Steps toward a New Financial Regulatory Architecture

Introduction
Today, we are still in the midst of the greatest financial stress our economy has seen since the Great Depression. The extent of the disruptions is very broad—from commercial paper to consumer and business loans to asset-backed securities, interbank lending, and risk management products. Many borrowers are finding it difficult to obtain access to credit under terms and conditions they would find in healthier times.

You as bankers are well aware that your industry has been under siege during the past year and a half, even though only a relative handful of institutions out of many thousands nationwide have actually been involved with the underlying problems that launched the crisis. But the widespread fragility of credit markets now affects us all, and it is deepening and prolonging our recession. So I think that all of us in the banking industry as well as the regulatory arena have a role to play in restoring public confidence and trust in what we do—we must all work together.

Significant monetary and fiscal forces are already at work to counteract the recession. A very sizable fiscal stimulus package is now in place, as well as a comprehensive strategy for addressing the plight of millions of distressed mortgage holders. The Federal Reserve is aggressively using all of the tools at our disposal to provide liquidity to financial markets and to promote an economic recovery.

In my remarks today, I will briefly explain my economic outlook and the Federal Reserve’s recent actions. Then I will make a few comments on changes to the financial regulatory system. I will make the case for a new framework for categorizing financial institutions based on the degree of risk they pose to the financial system, and I will add my endorsement to what some have called macroprudential supervision.

Of course, the views I express today are my own and do not necessarily reflect the views of my colleagues in the Federal Reserve System.

I. The Situation - Where Are We?
Let me start with what I consider to be the most important aspects of the circumstances we face in the economy today. Since the beginning of the recession in December 2007, about 4.4 million American jobs have been lost, with well over half of those losses coming in just the past four months. We have also seen a huge increase in the jobless rate since the recession began, jumping from 4.9 percent to 8.1 percent. Here in Ohio, problems in the...
manufacturing sector have taken their toll—our unemployment rate now stands at 9.4 percent.

Across the nation, businesses have been slashing production and reducing their capital spending plans. For consumers, the loss of wealth from the collapse of housing and equity prices has been staggering. Last year, the net worth of U.S. households declined by more than 11 trillion dollars, or by 18 percent. To put that in perspective, that is close to a year’s worth of U.S. gross domestic product.

In past recessions, we have been able to rely on international markets to cushion a domestic slump, but that’s not the case this time. Production and spending activity have been declining around the world. The International Monetary Fund projects that the world economy will contract in 2009 for the first time in 60 years.

The housing sector, which led us into the recession, has not yet regained its health. Housing prices are still declining in many parts of the country, housing starts have fallen by more than 60 percent since their peak in 2006, and the number of unsold homes is still quite large relative to the pace of sales. At the current selling rate, it would take 10 months just to clear the inventory of existing homes.

These are all rather grim statistics. We are experiencing a broadly based recession that is deeper and that has already lasted far longer than is typical. But we know that recessions do end, and this one will, too. I expect economic conditions to stabilize by the end of the year and then begin to recover next year as the fiscal stimulus boosts spending and as we work off excess inventories. My forecast for recovery also presumes the current actions undertaken by the Federal Reserve and the government are successful in restoring financial stability.

Indeed, many of the Federal Reserve’s recent actions are focused directly on getting the credit markets functioning again. We have lowered our federal funds rate target to a range of 0 to 1/4 percent. We are also using our normal lending authority to extend credit in significant amounts to commercial banks, and for longer terms, to help you extend credit to your customers for longer periods of time.

In addition, we have developed a set of policy tools to more directly support borrowers and investors in key credit markets. One example is a funding facility known as TALF, or the Term Asset-Backed Securities Loan Facility. The TALF is designed to bring investors back into the securitization markets, which is a vital step to enable financial institutions to originate and sell loans they do not want to hold on their balance sheets.

The TALF is already supporting markets for newly issued consumer credit and for student, auto, and business loans. In addition, the Federal Reserve expects to expand the range of eligible securities within this facility. The TALF could be extended to include other markets for newly issued debt, as well as markets for certain securitized loans already being held by financial institutions.

Yet another Federal Reserve policy tool is the direct purchase of certain kinds of longer-term securities for our portfolio. For example, we have announced plans to purchase up to $1.25 trillion of mortgage-backed securities from government-sponsored enterprises by the end of the year. This program is intended to improve the flow of credit to home buyers and to allow existing homeowners to refinance at lower rates.

When we first announced plans to purchase these securities, in late November of last year, the cost of mortgage loans began to decline,
and rates continued to fall as we began to purchase the securities. For example, the 30-year fixed, conventional mortgage loan rate was a little above 6 percent last November, and as of last week, it averaged just under 5 percent. We are also beginning to see a resurgence in refinancing activity in the residential mortgage markets, spurred on by these lower rates. In addition, sales of new and previously owned homes picked up in February, due in part to declines in home prices, and in part to the tax credits offered to first-time home buyers provided in the stimulus package. These are all encouraging signs.

