of the Financial Crisis”—provides wide latitude for a speaker to look back, look forward, and treat any number of topics. This afternoon, I plan to look ahead and consider certain challenges of the post–financial crisis period.

Indeed, I believe it’s a good time to start thinking about life on the other side of the financial crisis. Today, the economy is still very weak, but there are some encouraging signs that support cautious optimism.

My outlook calls for the beginning of a recovery in the second half of 2009. I do not expect a strong recovery, but I do expect the economic contraction we’re now experiencing to give way to slow and tentative growth as early as the third quarter.

Risks remain to this cautiously optimistic outlook. I am concerned about the commercial real estate sector and how its performance could affect the banking system, which I addressed in a recent speech. I am concerned that continuing job losses will reverse the slight indications of improving consumer confidence. And I continue to watch house prices with concern. House prices continue to fall, as indicated by the Case-Shiller index. Along with these domestic risks, global risks are also considered in my outlook given downward revisions in forecasts for gross domestic product growth in most major economies.

Nonetheless, I think this is an appropriate juncture to give more detailed and practical thought to the world we want to construct after this difficult period. In my remarks today, I plan to share my personal views (not necessarily those of my colleagues on the Federal Open Market Committee) on a basic question about the postcrisis environment. It is: What regulatory environment will both align with the reality of financial markets and adequately address recent failings?

I trust this topic is appropriate for a conference in honor of Hyman Minsky. As you know, he devoted much of his academic life to the forces that give rise to financial instability and the important role that institutional arrangements play in both the promotion of, and the remedy to, financial instability.

Financial markets and securitization
There has been much discussion about restoring a commercial bank–dominant financial system, downsizing large systemically critical financial institutions to eliminate the “too big to fail” problem, and limiting the role of securitization as part of a shrinking of the shadow banking system. These are examples of opinions that range from predictions to prescriptions on what the financial system will look like.

The financial system has already undergone what some would call radical change. I’m referring to the reduction of the number of stand-alone investment banks, the conversion of some investment banks to bank holding companies, and the forced consolidation of the commercial bank sector. I’m cautious about predicting such substantial change going forward. I expect the financial system to continue to involve a mix of capital markets and institutions, but with a wider array of institutions falling under regulatory supervision. Furthermore, I take it as given that there will continue to be large international institutions with operations in many countries, that is to say, regulatory jurisdictions around the globe.

Looking ahead, I see an ongoing role for securitization and the originate-to-distribute model. Securitization markets have shrunk dramatically over the last year and a half and in some cases have shut down altogether. I expect these markets to return, perhaps in simpler form and with more accountability.

I expect securitization to continue because this form of financial intermediation developed in response to needs and realities that have not disappeared. I was a commercial banker in the 1980s and I remember well the onset of the practice of balance sheet allocation according to return on assets and ultimately return on equity. Commercial banks were, and remain, caught in a dilemma of wanting to serve their clients by providing loans, but not always being able to justify booking very competitively priced loans on their balance sheets.

This tension gave rise to various securitization, distribution, and asset liquidity strategies including off-balance-sheet vehicles, such as the now notorious structured investment vehicles. The excesses that arose need to be addressed, of course, but the underlying economics of 12-to-one leverage banking continue to dictate that assets retained on balance sheet meet net interest margin and return requirements. Banks must compete against all businesses for capital and seek competitive returns and earnings per share growth. In this respect, they do not compete only against other banks.

Securitization has brought benefits to consumers that cannot be easily matched by a bank that originates a loan to hold. In particular, mortgage securitization, which began in the 1980s, has led to lower mortgage rates, advancing the social goal of homeownership by improving affordability. In more recent years, however, mortgage-backed securities have been engineered and resecuritized into increasingly complex structures known as collateralized debt obligations, or CDOs and even CDOs squared.

Investors in these securities relied on credit rating agencies to assess risk, and banks took advantage of regulatory arbitrage to conduct this business off balance sheet. The resulting lack of transparency regarding the value of the securities and the financial condition of the banks holding them was a central factor in the financial turmoil of the last 18 months.

Going forward, markets and investors will show a new awareness of the potential for complexity, opacity, and risk in securitized instruments. This awareness, in and of itself, has and will continue to provide incentives for the creation of simpler and more transparent securitization structures. For these and other reasons, I expect our securitization system to be reformed but not replaced.
Agile oversight required
The regulatory environment we construct in the coming months must be suited to a financial system that remains a mix of capital markets and institutions—formal and shadow banking—with an array of institutional operating models.

Against this reality, a system that responds to the perceived faults of the precrisis financial world by imposing a set of rules about what behaviors are prohibited is almost certain to amount to “fighting the last war.” I do not believe we can easily anticipate where the next source of stress in financial markets will arise.

