SPEECH

Progress toward Financial Integration and Financial Stability

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It is a privilege to be here today at this conference celebrating the 30th anniversary of SEACEN. Thank you to the SEACEN Centre for inviting me to participate, and congratulations to the Centre on the launch of the new *SEACEN Financial Stability Journal.*

We are at a good moment to consider financial integration, its benefits and costs, its prospects, and its challenges. We have gained a few years' distance and some perspective on the causes and consequences of the global financial crisis that began in the United States and Europe. We have seen for more than a decade sustained growth in many regions of the world, especially Asia, above that in the advanced economies, with important implications for the distribution of global income, wealth and financial activity.

In addition, the global financial crisis and the accompanying Great Recession in the advanced economies have produced a long list of challenges for central banks and supervisors: reform of the regulatory framework for global, systemically important financial institutions, strengthening of the financial infrastructure, and significant new efforts to monitor financial stability and proactively address vulnerabilities and threats. Central banks within the advanced economies are conducting unconventional monetary policy to combat the continuing sluggishness in their economies. All central banks are seeking to understand the channels of transmission of these new approaches to monetary policy and the zero-bound interest rate environment. The transmission channel to emerging market financial markets is important to study, both because of the market turbulence we've seen this year and the potential effects on emerging market economies and overall global growth.

In my remarks today, I will focus on the prospects for continued financial integration and then three challenges associated with stabilizing a financial system in which financial integration is substantial and advancing. As always, I will be expressing my own views and not those of the Federal Reserve System or the Federal Reserve Bank of New York.

Increasing Financial Integration

Modern financial integration really began in earnest with the resumption of international trade and financial activity in the 1960s. It is now 40 years since the postwar fixed-rate exchange-rate regime gave way to a more flexible, floating regime. Significant financial deregulation soon followed in the advanced economies, where such features as interest rate ceilings and credit controls were not uncommon in the 1970s. Several waves of liberalization reduced long-standing post-war restrictions on capital flows. Much of this liberalization took place because strong market forces made fixed exchange rates and the old controls on domestic financial activity and international capital flows increasingly ineffective and expensive to maintain. At the same time, market and technology forces also reshaped large parts of the financial sector, eventually producing the very large global financial institutions we have today.

Without question, global financial integration has advanced substantially over the last 30 years. The measurement of financial integration, however, is difficult.

Financial integration is often measured by the size of cross-border financial flows. Those flows over the past decade provide a very mixed message about progress in international financial integration. But interpreting flows during that period is complicated by our realization in hindsight of just how much the run up to the financial crisis distorted real and financial activity over this period. The tremendous expansion of U.S. housing finance, its amplification through the repackaging of risk exposures for global distribution, and the large rise in household and financial leverage created a volume of finance that was unsustainable. Quite possibly, that financial climate played some role in fostering strong capital flows to the emerging market economies. After the financial crisis, the unwinding of those exposures and the continuing impact of the recession depressed financial activity, including with it, capital flows. Moreover, the challenging macroeconomic impacts in the advanced economies and the resulting policy responses to them have no doubt contributed to volatility in those capital flows.

Yet capital flows are simply our proxy for the hard-to-observe features of financial integration. The benchmark for full financial integration is pricing of global financial assets that enables an efficient allocation of global resources. Two characteristics we might look for as signs of that pricing mechanism. One is the completeness of markets, including, for example, capital markets for business and government and markets for household credit. A second is greater convergence in the distribution of risk-adjusted interest rates and financial prices in national markets around financial prices in international markets. Such convergence may require strengthening the risk profile of financial institutions and financial activity in local markets as well as eliminating barriers

and business practices that create a “wedge” between international and national financial prices.

So rather than look at the slowdown of capital flows since the financial crisis as a sign that financial integration is decreasing and may be difficult to restart, we could look closely at developments outside the advanced economies and come to a very different conclusion—that financial integration is continuing now and will persist in the future. I see three ongoing drivers of integration.

First, the composition of global GDP has changed markedly in the last decade—the share of the advanced economies has fallen from roughly 80 percent to just over 60 percent today; and that of the rest of the world has doubled, with the rise in share most pronounced in Asia. The rise in incomes and standards of living around the world creates new consumer and business credit demand. Since investment, economic activity and finance gravitate to where incomes are growing, this redistribution of global income increases the impetus to financial integration.

