Financial Stability: Lessons from Monetary Policy

It is truly a pleasure to be here at this conference and to have the opportunity to address all of you. It is also a pleasure, and an honor, for the Federal Reserve Bank of Cleveland to sponsor this conference with the Department of the Treasury's Office of Financial Research. I would also like to thank the Federal Reserve Board of Governors' Office of Financial Stability Policy and Research for their support in hosting this event. I recognize that we are all here because of our common interest in, and concern for, preserving the stability of our nation's financial system. Partnerships like this among the regulatory agencies will enhance our ability to be successful in maintaining financial stability over the long term.

As I thought about my remarks for today, I reflected on the parallels between the evolution of monetary policy toward greater transparency over the last two decades and the evolution of financial stability policy toward greater transparency following the most recent financial crisis. I cannot help but acknowledge that there are also parallels between the loss of credibility that monetary policymakers faced in the 1970s and the situation that financial regulators faced following the most recent financial crisis. Both situations triggered a process of credibility-rebuilding that required greater transparency.

Today, we all recognize the critical role that transparency has come to play in conducting monetary policy. Going forward, transparency can also play a critical role in conducting financial stability policy. In the aftermath of the Great Recession, the Dodd-Frank Act gave financial regulators greater authority to address issues that could lead to financial system instability. Financial regulators and supervisors should use transparency as a means to more effectively identify, communicate, and mitigate risks to the financial system. In my remarks today, I will briefly review the evolution of the Federal Open Market Committee's (FOMC) efforts to increase transparency. I will then discuss how greater transparency can promote financial stability, and I will suggest additional steps regulators could take to increase transparency. Of course, the views I express today are my own, and do not necessarily represent those of my colleagues in the Federal Reserve System.

As president of the Federal Reserve Bank of Cleveland and a participant on the FOMC, I see similarities in how the FOMC has implemented greater transparency in conducting monetary policy, and how regulators can utilize greater transparency in conducting financial stability policy. Specifically, the FOMC has greatly increased our communications on two fronts: first, in the information we share with the public about our monetary policy decisions; and second, in the expectations we set for the policy actions that we will take over time and how we expect those actions to affect economic conditions.
Congress established maximum employment and stable prices as the goals for monetary policy. This dual mandate is not specific; however, over time, the FOMC has come to recognize that making our goals more explicit can help us to achieve those goals. Today, the FOMC states that the longer-run inflation goal most consistent with its price stability mandate is 2 percent. The FOMC also communicates the central tendency of FOMC participants' estimates of the longer-run rate of unemployment that is consistent with maximum employment, which currently ranges from 5.2 to 6 percent. In the Dodd-Frank Act, Congress established the statutory objective of promoting the financial stability of the United States. This mandate is also non-specific; nevertheless, I believe it will become more meaningful if financial regulators make it more explicit over time.

When I joined the Federal Reserve Bank of Cleveland 30 years ago, central bankers around the world were close-mouthed about monetary policy actions. Central bankers believed there was limited potential benefit and considerable risk to greater transparency. The conventional wisdom was that making information about monetary policy actions more transparent risked negative market reaction. Furthermore, policymakers believed that making information about likely FOMC policy actions more transparent might limit the Committee's ability to change course if different policy actions became warranted. In time, however, central bankers recognized the important role that expectations play in financial markets, and began to rely more heavily on forward guidance to improve the effectiveness of monetary policy.

The FOMC's first effort toward greater transparency came almost 20 years ago, in February of 1994. At that time, the FOMC issued a brief, four-sentence post-meeting statement that announced a change in monetary policy, but provided scant details. In the last decade, the trend toward greater transparency accelerated. The FOMC now uses several communications strategies, ranging from being more precise about the economic conditions we are trying to achieve to explaining the factors that will influence future policy actions.

Over the past two decades, the evolution of the FOMC's communications has made our monetary policy more effective by providing more information about the Committee's future actions. Financial markets adjust more quickly and smoothly to new information when market participants understand the FOMC's goals and likely actions. More transparency has not created significant problems for the FOMC; quite the contrary, more transparency has led to more effective monetary policy. For the same reasons, I believe that providing enhanced information about financial firms and clearer expectations for the future actions of financial regulators can also make our financial stability policies more effective.