We also announced our intention to begin purchasing up to $300 billion of longer-term Treasury securities. The announcement had an immediate effect on Treasury yields. Lower interest rates on these securities encourage investors to purchase other kinds of investments, which will improve conditions in the private credit markets. We have just recently begun to make these purchases.

These policy tools -- lending to financial institutions, providing liquidity directly to key credit markets, and buying longer-term securities - have a common feature. They represent our efforts to lower interest rates and ease credit conditions in a range of markets even when the federal funds rate is near zero.

Collectively, our actions have been aggressive and unprecedented. Since October 2007, the Federal Reserve’s balance sheet has grown from $855 billion to about $2 trillion, and with our recent announcements, we are prepared to expand it further.

In addition to these policy tools, we can also utilize our supervisory resources and authority to improve bank lending and the flow of credit. The Federal Reserve and other bank regulators are stress testing the largest banks to ensure that they have the capital they need to operate safely.

Ultimately, the surest sign that financial markets are on the mend will be an inflow of private capital into the banking system and a broad-based rise in bank lending. Since the beginning of the year, commercial and industrial loans, as well as loans for commercial real estate, have declined. On the other hand, consumer and residential mortgage loans are again increasing, particularly for refinancing. As economic conditions stabilize, more households and businesses will have the confidence to borrow, and more borrowers will become better credit risks. Both developments will contribute to economic growth.

II. Tiered Parity: A New Framework for Acknowledging and Addressing Systemic Risk

As our economy moves toward recovery, I believe it is critical for us to step back and take a closer look at how this turmoil came about and what we as regulators can do to minimize the risk of such crises happening again. There has already been much public discussion on these points, and more discussion lies ahead. So, while we are all thinking this through, let me share my preliminary thoughts on two directions for change. The first is to advocate for a new risk-based framework for categorizing and regulating financial institutions. The second is to affirm the benefits of macroprudential supervision.

Let me be clear that I do not think that we should rely on regulation, by itself, either at the micro- or macro-level, to prevent future crises. Markets can provide very effective discipline on the decisions of financial market participants. Any new regulatory framework should be designed to work with, and not supplant, market forces.

It is natural to equate the problems in our financial system with the
securitization of subprime mortgages. But the securitized subprime market happened to be the epicenter, and we now see that the fault line really ran for a very long distance and spanned many markets and many kinds of financial institutions - particularly those that were the most complex and the most interconnected.

I know that most of our country’s community banks have had very limited participation and exposure to the sorts of complex financial instruments that contributed to the current crisis. The size, complexity, and nature of operations of most community banks simply do not lend themselves to those types of activities. Also, a substantial amount of growth in the financial sector over the past 20 years has occurred outside the more highly regulated commercial banking industry. So it should come as no surprise that very serious problems developed in non-bank financial companies—in the form of high leverage, asset and liability maturity mismatches, and risk management shortcomings. These problems also emerged in the small minority of commercial banks that were among the most complex.

So, when I reflect on the causes of our financial crisis, I conclude that the architecture of the financial system had developed in such a way that a relatively small number of financial institutions occupied systemically critical positions. Once these institutions got into trouble, the public’s loss of confidence in them spilled over and spread to other companies in the same industry and across the financial sector through various linkages.

The degree of complexity in our financial organizations makes it imperative for us to craft our regulatory and supervisory approach with great care. Clearly, the risks posed by a $250 million, noncomplex institution are different from those posed by a $50 billion, moderately complex institution. And the highly complex, and often extremely large, institutions that pose significant systemic risk are in a category all by themselves.

Therefore, I propose a framework that I will call “tiered parity.” In this framework, I would construct a small number of tiers and assign each financial company to one of the tiers based on the complexity of its operations and the degree of risk it poses to the financial system. For example, a three-tiered framework could have categories labeled “noncomplex,” “moderately complex,” and “systemically important,” with corresponding degrees of regulatory requirements and supervisory oversight. Where an institution is placed could depend on the situation at hand. Some hedge funds, for example, might deserve closer scrutiny during an asset boom or commodities squeeze, but less oversight during normal times.

Institutions within each tier would receive the same regulatory treatment and supervisory oversight, thereby ensuring parity in treatment within each tier. But the differences in treatment between the tiers would be based on the differences in complexity and linkages- and therefore, risk to the financial system. In this framework, the systemically important institutions would be subject to the highest degree of regulatory scrutiny and more rigorous requirements that reflect the risk they present to the financial system. In effect, we need to recognize that there are different playing fields for community banks versus money-center financial conglomerates, so the rules and regulations governing those fields should vary accordingly.

