

Current Monetary Policy and the Implications for Supervision and Regulation

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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.

I am very pleased to be here today. This meeting provides an excellent opportunity to hear what others are doing to strengthen their supervisory systems, including those here in Africa. It also provides an important venue for turning our attention to the long-run implications of policies and what we can do to create a more-resilient financial system.

Financial supervisors and regulators are clearly facing unique challenges in the aftermath of the financial crisis. In the United States, financial institutions are stronger, although they still have not recovered fully from the problems they experienced during the crisis. Demand for credit has been relatively anemic during the domestic and global economic recovery, hindering efforts by these institutions to restore their lending business and other activities to more-normal levels. As supervisors, we face the additional challenge of implementing the many new laws and reforms that our countries have instituted in response to the crisis and to enhance financial stability.

There is another challenge that threatens to undermine our best supervisory efforts and could set the stage for instability if it is not addressed appropriately and in a timely manner. This challenge comes from the continued reliance on highly accommodative and unconventional monetary policies and the incentives such policies provide to pursue riskier banking and investment strategies. These policies have the effect of dampening the profitability of traditional banking activities, thus encouraging bankers and other market participants to look for greater returns in other, riskier areas.

Today, I will focus my remarks on the risks that current U.S. monetary policy poses to financial stability and the challenges it creates for supervisors. Then I will explore what steps supervisors might take to address these threats.

Current Monetary Policy and the Financial Implications

In response to the financial crisis, the Federal Reserve and other central banking authorities significantly lowered their policy rates during the financial crisis and have continued to hold these rates near zero. In some countries, these highly accommodative monetary policies have been supplemented by quantitative easing programs, expanded central bank lending authority and forward guidance statements committing central banks to hold rates low well into the future.

In the United States, the Federal Open Market Committee has held the federal funds rate in a 0 to ¼ percent range since December 2008. Furthermore, the Committee's forward guidance states that it anticipates maintaining these rates "well past the time that the unemployment rate drops below 6 1/2 percent, especially if projected inflation continues to run below the Committee's 2 percent longer-run goal."

To provide additional monetary stimulus, the Federal Reserve has also implemented three quantitative easing programs, involving extensive purchases of long-term U. S. Treasury securities and mortgage-backed securities issued by government sponsored enterprises. These efforts began in late 2008. Since September 2012, the Fed has been buying \$40 billion in mortgage-backed securities every month and about \$45 billion in long-term Treasuries—a policy that the FOMC announced last month would be tapered back by \$5 billion less in each category per month. This week the FOMC committed to another \$5 billion reduction in each of these categories. As shown in Chart 1, these quantitative easing programs have led to substantial expansion in the Federal Reserve's balance sheet—from around \$800 billion in late 2008 to more than \$4 trillion currently—and much of its traditional asset holdings have been replaced with longer-term Treasury and mortgage-backed securities.

The FOMC continues to support current levels of monetary accommodation as desirable and necessary as long as the growth in GDP and employment is slow and inflation remains low. Although the benefits of the current policy settings are presumed to outweigh potential costs, this tradeoff is not well understood. Accordingly, I remain concerned that continuation of these policies could have significant long-term costs.

The costs of accommodative policies, moreover, may not be confined to just the countries with expansive policies. Such policies can influence other countries by distorting their exchange rates and balance of payment positions, capital flows and rates of credit expansion.

As a former bank supervisor, I also am concerned about the effects of current monetary accommodation on the banking industry and financial stability. Simply put, holding the price of credit at near zero rates for years can negatively impact institutions whose primary business is making loans. As central banks undertake unprecedented actions to alter rates and prices in financial markets, we should not be surprised to find unintended, negative side effects.

Zero interest rate and quantitative easing policies clearly limit the returns that bankers can achieve in their traditional lending and investment activities, thus affecting the profitability of what we would view as essential banking activities. Beyond this, the forward guidance of central banks provides little assurance to bankers that this lending environment will improve—an outcome that is further compounded by modest economic growth and a more-limited pool of creditworthy borrowers for banks.

In addition, bankers face a great deal of uncertainty. Monetary policy has taken us far from a normal financial environment, and the influence that accommodative policy and quantitative easing will ultimately have on longer-term rates and inflation expectations is unclear. Similarly, some bankers are uncertain about how much of the surge in deposits produced

by accommodative monetary policies can be retained by their banks once interest rates and the competition for funds increase (See Chart 2).

As supervisors, we can conclude that this uncertainty and reduced profitability in traditional banking activities can provide a nearly irresistible incentive to expand into nontraditional and higher-risk activities. Bankers are also likely to “chase yields” by increasing their credit and interest rate exposures and by increasing their own leverage. There are signs that suggest we are already on this path—a path that is likely to become even more popular and enticing as financial competition increases and memories from the fears and threats of the financial crisis continue to fade.