I believe we would all agree that the recent financial crisis developed, in large part, due to both a lack of information transparency, and a lack of regulatory transparency. By "information transparency," I mean transparency of information about individual firms and the financial system. By "regulatory transparency," I mean transparency related to the actions of regulators. Regulators play an important role in promoting both information and regulatory transparency. Information transparency should reveal the risks in financial firms and markets, and regulatory transparency should communicate how supervisors will respond to situations that threaten the financial system.

During the financial crisis, information transparency and regulatory transparency were not optimal. The risks associated with various financial instruments were unclear. The extent to which specific
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The ability of supervisors to assess and communicate the status of individual firms and the potential impact of those firms on the financial system was unclear, and the actions that supervisors and other government entities would take if those firms endangered the financial system were unclear. In the absence of clarity, market participants assumed the worst, and took actions that in many cases exacerbated the situation, pushing the financial system towards collapse.

A well-functioning financial system relies on accurate information about the condition of each participant. Investors must have the information they need to effectively monitor financial institutions and to withhold funding from those that engage in excessively risky activities. The goal of information transparency and regulatory transparency is to increase market discipline. Greater market discipline enhances the likelihood that financial institutions—and, where appropriate, their uninsured creditors—bear the costs of taking on excessive risk. Banking supervisors cannot be expected to know about, and prevent, everything that could go wrong; neither can financial markets. However, supervisors and markets will be better able to limit risks to the financial system and support overall financial stability when they have access to accurate information.

Since the financial crisis, progress has been made toward both greater information transparency about financial firms, and greater regulatory transparency about supervisors' actions. The stress tests of large, complex bank holding companies, and the associated Comprehensive Capital Analysis and Review (CCAR), provide a great illustration of information and regulatory transparency. The stress tests began in early 2009 as the Supervisory Capital Assessment Program (SCAP). SCAP restored confidence in individual banks and in the financial system overall by providing information on how much capital the largest US banks would need in a macroeconomic stress scenario. SCAP also demonstrated the commitment of regulators to force firms that were short of capital to either raise capital from private sources or take equity from the US Treasury.

The decision to publicly release the results of individual banks as part of the original SCAP drew strong resistance from people inside and outside of the Federal Reserve. Some of my own staff expressed doubts that the public would be well served by seeing the results for specific banks. However, releasing the results proved to be a success on two levels. First, SCAP broke new ground for information transparency by disclosing which firms needed additional capital and how much more capital they needed. And second, the stress tests broke new ground in regulatory transparency by showing that regulators would enforce capital requirements and impose consequences for firms that fell short of those requirements. SCAP calmed the markets by increasing confidence in both the financial institutions and in the supervisory process.

Since then, the stress test has become embedded in the CCAR. CCAR is designed to ensure that bank holding companies have good capital plans and good capital planning processes in place. With CCAR, the Federal Reserve indicates whether a firm’s capital plan is approved, and discloses projected loan losses, income, and capital levels under a severely adverse stress scenario. The benefit of transparency regarding stress tests and CCAR is that the public understands which institutions are meeting the Federal Reserve’s standards, and the institutions understand and must bear the penalties for not meeting the standards—penalties that are imposed by the regulators, as well as from the markets.

Another example of where regulators are making progress in terms of information transparency and regulatory transparency is with the
resolution plans required by the Dodd-Frank Act. These plans, which are commonly known as living wills, detail the steps to be taken by systemically important financial firms in the event of their failure. The living wills are intended to limit the impact of one firm's failure on the entire financial system. Last year, 11 systemically important financial institutions submitted living wills to the Federal Reserve and the Federal Deposit Insurance Corporation. Both of these agencies are working with those institutions to ensure that the living wills will actually enable the orderly and rapid resolution of the firm in the event of its failure. A portion of each firm's living will has been made public, enhancing information transparency.

Importantly, the regulators are continuing to strengthen the process. Following their review of the initial resolution plans, the Federal Reserve and the Federal Deposit Insurance Corporation (FDIC) have developed instructions for the firms to detail the information that should be included in their 2013 resolution plan submissions. In particular, the supervisors have asked the firms to detail the obstacles to executing the resolution plans under the Bankruptcy Code. In my view, it is crucial that the public comes to see the living wills as credible resolution plans, and transparency can be of great assistance in that regard.

