FINANCIAL MARKET BEHAVIOR AND APPROPRIATE REGULATION OVER THE BUSINESS CYCLE
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Financial Market Behavior and Appropriate Regulation Over the Business Cycle: Summary Comments

Good afternoon. I'm Michael Moskow, president and CEO of the Federal Reserve Bank of Chicago. As you finish your dessert, and before I introduce our distinguished luncheon speaker, I'd like to take a few minutes to summarize some of the discussion we've had over the past couple of days.

The theme for this year's conference deals with the changing behavior of financial firms - and the appropriate regulatory response - over the business cycle.

The topic has generated significant interest in recent months as the U.S. economy experienced its first cyclical downturn in nearly a decade, and there is growing disagreement over the cyclical implications of proposed adjustments to bank capital requirements.

At issue is whether banks behave in a manner that tends to accentuate business cycles, and whether bank regulation further augments this volatility. It is generally thought that during business cycle up-swings, bank lending activity expands as loan standards soften and risk managers are excessively optimistic about future events.

Alternatively, when the economy starts to slow, risk managers realize they have been overly optimistic and may over-compensate at the first sign of credit deterioration. This leads to cyclical reductions in bank lending, and increased macroeconomic instability. Regulation can further augment this cyclicality since it restricts bank activity during downturns, and is generally not binding during upswings.

Two basic questions concerning the cyclical issues were repeatedly raised during yesterday's sessions:

Does this paradigm of bank lending activity still accurately describe the situation?

Or has the industry changed sufficiently as a result of increased geographic diversification, a wider array of product offerings, increased ability to hedge risk, improved use of loan sales and, in general, increased industry resiliency to adverse economic shocks?

and

Does regulation add to this procyclicality and can (or should) it be used to partially dampen cycles?

On the first point, most of the discussion yesterday simply assumed that bank behavior continues to accent the business cycle. However one of our theme panel speakers emphasized that we have had limited ability in recent years to evaluate whether the traditional paradigm continues to hold true. He emphasized the difficulty involved in assessing bank valuation over the course of the business cycle.

This is partially because of limited evidence from downturns over the past two decades and partially because of the increased opaqueness in banks' balance sheets during this period.

Fundamentally, it remains unclear how recent industry changes, and resulting changes in industry resiliency, have affected the typical banking cycle.

This morning, however, Chairman Greenspan emphasized an additional element in the changing nature of banking that could tend to dampen banking cycles; that is the development and increase use of sophisticated risk-management practices. As these practices improve, and the role of the risk manager increases, they can more promptly recognize and respond to changes in asset quality. As a result, cycles should be dampened.

Concerning the impact of regulation on business cycles, there was general consensus that regulation, by its very nature, is somewhat procyclical. When economic conditions are good there are typically fewer demands on bank capital.

There was less agreement, however, on the procyclical nature of the proposed revisions to bank capital requirements; and what, if anything, should be done about it. During yesterday's theme panel it was argued that the objective should not be to fine-tune the business cycle via regulatory policy, but to simply try to avoid aggravating the cycle. Fine tuning is inappropriate because there is no predictable cyclical pattern of fluctuations.

How can you protect against a downturn whose arrival is essentially unpredictable?

At best, one may hope to build up capital reserves during good times when asset prices are rising in an attempt to cushion banks during slower periods.

Discussions of the procyclicality of regulation were dominated by evaluation of the proposed Basel Accord. Basel II, as the new capital proposal is labeled, was intended to address the arbitraging which the current rules have encouraged. The proposed rules strive for a more precise calibration of economic and regulatory capital.

While there is general agreement that there are significant problems with the existing capital guidelines, there was little agreement on the appropriate adjustments. In fact, it was argued yesterday that the new rules raise at least as many questions as they answer.

There were concerns expressed that the proposed revisions could actually increase systemic risk and procyclicality; not reduce it. It was recommended that the capital proposal should include substantial revisions to the credit risk rules, including far greater reliance on reserves for expected losses, as a means to smooth the business cycle.

Perhaps the most contentious aspect of the Basel II debate is the introduction of a capital charge for "operation risk;" defined as the risk of the breakdown of information systems, internal controls and corporate governance. This component of the proposed Accord has evolved substantially from the original Basel proposal, reflecting significant input from the industry.

