

Looking Ahead: Financial Stability and Microprudential Supervision

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The views expressed by the author are her own and do not necessarily reflect those of the Federal Reserve System, its governors, officers or representatives.

Introduction

I am very pleased to be here. Once again, the Levy Institute has come up with an outstanding program and one that addresses a very timely and critical issue.

There are many views about what went wrong in the financial markets and global economy and what policy steps should now be taken to create a more stable and resilient financial sector. To date, we have implemented a number of changes in monetary, fiscal and financial policies to contain the damage and prevent future crises. Some of these policies focus on short-term solutions, while others are more long-term focused.

In my remarks, I will look at this issue largely from the longer-term need to build a stronger financial system structure. I will first discuss our recent experience in the financial markets and where we may have gone wrong from a supervisory and institutional perspective. Then I will turn to what we must do from a long-term perspective to create the type of financial system that will be better positioned to weather the next crisis.

Our Recent Experience

This crisis is following much the same pattern of previous financial crises—an inability or unwillingness to see the warning signs and take preventative action, followed by massive damage, and then working through the emergency policy steps and the rebuilding of our financial system. The aftermath of this crisis left no question about the enormity of damage that could be inflicted by a financial sector with too much leverage and risk. As a result, the steps we are taking to clean up the damage and begin long-term rebuilding take on added importance because the policies we put in place now will influence—for better or worse—the likelihood, nature and severity of the next crisis. While we know we cannot prevent the next financial crisis,

public policy and preventative steps play an important role in establishing the overall stability and resiliency of our financial system. Consequently, getting these steps right is essential if we are to avoid setting the stage for an even more severe crisis.

We must also recognize that our resolve in dealing with financial crises unfortunately tends to diminish after a crisis passes. Understandably, financial institutions want to get back quickly to a more profitable state, and the public wants a prompt and painless return to the prosperity they enjoyed before the crisis. As a result, policymakers and regulators can face substantial pressure to back off from implementing tighter oversight, especially if such oversight interferes with financial institutions going back to their usual operating parameters.

Many policymakers and market participants thus become reluctant when it is time to make the hard judgments about effective reforms and instituting greater risk restraints. Signs of this are already occurring with the efforts by financial institutions and others to weaken or delay stronger capital standards and other provisions of the Dodd-Frank Act. Before elaborating on those issues, though, it is instructive to examine some of the factors that led to this crisis.

Indeed, the housing bubble was a major factor in the crisis, but there is one thing that stands out to me as a banking supervisor: Both the private marketplace and regulators had become complacent and greatly underestimated the risks taken on by our financial system.

Too many were convinced that we had entered a new era and fully believed that we had new tools that could more accurately measure, price and control risk, even as financial instruments became far more complex and often were untested. This belief, for instance, led some to think that lower credit standards were simply another factor that could be priced into the terms of a subprime loan, thereby making such loans an acceptable risk. Or that bank leverage ratios were a thing of the past, especially because financial institutions and regulators could risk-

weight assets and off-balance-sheet exposures and use quantitative risk models to come up with “better,” “more accurate,” and, invariably, lower measures of capital needs.

Another factor in the crisis was misguided incentives to take on more risk. These included low short-term interest rates that encouraged financial institutions and other market participants to “borrow short and lend long” and to “search for yield.” These funding and lending incentives, along with other factors such as the low Basel risk weights assigned to certain financial instruments, further motivated major institutions to adopt very similar risk exposures. These exposures, in turn, contributed to the liquidity and funding breakdowns that were central to this crisis. Other misaligned incentives included the belief that larger institutions were “too big to fail” and the implicit guarantees behind the government-sponsored enterprises and certain other parts of the financial system—all of which gave creditors and stockholders added protection from default and less reason to be concerned about risk.

We also have had numerous changes in the structure of our financial markets over the past few decades, which have left us with a much different corporate culture in banking and finance. In fact, the new structure has brought with it a greater focus on short-term performance and more aggressive attitudes regarding risk-taking. These changes include a rapidly rising concentration in the banking industry, withering away of the Glass-Steagall constraints on banks engaging in securities activities, and the growth of securitization and money and capital markets.