Second, the continuing shift away from policy instruments that fix prices and quantities, such as interest rate ceilings, credit controls and capital flow restrictions, is another force behind continuing financial integration. As national or regional policymakers turn toward the use of open market operations and regulatory capital requirements, they are using instruments that seek to influence, but not determine market prices and the cost of capital. This shift in policy instruments promotes the interaction of national policies to occur in the price domain, rather than the quantity domain.

Finally, we have the continuing efforts around the world to strengthen the regulatory framework and financial infrastructure. Through forums such as the SEACEN Centre, the Asia-Pacific region has been working to strengthen prudential supervision and explore greater regional integration, including the development of regional capital markets. Those efforts are likely to contribute to the greater completeness and alignment of financial marketplaces that is a hallmark of financial integration. To the extent that Asian and other emerging countries continue to develop their domestic banking and capital markets, financial infrastructure and regulatory and supervisory regimes, the potential for further financial integration is good.

The benefits of financial integration are hard to disentangle from the benefits of economic integration—such as international trade and real investment. The benefits of global integration overall, however, are clear: standards of living and life expectancies have increased dramatically, poverty rates have dropped sharply in the countries of highly integrated countries, such as many in Asia. After several decades of stagnation, the gap between income levels between the advanced economies and the emerging countries, while still large, has narrowed, in emerging Asia especially dramatically.

But the rise in incomes and standards of living has not resolved all issues. The global financial system is still vulnerable to frequent and sometimes severe crises. Progress is being made on the international agenda to mitigate those risks, but much work is still to be done. And the level of real and financial wealth has grown staggeringly. With it, the size of the financial sector in the advanced economies has grown dramatically, as have levels of compensation in the financial industry. That growth has raised questions about the efficiency and the fairness of our financial mechanisms.

The post-crisis reforms are designed to address the issue of vulnerabilities and tools of crisis management, but may also have impacts on the size and structure of the financial sector. Let me turn to areas of post-crisis reform, beginning with globally systemically important financial institutions, the so-called G-SIFIs.

Global Financial Institutions

The activities of global systemically important financial institutions or G-SIFIs have been a major driver of financial integration. The recent financial crisis illustrates dramatically that problems at large, systemically important firms can have impacts on markets and the real economy not only where they are domiciled, but across the globe. This spillover has long been a concern of financial authorities in host countries.

The regulatory and financial stability agenda being advanced by the Financial Stability Board and the Basel Committee on Banking Supervision is intended both to reduce the probability that such firms could fail and to mitigate the costs of their failure, should it occur. Measures to raise both the quantity and quality of capital at the G-SIFIs, such as Basel III and enhanced prudential standards, are aimed at reducing the probability of failure. The work on recovery and resolution planning, as set out in the *Key Attributes for Effective Resolution Regimes*, a new global standard published in 2011, aims at mitigating the cost of failure by developing the institutional arrangements and concrete plans to place a failing G-SIFI into resolution. These initiatives at the global level have been mirrored at the national level in many countries.

I’d draw special attention to stress testing in its role in reducing the probability of failure and resolution planning in reducing failure’s social cost, because both represent an important shift of focus for the supervisory community. Both processes focus attention on the far adverse tail of the probability distribution of outcomes for a firm. Technology, financial modeling, and risk management theory and practice have greatly expanded and enhanced the supervisors’ ability to address those severe adverse outcomes.

As a result, supervisors and resolution authorities are having conversations with firms that were simply unimaginable prior to the crisis. For example, the U.S. requirement for firms to produce a “living will” or resolution plan under the U.S. Bankruptcy Code is forcing firms to confront the sources of their long-tail risk and the consequences to the firm of adverse outcomes in a manner

never discussed before.

I mention the breaking of these barriers because it is relevant to another set of conversations that have proven difficult: the conversation between home and host supervisors. Host jurisdictions for over 20 years have sought greater information about the parent organization as they supervise local subsidiaries and branches of global financial firms. The information need is felt most acutely, of course, when the global firm is in distress.

Resolution planning is developed in relatively small groups of authorities in the jurisdictions in which a G-SIFI's largest operations are located. Currently, work is underway under FSB auspices to find a way to communicate with other host supervisors where the local operations are systemically important in that nation.

Just as the dialogues within firms and between firms and their supervisors have had to break through old barriers, the dialogue between home and host supervisors will also need to break new ground. The preconditions for that dialogue are ensuring that safeguards to ensure the confidentiality of information are in place. Information about a troubled firm will need to be communicated with economy, given the time pressures and scope of communication needed in a crisis.