Bank net interest margins are already near historic lows as loan rates remain compressed and traditional banking activities no longer generate the profits they once did (See Chart 3). As a result, low interest rate policies may have the adverse effect of impeding traditional bank lending channels and reducing the availability of funds for business expansion. It should be no surprise that bankers supply less credit when the returns are so low—an outcome that keeps the economy well below its potential and, hence, more vulnerable to possible shocks.

Several measures point to the banking industry taking on added risk in an attempt to restore profitability. While overall lending growth has been slow, the greatest growth appears to be taking place in higher-risk categories, including oil and gas lending and leveraged lending (See Chart 4). Much of the recent growth in leveraged lending, moreover, is characterized by weaker underwriting standards, including higher debt ratios and fewer covenant protections. This deterioration in credit standards may not yet be a serious concern, but it is reasonable to assume that lenders will be even more aggressive in relaxing their terms as they seek more business and attempt to counter a prolonged low rate environment.

In addition, more interest rate risk may be building up in the banking industry as bankers respond to incentives to move out along the yield curve to generate earnings. In this regard, there are signs that a rising number of banks are increasing their holdings of longer-term securities and loans—all at a time when long-term rates may rise as economic growth strengthens (See Chart 5).

A final outcome of unconventional monetary policy and the incentives created by low rates could be a repeat of some of the liquidity and asset bubble problems experienced during this crisis. For instance, “borrow short and lend long” strategies are likely to be an outgrowth of the current environment and could eventually lead to another round of liquidity problems. Also, while it is hard to identify asset bubbles with much certainty or timeliness, we have already seen rapid increases in farmland prices and stock prices in the United States (See Chart 6).

What Can Supervisors Do?

Even as we see improvements in our financial markets, these concerns suggest supervisors still face key challenges and must give serious thought to how such challenges might be addressed. Relative to the highly accommodative and unconventional monetary policy settings in the United States, initial steps have been taken to slow the pace of asset purchases. I view this as a modest but positive step, allowing financial markets to better price risk and allocate credit and to provide the proper incentives for conducting traditional banking services. However, until policy normalizes, supervisors must deal with whatever risks might arise.

Some would argue that recent financial reforms have left supervisors with a better set of tools to address the type of liquidity, capital and asset bubble problems recently encountered. Considerable effort has been made to create a new system of macroprudential supervision,

countercyclical capital standards, liquidity requirements, stress tests and enhanced supervision of systemically important institutions. These approaches require careful quantification and measurements of risk, massive data sets, forward-looking assessments and more model-driven approaches. As we gain further experience with these tools, they may indeed provide additional insights into financial markets and their vulnerabilities.

In implementing this new framework, though, there are a number of inherent problems and challenges. When is the right time to impose countercyclical capital buffers? Will policy and information lags and the time that must be given for institutions to raise capital mean that such actions will be delayed until they are no longer useful or are even counterproductive? A similar set of concerns surrounds stress testing. What are the right scenarios, and are all key risks incorporated into the tests?

We should also note that a number of central banks did engage in a form of macroprudential supervision before the crisis through their Financial Stability Reports. Overall, these reports show that potential risks were identified before the crisis, but it was far more difficult for central banks to judge whether these risks would be fully realized and to then pursue corrective supervisory action in an effective and timely manner. Consequently, while we continue to experiment with macroprudential supervision, we must place primary emphasis on a more traditional set of supervisory responses.

What steps should we be taking now in our role as supervisors? First, given that it will be difficult to identify and quickly respond to the risks emerging under current monetary policies, I would argue for continuing to strengthen bank capital through higher leverage ratios. Our experience in the recent financial crisis provides strong evidence that risk-based capital standards may fail to capture actual risk levels and can further be exploited by bankers.

As shown in Chart 7, the ratio of risk-weighted assets to total assets among large U.S. banking organizations steadily declined before the crisis. While this chart might imply that these organizations were shifting toward safer assets, the resulting losses from the crisis certainly did not correspond to lower levels of risk on their balance sheets.

Given the apparent shortcomings in risk-based capital standards, stronger leverage ratios are the simplest and most direct way to ensure adequate capital in banks. Consequently, as quickly as possible, we should move toward higher leverage ratios and set these ratios at levels that will provide enough capital in a broad range of adverse economic scenarios.

Second, we should take a careful look at what we allow banks to do. In particular, we should think about how we can encourage traditional activities and the risks that are most consistent with public safety nets. One approach we are taking in the United States is to restrict the proprietary trading activities of banking organizations through the Volcker Rule. These restrictions have not been easy to design, but they offer a way to limit the incentives for certain riskier activities that may seem attractive, especially now, to improve profitability.

A final point on strengthening supervision is that we must continue to emphasize microprudential supervision and the important role that bank examiners play. It seems clear that many factors behind the recent financial crisis might have been detected through traditional examination and supervisory processes if properly supported and performed correctly.