The Federal Open Market Committee has had decades of experience in refining its approach to fulfilling its dual mandate. By comparison, the Federal Reserve and other financial regulators are in the early stages of crafting a comprehensive approach to fulfilling the mandate of ensuring financial stability. With the passage of the Dodd-Frank Act, Congress has redesigned the financial landscape. Some rules have been implemented while others have yet to be written. The Federal Reserve and other regulators are just beginning to navigate this landscape of new laws and new rules on a range of subjects, from capital and liquidity of financial companies, to the oversight of nonfinancial entities that have the potential to destabilize financial markets. Regulators need to finish getting the rules in place. Then, they need to demonstrate that they have the ability, and the will, to use these new tools to address financial system stability. In the meantime, I would urge some patience as we lay the foundation for a comprehensive framework for supporting financial stability.

Going forward, the Federal Reserve and other regulators will continue to take steps to improve information transparency and regulatory transparency in order to enhance the stability of our financial system. One way to improve information transparency is through broadening the stress tests. Systemically important non-banks will be subject to stress tests, once those institutions are identified. Also, stress tests could be broadened to explicitly consider the effects of a bank’s stress on its most important counterparties. This would be especially useful if many banks each rely on the same small set of counterparties for certain kinds of transactions, as was the case with AIG and credit default swap contracts in the most recent financial crisis.

Another way to improve information transparency is to provide the public with more information about the quality of bank assets. For example, regulators could require disclosure of material information on a firm’s portfolio risk structure, such as the geographic distribution of the firm’s loans. Market participants and banking supervisors would likely view the risk profile of an institution with 90 percent of its construction loans concentrated in either depressed or overheated real estate markets differently from the risk profile of an institution with its construction loans distributed across the country. Regulators could also require the disclosure of the distribution of FICO scores in a bank’s consumer loan portfolio. By requiring banks to make such disclosures, banking supervisors can promote information
transparency on individual firms. These disclosures also would reinforce regulatory transparency related to the actions regulators will take to address certain bank portfolio concentrations.

Greater regulatory transparency also can result from supervisors and regulators being more forceful and proactive in carrying out our expanded responsibilities. For example, in 2010, the Securities and Exchange Commission (SEC) imposed tougher rules on money market funds to bolster their solvency. However, some do not think these steps are sufficient to safeguard financial stability.

The Dodd-Frank Act gives the Financial Stability Oversight Council (FSOC) the authority to provide for more stringent regulations by recommending that the SEC apply new or heightened standards or safeguards. And, in fact, in an effort to address threats money market funds can pose to the financial system, the FSOC is considering whether to formally recommend that the SEC proceed with structural reforms of money market mutual funds, and has asked for public comments on several options designed to address the issue. In the interest of full and transparent disclosure, I should note that I, and each of the other 11 Federal Reserve Bank Presidents, co-signed a letter recently in support of the FSOC's efforts to address the risks to financial system stability that are posed by money market funds. Regardless of the final resolution, this new process enables the regulatory community, acting as a whole, to take action.

Another way to enhance regulatory transparency is to keep pushing forward in the area of living wills. As I mentioned earlier, the Federal Reserve and the FDIC have published living wills for 11 systemically important financial institutions. However, it is not clear to me that market participants have reached the point where they trust that the living wills, in concert with the Bankruptcy Code and the Dodd-Frank Act's Orderly Liquidation Authority, can be relied upon for safely liquidating a firm in acute financial stress. Furthermore, even though the FSOC has designated eight financial market utilities as systemically important, no non-bank firm has been named to that list, and subsequently, none has been required to create a living will. I think that successfully addressing the "Too Big To Fail" problem requires the establishment of a credible resolution process, one that appears capable of safely managing the failure of systemically important financial institutions in times of distress. Achieving this credibility will, in turn, require a fair amount of informational and regulatory transparency. This is hard work, I know, but the gains from success are likely to be substantial.

I’d like to end my remarks where I began, with monetary policy. As a participant on of the FOMC, I have learned that transparency, practiced consistently, promotes accountability; and accountability leads to credibility. Credibility is crucial for financial firms and for supervisors, just as it is for the monetary authority. Credibility accumulates when there is public confidence and market confidence that rules are clear and are being followed—by the supervisors as well as by the financial firms. Access to accurate information about financial firms and about the actions regulators will take is a key factor in promoting transparency, and transparency promotes financial stability. In a healthy information environment like the one I am describing, both market forces and banking supervisors will have greater scope to discipline firms. Constructively used, transparency can enhance the ability of supervisors to achieve their goals. Over time, as we navigate the new financial services landscape, I hope that the benefits from increased transparency that I have seen at work in monetary policy will become increasingly evident in financial stability policy.