

Securing Economic and Financial Stability

Remarks By

Esther L. George
President and Chief Executive Officer
Federal Reserve Bank of Kansas City

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Looking Back and Looking Forward: How Do We Preserve Monetary and Financial Stability?
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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.

Good afternoon. I want to thank the organizers and, in particular, Már and the Central Bank of Iceland for inviting me to participate in this program. It is timely to consider the lessons looking back and to continue to do the hard work of implementing needed change to secure and preserve monetary and financial stability. Preserving that stability is especially important today as central banks work within more limited policy space and, to varying degrees, under challenges to independence.

This month marks the tenth year of expansion of the U.S. economy, now the longest economic expansion in its history. This long period of expansion has been one of generally moderate growth, but also a period during which the stance of monetary policy remained accommodative for many years, only recently approaching what appears to be a neutral level. The unemployment rate, currently at 3.7 percent, remains below most assessments of its long-run natural level and stands in stark contrast to its peak of 10 percent nearly a decade ago. Inflation has remained low and relatively stable throughout this period even as labor markets tightened, wages moved higher and domestic demand grew. After years of accommodative policy, the U.S. economy appears to be performing reasonably well notwithstanding the emerging downside risks coming from slower global growth and trade policy uncertainty. Even as the U.S. economy has achieved a degree of stability, the prolonged low rate environment accompanied by unconventional policy has increased risk appetites and influenced asset values. And signs of financial imbalances are growing, while capital in the nation's largest banking organizations is not.

Securing economic and financial stability for the long-run health of the macroeconomy requires balancing monetary policy calibration with an understanding of potential vulnerabilities in the financial system. This remains a focus in the United States. My comments today will look

at the nature of current financial vulnerabilities and the challenges I see associated with responding to those vulnerabilities at this stage of the expansion.

The Expanded Regulatory Toolkit

Following the 2008-09 financial crisis, massive regulatory change came from legislation known as the 2010 Dodd-Frank Act and revamped supervisory approaches and keener attention to financial stability. Among improvements in U.S. bank regulatory policy and the tools implemented to evaluate and promote financial stability, the supervisory stress tests have been a key innovation for assessing the level of capital in the banking system. This analytical exercise provides a quantitative and comprehensive process for evaluating the sufficiency of an individual bank's capital, as well as aggregate levels of capital in the system, to offset losses that stem from a simulated stress environment. In addition to stress testing, regulatory capital requirements for the largest banks have been strengthened through more rigorous risk-weighting approaches and increased leverage capital requirements. To address cyclical concerns about financial stability risk, the Federal Reserve now has the authority to impose a countercyclical capital buffer (CCyB) requirement on the largest banks. On the other hand, its authorities related to its role as lender of last resort were constrained.

Regulatory changes for the largest banks also have improved their liquidity cushions. These firms now hold a larger amount of high-quality liquid assets and must routinely demonstrate their ability to meet short-term liquidity demands. Efforts are underway to develop requirements to address longer-term liquidity risk.

In addition, U.S. regulators implemented structural reforms in derivatives markets, including promotion of central clearing and swap execution facilities, margin requirements,

improved reporting, and bank capital rules for derivatives. Money market mutual fund regulations were implemented to reduce run risk in these funds. Finally, the Financial Stability Oversight Council was formed along with the Office of Financial Research.

Taken together, these changes undoubtedly have improved the overall health and resiliency of the U.S. financial system. Whether these steps will prove robust to a future shock however has yet to be tested.

Identifying Vulnerabilities

Identifying vulnerabilities has taken on renewed focus. To that end, the Federal Reserve publishes its assessment of risks and vulnerabilities in the economy twice each year. The framework used by the Fed looks at vulnerabilities across four dimensions: 1) asset valuations; 2) household and business debt; 3) leverage in the financial sector; and 4) funding risks.

The most recent financial stability report highlights a variety of risks and vulnerabilities. Among them, for example, corporate leverage in the United States has grown rapidly and is at a record level. The amount of outstanding debt among the corporate sector in the United States has grown to an unprecedented amount during the long expansionary period. Non-financial corporations now have approximately \$6 trillion in outstanding debt, roughly twice the amount of debt outstanding at the beginning of the expansion. Much of the growth in corporate debt outstanding is due to borrowing by firms that were already highly leveraged.

The ratings for many of these corporate bonds are at the margin of investment grade and are at risk of being downgraded if economic conditions were to deteriorate. In addition, the standards for leveraged corporate loans have declined steadily in recent years as loan structures and covenants have weakened.

With much of the recent growth in leveraged borrowing funded by non-bank lenders, vulnerabilities that originate outside the banking sector could pose substantial challenges for both the macroeconomy and U.S. banks during times of financial stress. Close links between the traditional banking sector and the so-called shadow banking sector are evident, but not well-understood. However, disruptions in the corporate debt markets are likely to flow through these links and raise demands for short-term funding from banks during a period of market stress. A decline in investor demand for corporate debt could also create loan syndicate pipeline risk and downward pressure on values that would have adverse impacts on banks. More broadly, a disruption in corporate debt markets could cause broader spillover effects on other assets classes, where values are currently elevated, adversely impacting overall bank health and the macroeconomy. For this reason, a focus on the stability of the banking system is essential.