For example, lax lending standards, risky funding strategies, poor governance and overly optimistic risk-management strategies all played key roles in the crisis. Each of these is a factor that experienced examiners have the best chance of identifying at an early, remedial stage and then pursuing corrective action and improved bank risk-management practices. In contrast, these risks and weaknesses may be difficult to estimate until much later and are thus likely to escape

timely detection if we rely primarily on purely quantitative approaches and other elements of macroprudential supervision.

To the extent similar weaknesses emerge as an outgrowth of current monetary policies and risk appetites, strong examination processes are a critical element in flagging such risks at the firm level. However, limiting the conditions or incentives for risk-taking and their broader effects on financial stability must be recognized as beyond the scope of supervision

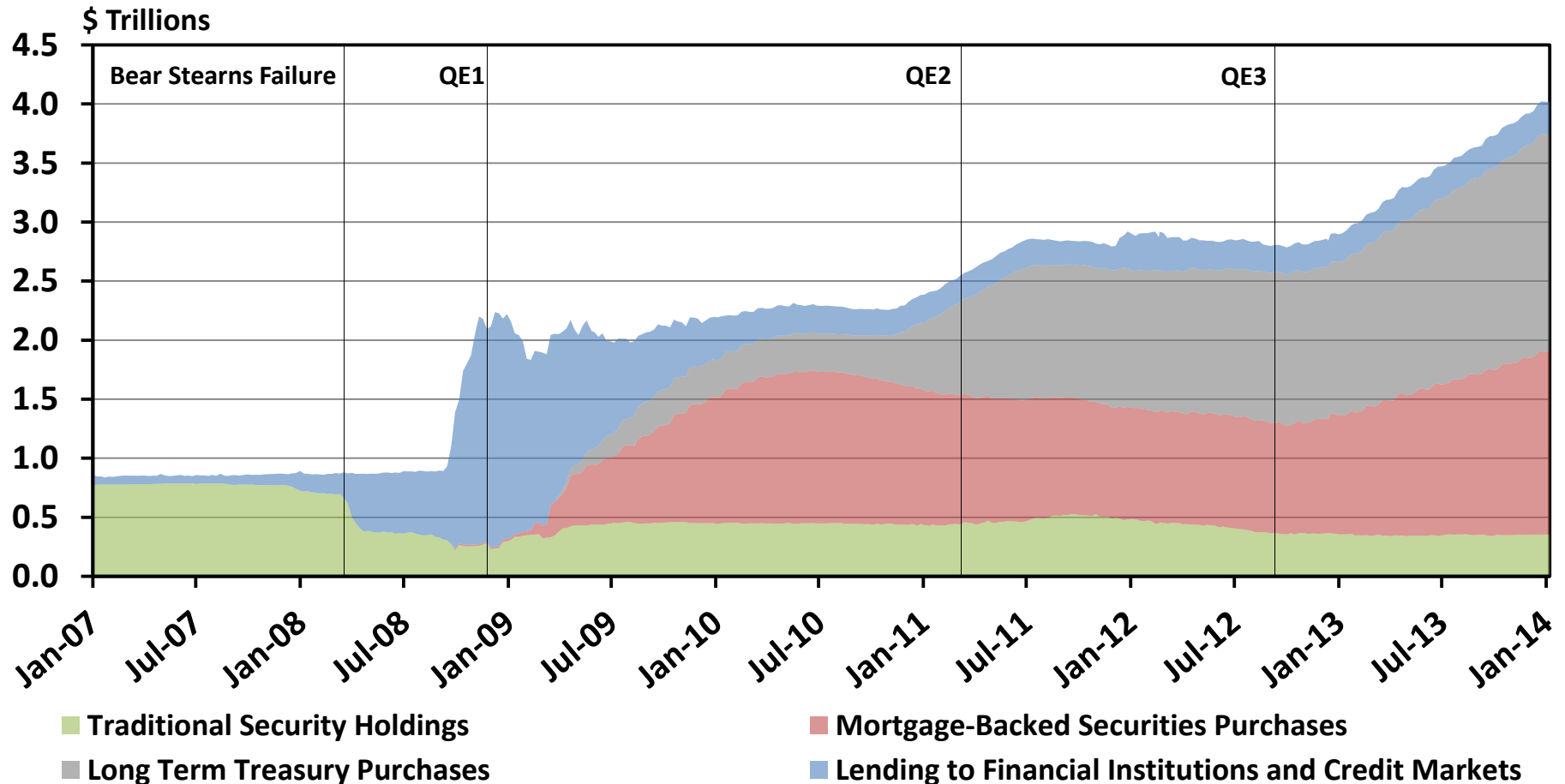
Concluding Comments

Supervisors face a number of challenges associated with implementing new rules and reforms, but they must also remain attentive to the incentives for risk-taking in an unusually low and prolonged interest rate environment. The incentives to reach for yield and boost profitability pose particular challenges for supervisors and could introduce undesirable and destabilizing conditions.