Cultural change in investment banking began to occur more than 40 years ago, when the New York Stock Exchange relaxed its rules to allow member securities firms to break away from their partnership structure and adopt a corporate framework. With partnerships, the driving force had always been to safeguard the value of partnership interests by maintaining the long-run prosperity of the firm and developing new partners with similar objectives. Bringing in outside

capital through conversion to a corporate structure—which all major securities firms did by 1999—put these firms under greater investor pressure to exploit short-term opportunities and engage in riskier strategies. As banks took on more investment banking activities, competitive pressures then led to similar changes in the culture of banking. The outgrowth of all these changes in the financial system was a complacency and false confidence in new risk-management practices and a substantial and largely unrecognized build-up in leverage and risk that laid the groundwork for this crisis. Unfortunately, the pendulum swung from confidence that we could measure and control virtually any risk to the opposite—an environment during the crisis where market participants had virtually no idea how to price many financial instruments nor how to determine which institutions were still sound.

Looking to the Long Run

If we are to construct a stronger financial system, we must address the significant problems and obvious shortcomings that led to the crisis. First and foremost is to correct the misaligned incentives and the improper expansion of federal safety net protections that encouraged and enabled institutions to take excessive risks. In addition, I believe we must return supervision to its traditional role of exercising sound judgment and making informed decisions. In recent years, the supervisor's role has become a more passive one, with examiners spending much time monitoring regulatory compliance and tracking the risk-management practices adopted by financial institutions.

With regard to correcting the incentives in banking, the most important challenge we face is in constructing an appropriate, but carefully limited, public safety net. During this crisis, our safety net was stretched far beyond anything we had previously done, and this expansion in

safety net protections has left us with a broad and pervasive range of moral hazard issues. Not only did we expand deposit insurance coverage during the crisis, but we also guaranteed bank debt instruments, used the discount window to lend to nonbank institutions and conduct special lending programs, and bailed out large institutions and segments of the financial markets not covered by the traditional safety net. The largest financial institutions in the United States further received significant injections of public capital through TARP. Some would argue the only ones not protected from losses were the taxpayers.

It is hardly a coincidence that at the center of this crisis were a substantial expansion in public safety nets and the presence of major financial institutions, which were treated as being too big to fail (TBTF). This linkage between expanded safety nets and TBTF institutions has increased in importance over the last few decades, with the growth of one linked to the growth of the other—all in a cycle that poses a significant threat to financial stability.

This link between large institutions and special public support has left us trapped in a pattern in which public authorities believe they must expand the safety net each time a crisis is brought on by excesses in risk-taking at large institutions. This broadening of the safety net facilitates the next and even more severe crisis, as new moral hazard issues are introduced and major institutions are left with greater incentives for taking on risk. The critical and defining question for us is how to break this pattern of growing safety nets and escalating crises, while restoring much-needed market discipline to the financial system.

I believe the first and most important step that we can take is to eliminate TBTF policies. This crisis provided overwhelming evidence that the ingrained response of policymakers is to treat our largest institutions as being TBTF. With the help of bailouts, TARP money, the discount window, accommodative monetary policy and other actions, our largest institutions not

only survived the crisis, but in many cases, emerged as even larger players in the financial system.

The funding, capital and other advantages that TBTF provides are enormous, and such advantages—as seen in this crisis—remove important constraints on risk-taking that financial institutions would otherwise face from their stockholders, creditors and uninsured depositors. One simple example of these advantages is that the five largest U.S. banking organizations in June 2009 were given ratings on their senior long-term bank debt that on average were four notches higher than what they would have received based on their actual condition alone. One of these organizations even received an eight-notch upgrade for being TBTF. In a very competitive marketplace, such advantages are enormous and highly unfair to those institutions not receiving them. These ratings advantages continue to exist after the crisis—albeit at a notch or two less now, and investors have reason to believe that similar advantages may yet exist.

What can be done to address these moral hazard and TBTF issues? The Dodd-Frank Act provides an orderly liquidation authority for resolving the failure of a systemically important organization, thus adding to the existing framework for closing insolvent or nonviable commercial banks. Having this legal framework, though, is only the first, and perhaps easiest, step in dealing with TBTF. In fact, during the recent crisis we had a number of powers that might have been used on TBTF institutions, but were not employed to any notable extent. I'll offer just one example.

Part of the discipline associated with taking on expanded powers under the Gramm-Leach-Bliley Act was that all depository institutions in a financial holding company were required to remain well capitalized and well managed. If not, the company would have 180 days to correct the deficiencies or face divestiture of its depository institutions or termination of newly

authorized financial activities. To the extent that such divestitures or terminations might be difficult to do in the midst of a crisis, the Act gave the Federal Reserve the flexibility to grant additional time for such restructurings. One might fairly ask whether all of the major financial holding companies were in strict compliance with these provisions throughout the crisis or whether pursuing such actions might have been justified.

