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SPEECH

Introductory Remarks for the Panel on Regulating Financial Markets: Lessons from Crisis Management

May 29, 2013
Posted May 31, 2013

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Introductory Remarks for the Panel Discussion Sponsored by the Heller-Hurwicz Economics Institute and the Economic Club of Minnesota at the University of Minnesota, Minneapolis
As prepared for delivery

Opening

It is an honor to speak here at the University, especially as an alumna.

I'll be expressing my own views, not those of the Federal Reserve System or the Federal Reserve Bank of New York.

We're all familiar with the arc of a financial crisis—a period of building financial imbalances or excesses, a sharp break to a "distress" period of liquidity and credit strains, financial losses, and other financial dislocations, and a recovery and repair period.

I'd like to focus on the second two crisis phases—stabilizing distress in the downdraft and advancing the recovery and repair process in the financial system.

Stabilization

In a crisis, both market prices and transaction activity fall precipitously, reflecting a powerful shift in the willingness of market participants to take risk. Several factors contribute to the pullback: downward revisions to expected losses (that is, the expectation of bigger losses), uncertainty about the actual distribution of gains and losses, and defensive positioning ("hunkering down"). The pullback by market participants effectively dries up credit and liquidity.

When that pullback occurs, financial institutions simply can't run off or liquidate assets fast enough to meet their maturing obligations, given the leveraged nature of financial institutions. Financial firms are forced to cut back credit extension and liquidity services, and if the cut back Is severe enough, they and their customers begin to deleverage and cut expenses; in the extreme, the customers may be forced to default—not because they are insolvent, but because they are illiquid. The liquidity squeeze creates a self-reinforcing contractionary spiral—for example, as financial and other firms liquidate assets, prices fall to fire-sale levels and a new round of liquidity squeeze is triggered. We saw the contractionary spiral in the worst of the crisis, Q4 2008 to Q1 2009, and it persisted for some time after.

Central banks provide a "lender of last resort function" in these situations to offset the liquidity and credit contraction. The basic prescription as set out by Bagehot is to lend freely against good collateral at a penalty rate of interest. In the U.S., the Fed's discount window involves lending against good collateral to banks. But in 2007-2010, the Fed went well beyond traditional discount window lending. In designing its liquidity and lending programs, the Fed had to address several problems with discount window lending as it is commonly understood.

- Stigma—reluctance to borrow at the window because firms that did were perceived as "weak"
- Market function—avoiding displacing the private market mechanism
- Exit—in the U.S., the discount rate has been traditionally lower than market rates—not a penalty rate. Thus, if not limited in some way, banks have an incentive to borrow as much as possible from the discount window, making exit difficult.
- Historical evidence of a diminution of channels through which discount window lending to banks reaches the rest of the financial system and the private sector. The financial system is efficient at collecting small funds and aggregating them to large flows, but has a harder time pushing money back through the financial system.

Stigma could be addressed by moving to market rates and using a market mechanism.

- Started in the fall of 2007, the Term Auction Facility, or TAF, conducted auctions for discount window collateral, market rate and a market mechanism to distribute it.

But as the financial crisis worsened, discount window lending to the banks wasn't sufficient. The Fed chose to lend directly to nonbanks through authority in Section 13(3) of the Federal Reserve Act. To use that authority, the Federal Reserve Board has to find that unusual and exigent conditions exist (in funding markets); the relevant Reserve Bank (in most cases, New York) has to find that it can be secured to its satisfaction.

To avoid atrophying private financial market mechanisms, the Fed designed several facilities to "backstop" private credit extension. For example in the Commercial Paper Funding Facility (CPFF), the goal was to make commercial paper (CP) investors more comfortable continuing to fund corporations by making it possible for a CP investor to bring commercial paper to the Federal Reserve to be monetized at a discount. And indeed, as soon as the Federal Reserve opened the CPFF, CP spreads over Treasury bills began declining. The Fed used a similar approach to backstop the repo market through the Primary Dealer Credit Facility (PDCF).