The current proposal emphasizes using bank's internal risk measurement models to allocate capital for operational risk. This approach reinforces banks' existing risk management practices and should result in a more accurate allocation of capital.

However, again, there was disagreement on the effectiveness of allocating capital to operating risk. One panelist emphasized that there is no widely accepted methodology for measuring operational risk, let alone assigning capital in relation to it.

Another panelist argued that regulators should be aware of their own limitations.

He warned that they should resist the temptation to "hard-wire" evolving management science into regulations that can be changed only with great difficulty following laborious international negotiations.

However a regulator actively involved with the implementation of Basel II stated that while the new Accord can easily be criticized, market participants must not let the views of the "best" become the enemy of achieving the "good." He argued that there is a lot of good in the new Accord - more risk sensitivity, more options and flexibility for banks, and more support for sound risk management. In his view it is time to move forward and make Basel II a reality.

As usual at this conference, we covered a number of policy issues in addition to the conference theme. For example, yesterday we had an excellent discussion of how the industry responded to the tragic events of September 11 to insure the financial sector continued to function.

Federal Reserve Vice Chairman Ferguson emphasized how past industry efforts at business continuity planning had paid off during the crisis. He also stressed the cooperative effort of the industry and supervisory agencies in evaluating best practices aimed at increasing financial system resiliency. The Federal Reserve Banks themselves are also strengthening their own business resumption plans and updating emergency communications protocols to allow cross-district servicing of financial institution needs.

There were also discussions concerning industry consolidation and geographic expansion.

Much of the research evaluating industry consolidation has found limited benefits and occasional perverse effects for consumers.

However a study presented yesterday emphasized the need to allow sufficient time for the full effect of industry consolidation to play out. Analyzing the market for bank deposits, the authors argued that the short-run and the long-run consequences of mergers could differ significantly. They find evidence consistent with this contention. In the short run the costs of restructuring the consolidated firm may overshadow the gains, which may not fully emerge for years. The result suggests that mergers can help shift assets to more productive uses, but those gains may require a significant transition period.

Timing effects were also found to be important in another study evaluating the ability of bank management to effectively grow and expand their geographic presence.

In recent years, as banks expanded across the country, they ran into a management problem that has long affected other industries - i.e., the integration of geographically dispersed operations.

A study presented this morning showed that operating a geographically diverse banking organization is indeed very costly. But the costly effects of distance have declined significantly over the past 15 years. The authors conclude that by applying new information, communications and financial technologies, banks can, and have, increased the profitability of geographic expansion.

In summary, I believe that once again the conference has succeeded in bringing together relevant parties from within the industry, the regulatory agencies and academia to provide critical input to help shape public policy. I appreciate the advancement of the debate by both program participants and experts within the audience.

This format has allowed us to discuss some of the more contentious policy issues affecting the financial services industry. In fact, if one thinks about the relevant policy issues of the day, I believe that the only issue not discussed that could generate as much controversy as those we have covered, may be deposit insurance reform.

How convenient!

Before I go on, I want to remind everyone that there is a very interesting session following lunch, beginning at 2:00 p.m. back on the 2nd floor, addressing: “Failure Resolution of Large Complex Financial Organizations.”

Now it’s my great pleasure to introduce our keynote speaker today, Donald E. Powell.

Don has more than thirty years of experience in the financial services industry. He was sworn in as the eighteenth chairman of the Federal Deposit Insurance Corporation (FDIC) on August 29, 2001.

Prior to being named chairman of the FDIC by President George W. Bush, Don was president and chief executive officer of the First National Bank of Amarillo. He has served on a variety of boards, including chairman of the board of regents of the Texas A&M University System, advisory board member of the George Bush School of Government and Public Service, and chairman of the Amarillo Chamber of Congress.

Don also has a long history of community service, ranging from the City of Amarillo Housing Board to the Franklin Lindsay Student Aid Fund and Cal Farley’s Boys Ranch.

He received a B.S. in economics from West Texas State University and is a graduate of The Southwestern Graduate School of Banking at Southern Methodist University.

Please join me in welcoming Don Powell.