

Supervisory Frameworks and Monetary Policy

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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.

Thank you for the invitation to speak this evening. It is an honor to address such a distinguished group on an important topic. Given the events of the past several years, this conference's focus on "Frameworks for Central Banking in the Next Century" is certainly fitting. Central banks are grappling to apply the lessons of history in the context of today's economic realities, and I expect this forum will contribute importantly to that essential evolution.

One issue that the crisis has pushed to the forefront is the relationship between macroeconomics and finance, and how we think about the footings of financial stability. My comments this evening will focus briefly on this intersection of monetary policy and supervisory and regulatory issues. I am convinced that promoting financial stability requires a comprehensive approach that uses both macroprudential tools and the examination of individual firms, relying on the judgment of experienced examiners. In addition, I am skeptical of a clean "separation principle" that places financial stability squarely in the purview of the supervisors. Instead, I think monetary policymakers also need to maintain a careful eye on the financial system and how interest rate policy affects incentives for financial markets and institutions.

As usual, my comments today reflect my own views and not necessarily those of the Federal Open Market Committee (FOMC) or the Federal Reserve System.

The path of policy and incentives

A primary mission of financial regulators and supervisors is to foster financial stability by monitoring the health of individual financial institutions. Broader financial conditions also play an important role in achieving these objectives. In some respects, financial institutions are stronger today than prior to the crisis, but I remain concerned about how the stance of monetary policy is affecting their incentives and attitudes toward risk. As a result of near-zero interest rates

for five years, the profitability of traditional banking activities is strained and incentives to reach for yield are tempting. Net interest margins continue to trend lower and are at their lowest level in 30 years. Banks are responding as we should expect, which is to say they are engaging in riskier activities. For example, an all-time high of \$600 billion of leveraged loans were issued in 2013. This lending is often characterized by weaker underwriting standards, including higher debt ratios and fewer covenant provisions.

The incentives to reach for yield extend to smaller financial institutions as well. Commercial banks with assets of less than \$50 billion have increased exposure to interest rate risk, due in part to the guidance the FOMC has provided regarding future interest rates. Today, 53 percent of the securities and loans held by these banks have maturities of more than three years, compared to about 37 percent back in 2005. If longer-term interest rates were to suddenly move higher, these institutions could face heavy losses. These conditions create a challenging climate for supervisors. Not only are they implementing many new rules associated with regulatory reform, but they also are monitoring these and other areas of increased risk-taking.

Having just painted a picture where the extended, low-rate environment adversely affects traditional banking activities, the question is, What steps might be taken to address it and its effects?

First, I would like to see short-term interest rates move higher in response to improving economic conditions shortly after completion of the “taper.” Many of the rules offering policy guidance on the federal funds rate—such as the “Taylor rule” and its variants—are already or close to prescribing a policy rate higher than the current funds rate. Second, the path toward the longer-term neutral funds should be gradual. Given the lengthy period of unconventional policy and low rates, the necessary adjustment by financial markets to less central bank intervention and

influence could be volatile. In this environment, the pressure to quickly back away from a rising rate policy will be significant; such pressures will need to be resisted. If not, we risk moving into a confusing stop-and-go policy environment.

In terms of the path after liftoff, the FOMC has signaled that it will take a gradual approach toward the longer-run funds rate. For example, the median of the latest FOMC Summary of Economic Projections shows the economy reaching full employment and inflation at the 2 percent target at the end of 2016. Such conditions, under more normal circumstances, would imply the federal funds rate should be at, or at least near, its longer-run level. However, the federal funds rate is expected to be 2¼ percent by year-end 2016, compared to a median of 4 percent in the longer run. So, the funds rate could reach its longer-run level well after the economic recovery is complete and inflation has returned to the 2 percent goal.

These signals suggest to banks that they will continue to contend with a low interest rate environment for a few years, even as economic conditions are likely to improve. I see this as a set of conditions ripe for greater risk-taking as firms reach for yield and the imbalances related to such incentives grow.

Gradualism can promote financial stability, as it reduces the incidence of unexpected shifts in interest rates. Even so, the degree of inertia suggested in the median path of the federal funds rate in the FOMC's Summary of Economic Projections goes beyond what is required to achieve a smooth exit. In my view, it will likely be appropriate to raise the federal funds rate at a somewhat faster pace than the median of committee members' projections. Low rates into late 2016 will likely continue to provide incentives for financial markets and investors to reach for yield in an economy operating at full capacity and risks achieving our objectives over the longer run.

A comprehensive approach to supervision

Given this landscape, how can bank supervisors respond? I will begin here by noting that substantial efforts have been devoted to enhanced macroprudential supervision and requirements aimed at strengthening bank balance sheets. Higher leverage ratios, liquidity requirements, stress tests and enhanced supervision of systemically important financial institutions are designed to contribute to a more stable financial system in the future. However, our experience with these tools and the model-driven approaches when evaluating the balance sheets of large financial institutions is limited. For example, counter-cyclical capital buffers lack a type of “Taylor rule” that would help guide us on when to make adjustments. Absent a rule for guidance, knowing the right time to adjust the buffers and by how much pose considerable challenges.

I would 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.

Until we better understand how to utilize such tools, macroprudential supervision and the identification of systemic risk can be most effective when it serves as a complement to a rigorous microprudential regime. Assessing risk-management policies and governance offers a window into the incentives that drive decision-making and risk appetite at the level of an individual firm, providing important context for macro views of the system.

Enhanced supervision over the past few years has focused more heavily on the role of quantitative models rather than experienced bank examiners. These contributions surely have

been important complements to the supervisory regime. But they are not a substitute for the perspectives of bank examiners. Macroprudential tools take a different approach to the supervisory process than a commissioned bank examiner in two ways: The credentialing process for examiners involves hands-on experience and assigns accountability to the findings of an examination. Early training includes classroom time in addition to work on bank analysis and transaction testing. Once an examiner is credentialed, that person can be the Examiner-in-Charge (EIC). As the EIC, you sign the examination report. And when you sign the examination report, you are accountable for the judgments and assessments contained in the report.

I take a similar approach to monetary policy. Economic analysis from my staff provides a useful high-level overview of economic trends and issues relevant to monetary policy. I feel most confident when their analysis is consistent with anecdotes from my contacts, who are operating businesses and making real-time hiring and pricing decisions. The macro view complements the micro information, and vice versa. In the same way, this dynamic applies to financial supervision.

Thus, an effective supervisory framework blends the new quantitative macrosupervisory approaches with the qualitative judgments that supervisors bring from examining individual firms. So, as we experiment with macroprudential tools, we also must continue to devote resources to and emphasize microprudential supervision. In addition, strengthening bank capital with sturdier and higher leverage ratios is an essential and prudent course of action. Recent changes along these lines are encouraging. For example, I see the enhanced supplementary leverage ratio as a positive step that avoids relying on risk-based capital standards, which can be exploited.

Conclusion

Certainly, the frameworks for central banking in the future are evolving and include all of the topics being discussed during this conference. They also will require a healthy dose of thinking—and humility—about the interaction between regulatory and interest rate policy if sustainable economic growth is to be achieved. Interest rate policy needs to adjust to achieve price stability and sustainable growth, both now and in the future. However, we have seen how asset bubbles can derail these goals. Finding the intersection of supervisory and interest rate policy to achieve financial stability will be an important contribution to central banking in the next century.