For example, systemically important companies pose threats to the entire economy because of the spillover costs that can be imposed on others if they fail. Given that risk, these companies should be subject to a higher level of regulatory requirements and supervisory oversight. The goals are not only to limit the amount of risk these companies could pose on the financial system overall, but also to
discourage the combination of size, complexity, and nature of operations that enabled them to become a systemic threat in the first place.

In the new regulatory architecture I am describing, any institution that is identified as systemically important should be subject to tighter regulation, as well as close supervision of its risk taking, risk management, and financial condition. It should also meet high capital and liquidity standards. The objective, of course, is to enhance risk management at two levels: for the financial system as a whole, and at individual financial institutions.

We know that risk management failures were one of the major contributors to the financial instability we have witnessed over the past 18 months. So we want to force firms to reduce the risk that they will impose costs on the rest of the system and the taxpayers. I like to think of regulating systemically important institutions in the way that fire departments minimize the risk of fires starting and of fires spreading—they rely on measures such as fire codes, safety inspections, and fire drills. And as a society, we accept the principle of paying for fire insurance.

I do not mean to imply that regulation should punish firms for being efficient and innovative. Instead, it should offset or remove any advantages to becoming systemically important in the first place, perhaps encouraging some institutions to shrink, become less opaque, or lower their risk profiles.

III. Establishing Financial Stability Oversight

Let me now shift to the second direction for change, macroprudential supervision. Today, supervision is mainly geared toward the safety and soundness of individual banking institutions—what we call “microprudential” supervision. Effective microprudential supervision remains an essential component of the financial architecture. Within the framework I am proposing, a microprudential supervisor would still be needed to subject the consolidated entities - bank and nonbank entities alike - to the same level of oversight within each tier.

But we need more. I think we need to build macroprudential oversight into this new supervisory framework. Chairman Bernanke and Treasury Secretary Geithner have spoken to this aspect of the regulatory framework recently, and I would like to add my own comments to the discussion. As I envision it, one or more financial regulators would have the responsibility, accountability, and authority to identify and mitigate risks posed to the entire financial system. This means making sure that systemically important financial institutions have proper supervision, but it also means looking at possible linkages among firms and at market practices that might pose systemic risk, such as the design and distribution of asset-backed securities and the organization of the credit default swap market.

Macroprudential supervision suggests that we examine the system as a whole and look for situations that lead to financial instability. For example, when prices of financial assets fall steeply, financial institutions often need to obtain liquidity and preserve capital. This prompts them to sell assets they hold, which further depresses market prices and sets in motion a negative chain of events. In such an environment, individual banks may appear healthy, but that health can quickly deteriorate if they are all attempting to strengthen their balance sheets at the same time. Similarly, heavy reliance on a small number of financial guarantors should prompt a review of their ability to perform under stress.
Establishing a failure resolution process for nonbank financial companies should go hand-in-hand with the establishment of macroprudential supervision. The systemic effects that arise from the failure of a single firm are sometimes made worse because there is no clearly defined method for government authorities to intervene and resolve the situation. In the case of the potential failure of a commercial bank, the government, the general public, the bank’s creditors, and potential investors clearly understand the rules of the game. Once we move outside that arena, we are in uncharted territory. True, there is always the option of a bankruptcy filing, but bankruptcy of a systemically important financial company in a time of crisis could be profoundly destabilizing.

That is where the establishment of both macroprudential supervision and a more robust failure resolution process could make a real difference—to help ensure that the government has the tools and authority to resolve crises at systemically important nonbank financial institutions in ways similar to those that currently exist for banking organizations.

Helping the public and institutions understand the new rules of the game and how they will be applied may be a challenge, but that understanding is critical to gain the full benefits of the program. One way to begin is to follow the example of some foreign central banks and financial authorities, by publishing financial stability reports. All financial supervisors, but especially the macroprudential supervisors, should regularly describe their objectives, the risks they see, and the actions they are taking to address those risks.

By doing so, supervisors will also receive informed feedback from bankers and the public regarding the goals, effectiveness, and consistency of supervisory activities. By establishing a dialogue with the public—inviting them into the room, so to speak—supervisory agencies will empower all concerned parties to make more knowledgeable decisions. Enhanced communication has benefited the monetary policy process, and I believe it will benefit the supervisory process as well.

**Conclusion**

The Federal Reserve is working hard to resolve the current financial turmoil, but it is not too early to look ahead at ways to fix the underlying problems in the system. I believe the new framework I have suggested for categorizing financial institutions and addressing the systemic risk they pose to the financial system will provide a solid foundation. This approach will add the clarity and focus we need to limit the advantages of being systemically important, thereby reducing the threat these institutions pose to the financial system. The establishment of one or more macroprudential supervisors, with the adequate tools to resolve crises, will help to identify and mitigate significant risks to the financial system.

These elements are critical to any reforms of our regulatory system and structure, and I welcome your thoughts and participation as the process moves forward.