Although recent financial reforms have given supervisors a broad range of new tools, considerable value remains to affect supervisory outcomes through the microprudential tools we already have. Key steps we can and should take include imposing stronger leverage requirements, focusing banking activities on traditional credit intermediation functions, and using experienced and skilled examiners to apply informed judgments in the identification of emerging risks and unsound banking strategies.

Chart 1

Rapid Expansion in the Federal Reserve Balance Sheet

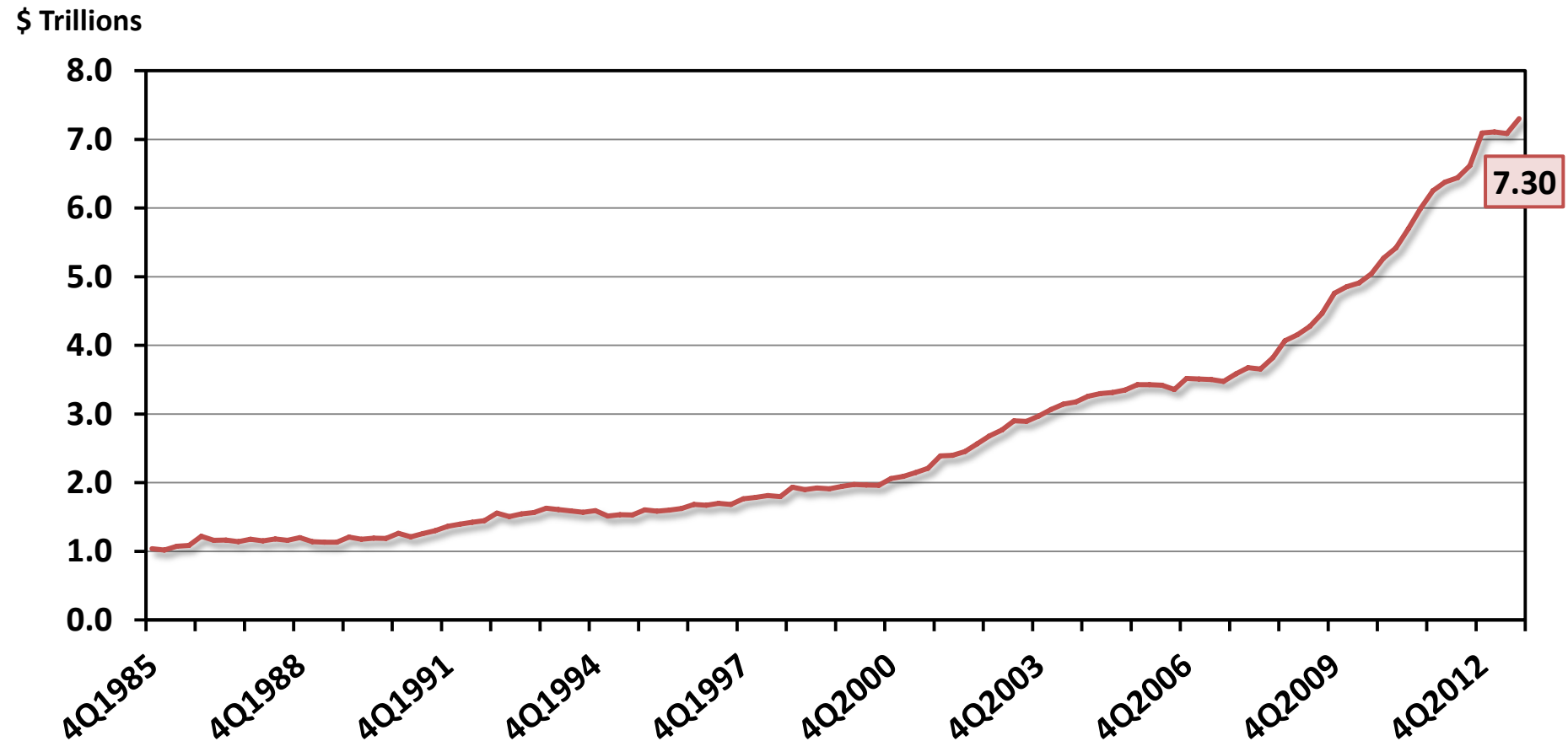


Source: Federal Reserve Bank of Cleveland – Credit Easing Policy Tool



Chart 2

Bank Deposits Have Surged Since the Crisis*



7.30

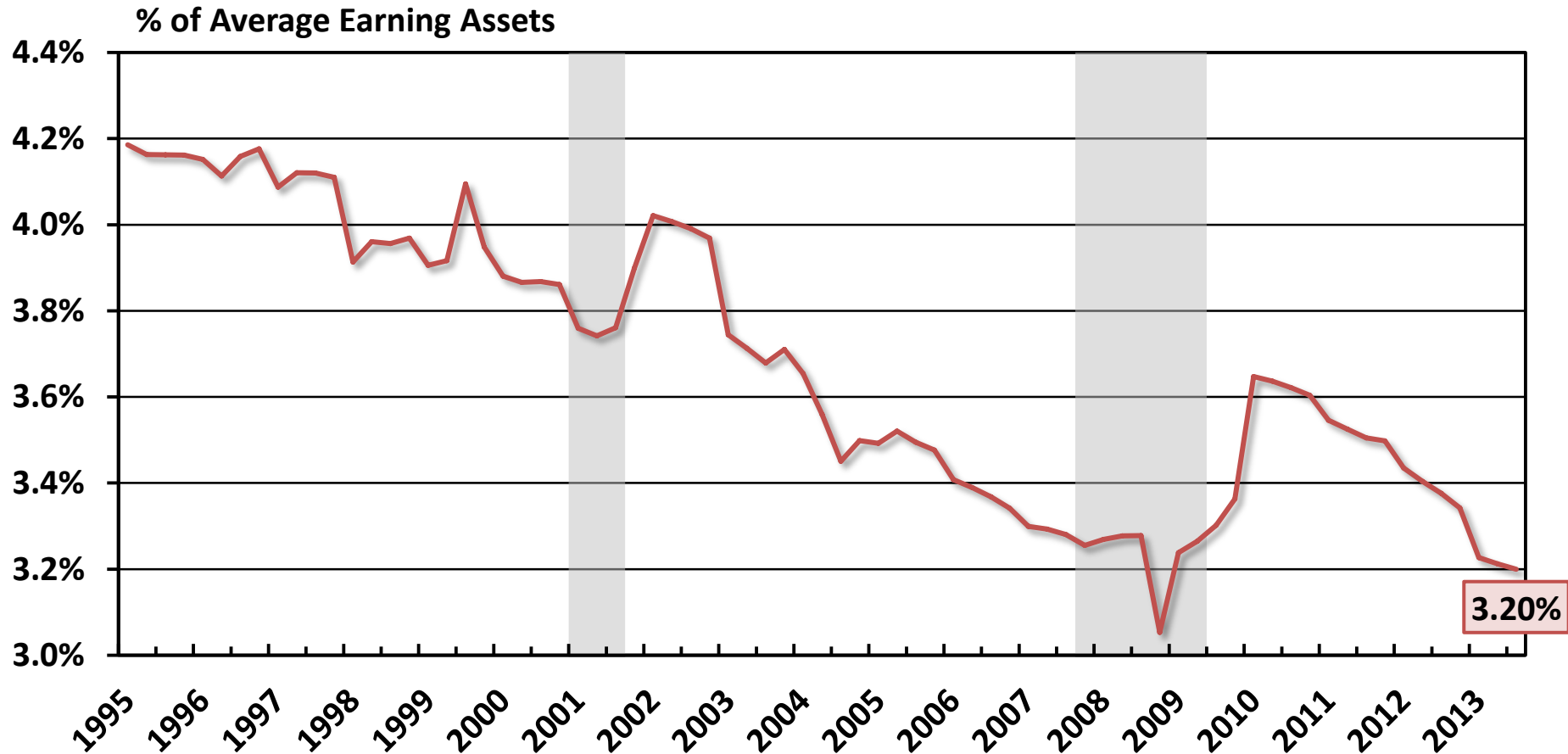
* Excludes Time Deposits

Source: Reports of Condition and Income



Chart 3

Bank Net Interest Margins Have Declined

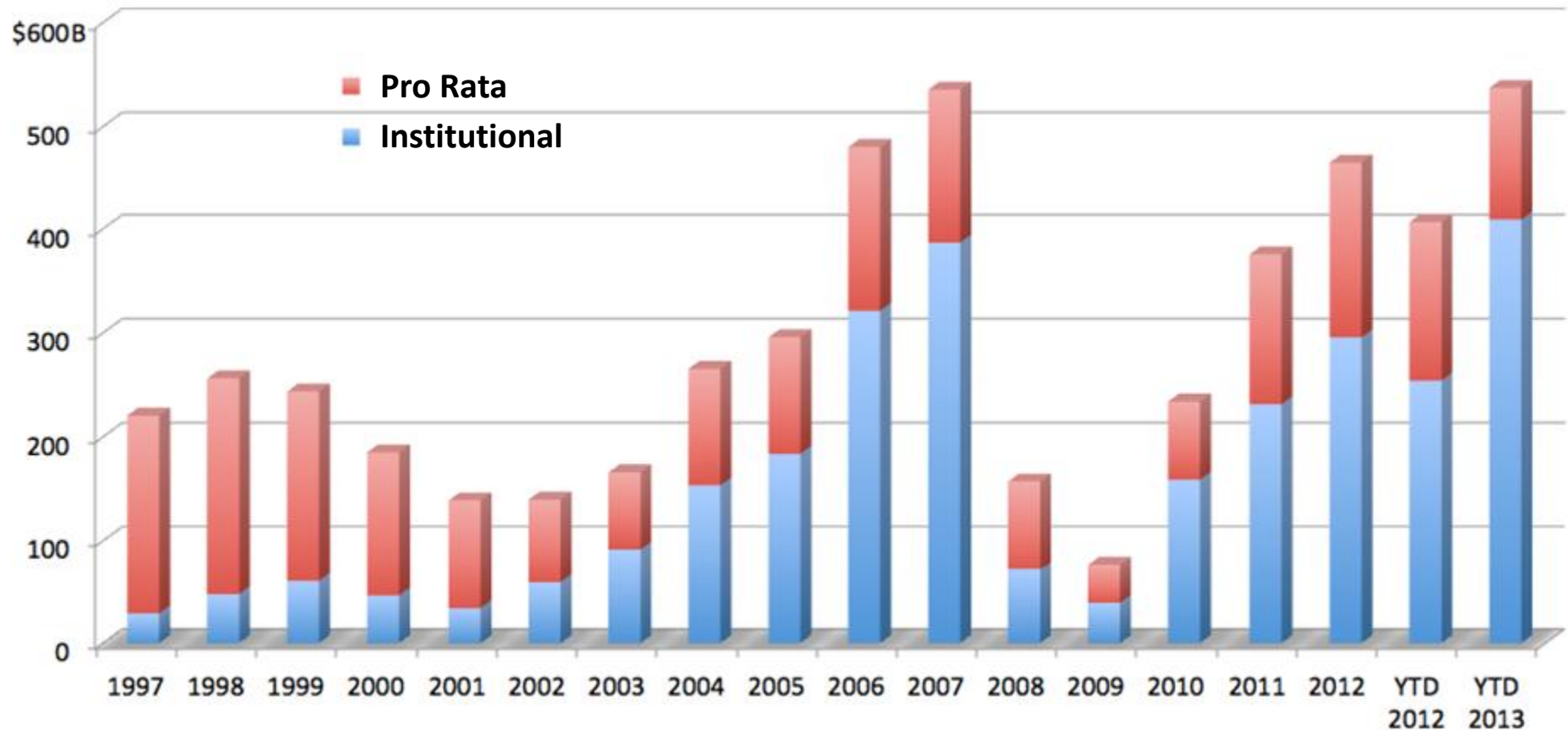


Notes: Net interest margin is measured as interest income net of interest expense (YTD), as a percentage of average earning assets - annualized.
Source: Reports of Condition and Income