Exit was dealt with by pricing the credit above normal market rates but below the much higher rates found in the marketplace as conditions deteriorated.   Indeed, the PDCF and CPFF wound down well before their announced expiration dates. This was because the credit was priced at a premium to historical market rates, but well below the rates prevailing in the spring of 2008 and the fall of 2008 respectively. As markets calmed and market rates fell, the credit came to be seen as expensive.

I should note that other lending facilities attracted more controversy: The Maiden Lane portfolio (associated with the Bear Stearns merger) and the large loan to AIG and to Maiden Lanes II and III were more "single credit" in nature. The Dodd-Frank Act has effectively eliminated the Fed's ability to provide that kind of credit.

I'd emphasize that providing liquidity facilities such as CPFF and PDCF to stabilize the financial system is a bridge—it is not a destination. Liquidity buys time, but to have fulfilled its purpose, market participants and governmental bodies need to take the necessary actions of repair and recovery.

Recovery and Repair

Recovery and repair has two dimensions. The first is the process of healing financial institutions.   During the early 1990s, when the major banks were struggling with large, deteriorating exposures to commercial real estate and leveraged buyouts, the Federal Reserve employed a three-part program that still has great relevance today.

- Recapitalize the institution and restore liquidity.
- Identify all troubled exposures and place them in workout.
- Develop a new business plan.

The elements were interlinked: the new business plan helped with raising capital and the identification of credit problems and potential losses is key to determining capital adequacy.

If we think about the recovery process for financial institutions since the financial crisis, we can see that the framework can be applied. The large stress test that occurred in the spring of 2009, called the S-CAP, was a process that sought to identify all problematic exposures and to determine the bank's true capital need in a comprehensive manner and with a high degree of rigor and sophistication.

But the framework hasn't been fully completed. In my personal view financial institutions are just starting to come to grips with their business model. We've seen a few banks announce reductions in their capital markets activities and renewed focus on their activities in relationships directly with consumers and business. I think it likely we'll hear more.

The second dimension of recovery and repair is strengthening the regulatory framework, corporate governance arrangements and the financial infrastructure to prevent a recurrence of the factors that led to the crisis. So, for example, the Dodd-Frank Act seeks to address a number of shortcomings that were believed to contribute to the financial crisis: gaps in resolution authority, especially for systemic banking companies and nonbank companies; a level supervisory and regulatory playing field, including consolidated supervision, for all systemically important financial institutions; and a forum for coordination across the many Federal financial regulators, to name three of the most important. Outside of Dodd-Frank, stronger international capital requirements and resolution planning are intended to reduce the too-big-to-fail problems.

But issues remain. A good example is the operation of U.S. money markets—as noted in the recent Financial Stability Oversight Council (FSOC) report, we still have some of the vulnerabilities in the wholesale funding markets that led to the Fed's intervention: triparty repo, and the risk of money market mutual funds breaking the buck. The whole set of issues around the Volcker rule in the U.S., the Vickers report in the UK, and the Liikanen report in Europe are addressing the role of capital markets within financial institutions and how those relate to the traditional commercial banking activities—how separate, how big.   And we are still wrestling with the corporate governance challenges revealed in the crisis—how independent boards of directors are from management; the role of the risk manager within the financial firm.

Addressing the unfinished business of the crisis is important—as I noted, for financial institutions to heal fully, they need to have

future oriented business plans.

Closing

I started with the usual financial cycle—build-up, crisis, recovery. History suggests that as we complete recovery, we are already at risk of the next build-up. I've always thought that the gold standard of prudential policy is to identify the potential sources of trouble early enough to nip them in the bud. So, even as we are still working through recovery and repair, the FSOC and the Federal Reserve have developed new ways to monitor the financial system more intensively. The movement through the cycle continues.