Identifying risks is clearly important. Equally important is understanding what tools are at our disposal to address such concerns. In the case of the United States, this is very much a work in progress.

In my view, monetary policy settings are not well suited to react, notwithstanding the effect it may have in influencing the conditions around risk and investor's reach for yield. And, it seems to me, macroprudential approaches are desirable in theory but face considerable challenge around the age-old issues of being delivered timely and potently, at least in the United States' experience. Other countries have different macroprudential loan-to-value measures to use.

Within the Federal Reserve, a number of my colleagues and I participated in a tabletop exercise a few years ago. The exercise was designed to assess the efficacy of certain macroprudential tools in responding to a hypothetical financial crisis. In the exercise, we examined the use of capital-based, liquidity-based, and credit-based tools, along with stress

testing and supervisory guidance in mitigating the effects of an overheating of the financial markets. What we discovered in conducting the exercise was that the effectiveness of the tools varied because of realities like implementation lags and/or limited scope. Clearly, this particular exercise is not conclusive in all scenarios, but it cautions against becoming overly confident in relying on macroprudential tools to address growing financial imbalances.¹

I'd like to mention two potential macroprudential approaches in play: the CCyB and stress testing.

The CCyB, as I noted earlier, is a new authority granted the Federal Reserve post-financial crisis. Based on the framework approved by the Federal Reserve Board in 2016, the CCyB is designed to be implemented while economic growth is healthy, bank profitability is rising and financial stability risks are “contained, but above normal.”

Based on the Federal Reserve Board’s assessment, the CCyB has not been deployed and remains at zero, concluding that financial risk is not meaningfully above normal.

A second tool, stress testing, has been considered. The supervisory stress tests have been viewed as a more dynamic method for evaluating capital against vulnerabilities. Stress tests are forward looking, and by choosing adverse scenarios carefully, the tests can be used to measure exposure to specific risks, such as those associated with real estate or rapidly growing corporate leverage. While the stress testing exercise has been a useful tool to gauge bank capitalization and promote safety and soundness, the underlying assumptions are subject to certain limitations. All model results have some degree of uncertainty, especially when the current vulnerabilities, such as in leveraged corporate debt, represent uncharted territory. Stress test results need to be interpreted carefully and used among other indicators of resiliency.

¹ Tobias Adrian, Patrick de Fontnouvelle, Emily Yang, and Andrei Zlate, “Macro-prudential Policy: A Case Study from a Tabletop Exercise,” FRBNY Economic Policy Review, February 2017.

Some have argued that stress tests are counter-cyclical in that more stringent scenarios created during good times encourage (even require) banks to build capital during periods of economic growth, thereby preparing for future downturns. I find little evidence that stress tests have done this. The latest results of the Federal Reserve stress tests that were released last month concluded all have sufficient capital and all were permitted to proceed with capital distribution and stock buybacks. Despite continued economic growth, actual capital ratios on a consolidated basis for the largest banking organizations have not increased in recent years.² Instead, Supplementary Leverage Ratios (SLRs) have declined in recent years. In addition, recent research has shown that the stress tests have not required banks to build capital.³ After distributions and stock buybacks, the losses (declines in capital) in stress scenarios have been smaller over the last few years. Banks only need to add capital (or reduce capital distributions) when losses push projected capital ratios below required minimums. These results suggest that stress tests cannot be relied upon to make banks build capital as we progress through the economic cycle. The prospect of the stress tests not having the desired counter-cyclical outcomes should have the attention of bank regulators and supervisors against a backdrop of increasing vulnerabilities.

Conclusion

² For the larger “advanced approaches” banking organizations, the average Tier 1 leverage ratio declined from 9.0 percent at December 2016 to 8.7 percent at December 2017 to 8.5 percent at December 2018.

³ Berrospide, Jose, Andrew Cohen, Ronel Elul, David Hou, Aytek Malkhozov, Marc Rodriguez, and Robert Sarama (2019). “Cyclicality and the Severity of the U.S. Supervisory Stress Test: 2014 to 2018,” FEDS Notes. Washington: Board of Governors of the Federal Reserve System, June 7, 2019, <https://doi.org/10.17016/2380-7172.2393>.

Looking back, the lessons of the financial crisis should remain in front of us. They were costly to learn.

Even as we work to develop the most effective macroprudential tools, we must take to heart the important lesson of bank capital as the single most important element in our framework for financial stability. It serves as a buffer. Whether or not our judgments about the size or scope or timing of risk is properly judged, higher capitalized banks have been shown to lend through the cycle at a higher rate than those with lower capital and are much less likely to fail.

If we are to secure economic financial stability for the future, building stronger capital is essential.