Chart 4

Leveraged Loan Issuance Surpasses 2007 Peak



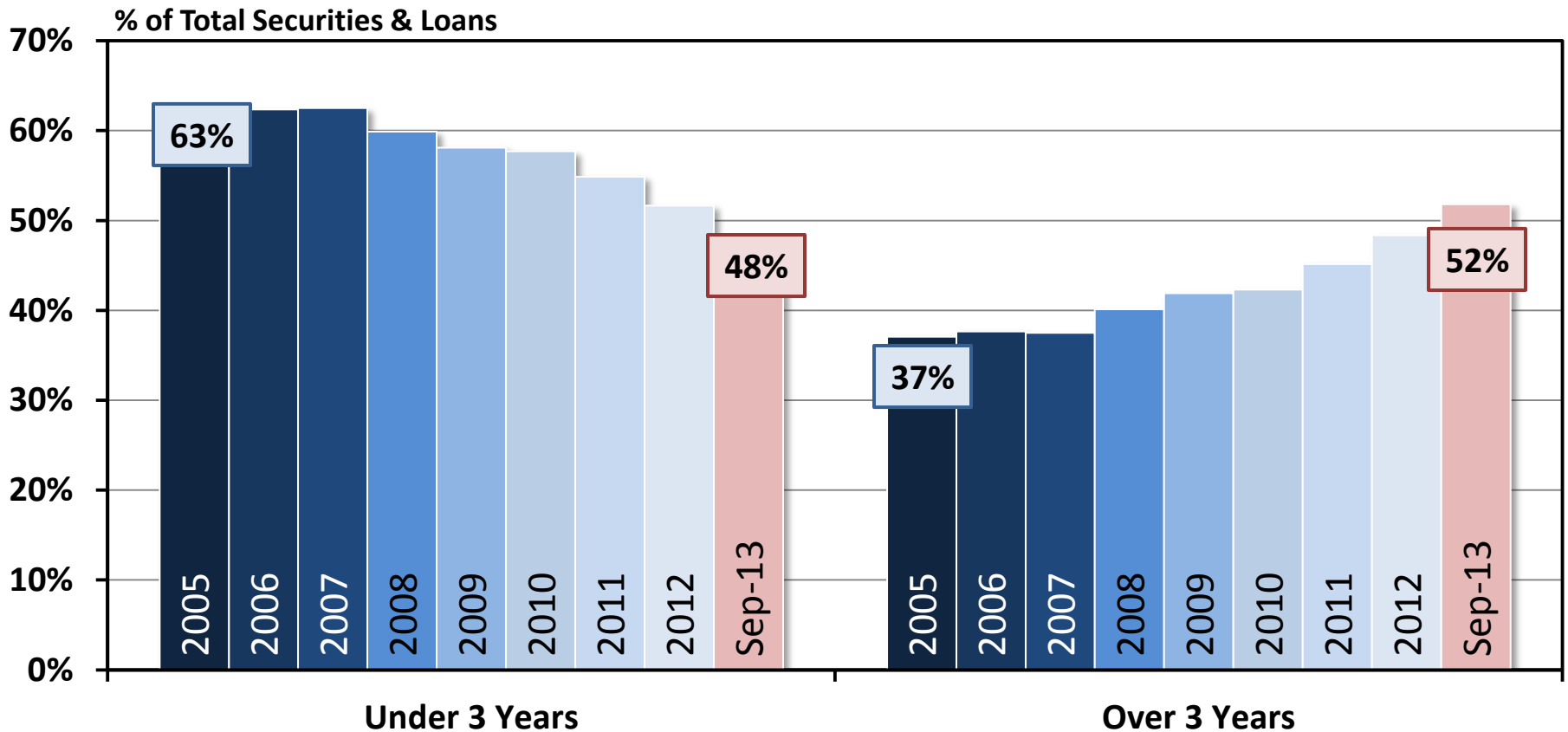
Source: S&P Capital IQ/LCD



Chart 5

Increased Holdings of Longer-Term Securities & Loans

(Commercial Banks Under \$50 Billion)