Thus, as we can see from this crisis, the most critical issue in addressing TBTF concerns is having policymakers with the resolve to follow through. In a crisis, there will always be concerns about creditor or depositor panics, public confidence issues, interconnections with other institutions and disruptions in financial services. While I believe these concerns often are exaggerated and can be minimized through the resolution frameworks we now have in place, others will almost certainly have different views. What we must remember, though, is that ending TBTF is the only sure way to curtail the expansion of public safety nets and break the pattern of repeated and ever-escalating financial crises.

A second step we must take is to strengthen bank capital standards with particular emphasis on leverage requirements tied to equity capital. In addition, we should weigh carefully the lengthy transition period contemplated by Basel III. There is risk that banks will be caught short again if we adopt a lengthy phase-in period and let banks manage their capital down to the minimum transition standards through substantial dividend payouts and stock buybacks.

I am cautious about relying heavily on risk-based capital standards for two reasons. First, banks have been quick to arbitrage whatever risk-based standards are in place, and second, it is hard to say that our risk weights have been accurate measures of risk. For example, many mortgage-backed securities were constructed to marginally meet the requirements for lower risk weights. These risk weights, moreover, bore little relation to the losses banks took on such

securities during the crisis. Instead, we must insist on capital standards that can fully protect against losses—both expected and unexpected—and we must avoid creating standards that give institutions incentives to adopt more concentrated risk exposures.

I am also in favor of some constraints on the type of activities that can be conducted by institutions protected by the safety net. The expansion in activities conducted by banking organizations over the past few decades has greatly increased the level of complexity in such organizations, making effective management and supervision of these entities much more difficult. In addition, this growth in activities has brought with it a changing culture in banking—one that is more characteristic of investment banking and other parts of the capital markets. Accordingly, the major banking organizations have become much more concerned about exploiting short-term opportunities and expanding their risk exposures, and many of the financial incentives provided to key personnel in banking organizations have become more closely aligned with those in investment banking. For these reasons, I support the goals of the Volcker Rule in eliminating proprietary trading by bank and thrift organizations, and I hope we can develop an appropriate regulatory and supervisory framework to implement these provisions. We should also take a careful look at other financial activities and their compatibility with public safety nets to avoid a replay of the expanded safety nets and the public assistance that was provided to financial institutions in this crisis.

My final comments concern the role of bank examiners. Increasingly, examiners have had to spend more time reviewing risk-management practices at banks and compliance with a wide variety of regulations. These demands will grow as examiners become more involved in stress tests, enhanced supervision, living wills and other features of the Dodd-Frank Act.

While I recognize these aspects of supervision warrant examiner attention, they should not detract from the more traditional and time-tested efforts of examiners in verifying the quality of a bank's assets, understanding the bank's business model and evaluating lending standards and other factors that shape risk within a bank. In my experience, the judgments and decisions by examiners typically provide the earliest warning signal of problems at a bank, and we must continue to provide examiners with the independence and authority to fulfill this role. Also, as impartial observers, examiners are likely to be in the best position to identify the type of risk exposures and conditions that could lead to a crisis, particularly in the case of examiners who have dealt with previous crises. In fact, during my career in supervision, I have seen no substitute for the judgment of experienced examiners. This crisis further indicates the need to have examiners with the ability and knowledge to distinguish between institutions that are viable entities capable of withstanding significant financial distress and those that can no longer continue in their current condition.

The breakdown of risk models and risk-management practices during the crisis also tells me that we must not view stress tests, other forms of quantitative analysis and models used by macroprudential supervisors as being a substitute or replacement for examiners and onsite supervision. In particular, the breakdown we have seen in models-based approaches suggests that we should not develop a false sense of security from the stress tests and other new supervisory tools we are now putting in place. While these tools can be useful additions to supervision, we must recognize the very important and unique role that examiners have in supervision and their ability to bring a strong sense of reality and caution to the oversight of the financial system. Microprudential supervision must remain an essential and central part of our supervisory framework.

Concluding Comments

We now face a real challenge in rebuilding our financial system and its supervisory framework. The steps we take today will either serve us well in the inevitable future financial shock, or they will sow the seeds of the next crisis. If we are to be successful, though, we must stop and ask ourselves what really went wrong this time and what can we do to construct a more stable and resilient financial system.

I would like to conclude with a thought very aptly expressed in the Central Bank of Norway's 2009 Financial Stability Report: "It is difficult to estimate the probability and price the risk of all possible outcomes in financial markets. This particularly applies to events that occur rarely and have not occurred for a long time...In the long term, public authorities have an important role to play in maintaining a collective memory of previous crises."