In my view, the postcrisis environment will require agile oversight. This regulatory approach should stress actively managing risk as it evolves with the associated potential for an institution failing versus an approach that focuses on avoiding failure.

Following this logic, the regulatory environment we construct should be a well-balanced mix of rules and principles guiding flexible response and should also give a meaningful role to market discipline. In an ideal world, effective market discipline necessarily allows for failure in a system in which no institution is too big (or interconnected, or complex, or operationally critical) to fail. It will take some time to achieve this ideal situation.

Several policy actions over the last year and a half have been about avoiding the failure of a large, systemically critical institution. It’s important to emphasize that some of these actions took place in the absence of resolution authority, that is, the authority of a regulator to manage the failure of an insolvent institution in a purposeful and orderly manner.

In simple terms, resolution involves these steps: 1) seizing control of the entity, 2) finding an acquirer or acquirers, 3) selling off assets, 4) stabilizing funding arrangements, including insured depositors and counterparty exposures, 5) working out unsold assets, 6) allocating losses to shareholders, bondholders, wholesale depositors, and other claimants, and 7) managing final liquidation and shutdown, if required.

Though this list sounds relatively straightforward, aspects of it are extraordinarily complex. At the core of the systemic risk issue is the fact that banks and other highly leveraged financial institutions are involved in a complex network of two-way, short-term funding arrangements. The failure of a large interconnected financial institution threatens the funding of its counterparties, which then threaten their counterparties, and so on.

The metaphor that seems apt is a chain of falling dominoes. Any robust resolution process must come to grips with the potential for these sorts of network spillovers and include mechanisms for short-circuiting the potential cascade of counterparty failures when a lead domino falls.

It seems to me that this type of resolution of a large, globally integrated and diversified financial institution is new territory for regulators and involves some challenges that haven’t been faced. Ideally the process would be substantially accomplished in a short period of time with as little expense to the taxpayer as possible. Some commentators have suggested that “a short period of time” be defined as something along the lines of “over a weekend.” Given the required scope and degree of integration with multiple national economies, that description of speed may be unrealistic.

The challenge (or problem) of resolution can be summarized as follows: The entity is not just a domestic financial institution, but a collection of many domestic institutions, all with cross-border connections. These entities in aggregate involve hundreds or more legal vehicles, operating across a range of business lines that are not easily separable, in as many sovereign legal and regulatory structures, each interested in orderly resolution in its jurisdiction. Further, there may be (is likely to be) no single buyer that is qualified and acceptable to all. A resolution exercise of this magnitude has not been performed before.

Yet, without a believable resolution capability, the too-big-to-fail problem isn’t reduced. The problem becomes “too big (interconnected, complex, etc.) to resolve.”

This challenge suggests resolution planning should be a continuous effort on the part of regulators. Practices might include “what-if” consultation with national authorities where the biggest offshore operations are located, resolution simulations to identify potential problems in advance, and working with institutions and host governments to achieve cleaner and simpler legal structures that are resolution-ready. By resolution-ready, I’m envisioning legal vehicle structures that wrap the assets and business units of organic businesses into entities that can be easily evaluated and transferred in the event of a necessary disposal.

These are just top-of-mind ideas. My point is I’m urging careful thought on the implementation and execution capabilities required to limit systemic risk. In assessing the proliferating opinions about regulatory reform and focus, we should ask, how would you operationalize it?

The financial crisis in this country has resulted in financial industry consolidation. The effect of industry consolidation is greater concentration without, as yet, much reduction of systemic risk. The preferable direction is the opposite—toward less concentration.

Ideas have been floated, but there is not yet much consensus on how to accomplish deconcentration. Forced downsizing and breakup is an option. I have concerns about such an approach. It strikes me as a drastic measure that could unfairly penalize relatively healthy and successful institutions.

An alternative could be a scheme of escalating supervisory attention as a financial institution approaches and exceeds thresholds of systemic risk. This approach might provide a check on institutions and be a disincentive to becoming a potential systemic problem.

No return to simpler times
In my remarks, I have tried to contribute—based on my experience as a banker turned policymaker—constructive thoughts for the architects of the postcrisis financial and regulatory world. Next month, the Atlanta Fed hosts a conference at Jekyll Island, Ga. The conference will take place where about a century ago many of the ideas leading to the Federal Reserve System were deliberated. Those meetings were held in 1910 in the aftermath of a financial crisis that bears strong resemblance to our current experience.

Coming off the turbulence of 2007 through 2009, I can appreciate the yearning for a simpler era. But the future financial architecture and the regulatory approach that lines up with it must be constructed, in my view, to be durable, evolve with inevitable change, and be equal to the reality of the financial sector that will survive this period. I expect the financial system to retain its diverse elements including securitization markets, large globally integrated institutions, and vigorous innovation.

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