Under 3 Years

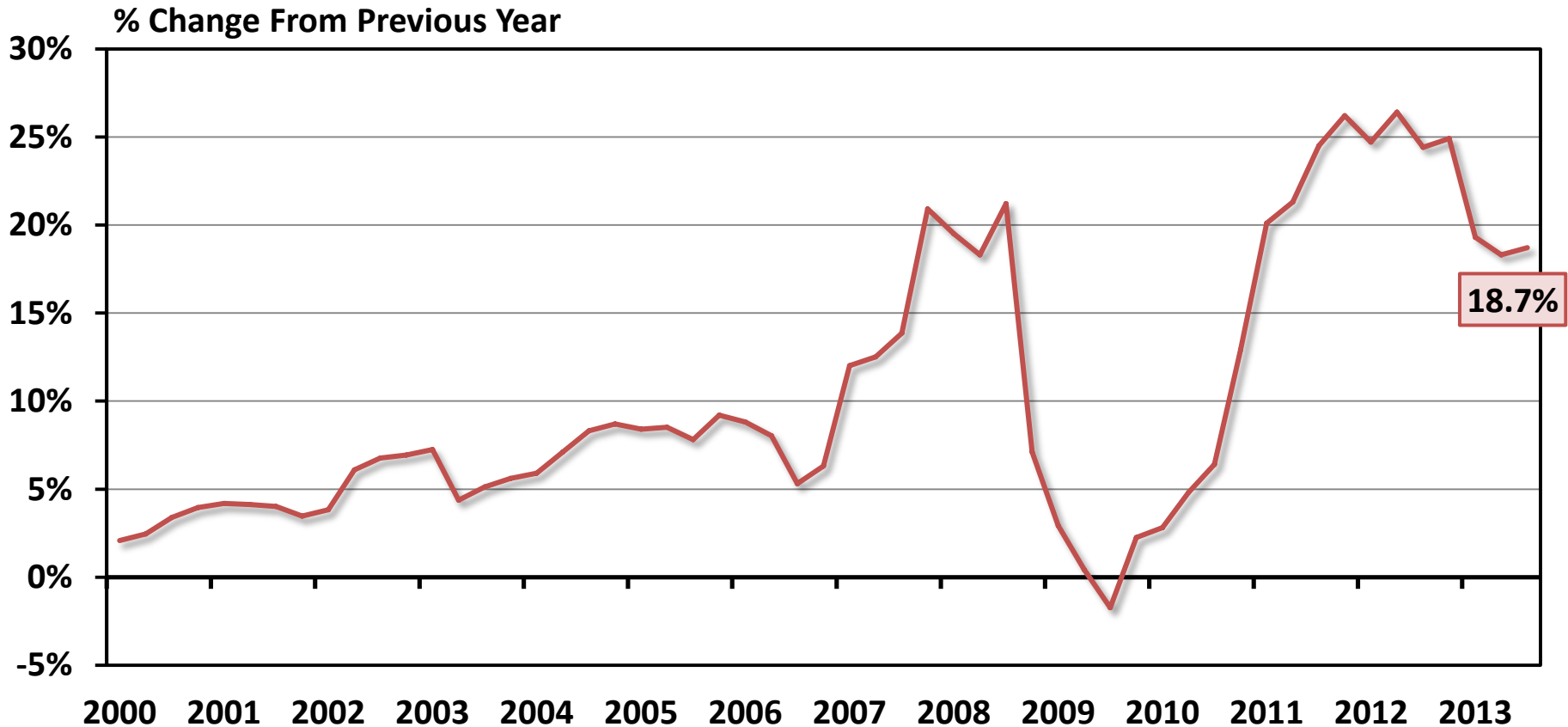
Over 3 Years

Source: Reports of Condition and Income



Chart 6

Annual Percentage Increase in Midwest Farmland Values



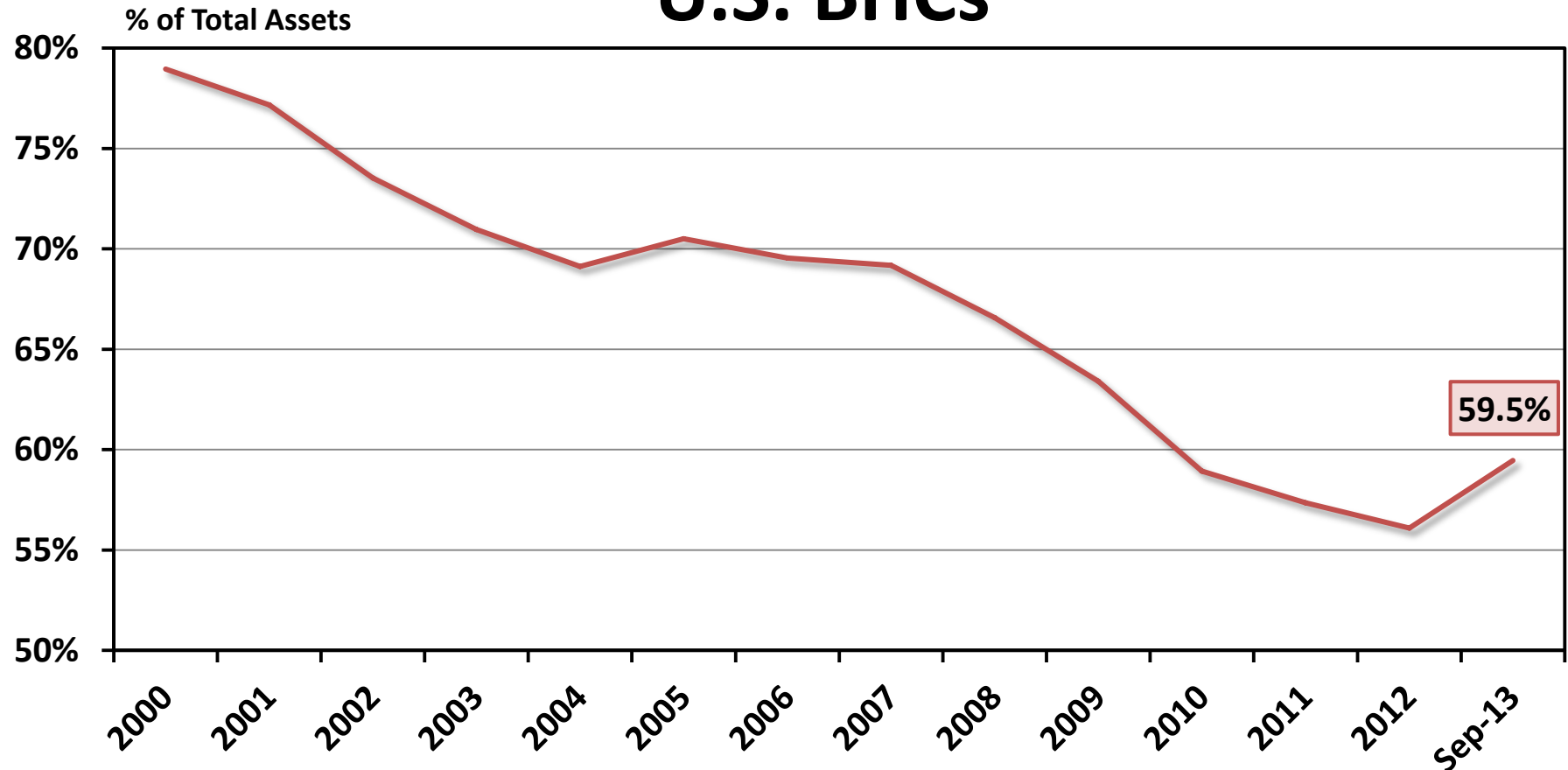
* Non-irrigated Farmland

Source: Kansas City Federal Reserve's quarterly Survey of Agricultural Credit Conditions



Chart 7

Risk-Weighted Assets at the Ten Largest U.S. BHCs



Notes: Depending on the year, the chart excludes MetLife and foreign BHCs.

Source: Reports of Condition and Income