We do not know yet how the reform agenda will affect the international activities of G-SIFIs, although we can see some early indications. Higher capital requirements and more stringent prudential standards are causing some firms to re-examine their correspondent and business relationships and make new cost-benefit assessments. The greater focus on stress testing and resolution planning may lead to more discussion of firm structure, including the number of subsidiaries, the alignment of the corporate structure with the firm's business activities, the management of intragroup exposures, the use of parent guarantees, and the correlation of the firm's capital and liquidity structure with the firm's business and legal entity structure.

In my personal view, discussion will no doubt lead to action, in the best scenario, by G-SIFIs themselves. In my personal view, these issues reflect areas where the true costs of managing a large, complex, internationally active firm have not yet been fully internalized by the firms. Said differently, the cost of international financial activity has probably been too low, and as it rises, some readjustment of those activities will be inevitable.

This touches on one area of global financial firm recovery where more progress will need to be made. I like to benchmark progress toward financial institution recovery against the program that U.S. regulators used in the domestic banking crisis of the early 1990s. Because the problems at that time were simpler, the remediation program imposed by supervisors was easy to understand and it was effective. The program had three principal actions: a troubled bank had to raise additional capital and strengthen its liquidity; it needed to fully identify its problem assets and exposures, isolate them and place them in workout; and it needed to develop a new business plan.

The international community of supervisors has done a great deal to address the need for more and better quality capital through new capital standards. The identification and workout of troubled assets has made significant progress, which we can observe in the recovery of markets for some troubled assets. But global financial firms are still working on the new business plan. From the financial press, it's clear that many large financial companies are rethinking their strategies, often along the lines of increasing the focus on nonfinancial businesses and households and reducing the focus on expanding capital markets businesses. But I believe we are more at the beginning than toward the end of that reconsideration.

Complexity

Let me turn to complexity. The development of international and domestic capital markets has been one of the dramatic developments of the last 30 years. A combination of new instruments, new national markets, and the development of a range of complex securitization and derivatives structures has made the financial system substantially more complex. The global financial crisis underscored the difficulty of monitoring and containing mounting financial stress in the global system and the specific dangers that lie in very complex products with opaque risk characteristics.

Complexity is a fact of modern life—look at the global supply management chain or the integration of activities guided today by "smart" technology. Cost, however, can grow geometrically with complexity, and may be one reason why the share of the financial sector in GDP has grown so much. For central banks and supervisors, complexity makes it difficult to identify emerging problems, understand the potential for one adverse development to trigger others, and close gaps in regulatory coverage that encourage regulatory arbitrage.

Whatever the costs of complexity are under normal operating conditions, those costs escalate sharply under conditions of distress. Indeed, in the early stages of the recent crisis, many financial market participants had to scramble to understand the nature of their exposures down to the details, including details about the clearing and settlement of transactions.

Complexity therefore needs to be managed and reduced meaningfully whenever we have the opportunity. I would point to four ways that we in the official community can reduce complexity.

First is the development of international standards in forums such as the Financial Stability Board and the Basel Committee on Banking Supervision and the application of those standards in all our jurisdictions. Consistency in our approach to supervision

and regulation across jurisdictions can make the regulatory environment more seamless and less subject to arbitrage.

The expansion of the Financial Stability Board and other standard setting bodies to include the G-20 countries means that more voices are heard as these standards are developed. Regional organizations such as the SEACEN Centre, as well as the FSB's regional consultative meetings, provide a forum for discussion of policy matters with a much wider set of countries.

Second is the move to regional financial markets. A regional financial market has obvious benefits in scale and liquidity. It can harmonize market practices across many jurisdictions and consolidate financial infrastructure, thereby simplifying the financial system.

Third is greater standardization of financial products. The global financial crisis highlighted weaknesses in infrastructure and risk management because of the lack of standardization in the global derivatives markets. Highly customized complex transactions produced large losses in part because their inherent risks were poorly understood; conventional risk management and infrastructure systems could not capture and flag all of the risk dimensions.

The Financial Stability Board and in the U.S., the Dodd-Frank Act, as well as earlier international supervisory efforts led by the Federal Reserve Bank of New York, have pushed forward centralized clearing of derivatives. The move to trade repositories and clearinghouses may also lead toward more transactions through exchanges or electronic trading platforms, where products are generally standardized.

Fourth is seeking greater transparency into firms and markets. International standards and standardization of financial products create some of that transparency. But much more is needed. Requiring a financial institution to explain to the public the nature of its risks and their management is a strong discipline on both risk-taking and complexity.

Financial Stability

Let me end with a few words on financial stability. How adeptly financial institutions and financial supervisors manage the risks associated with complexity and large, globally connected institutions will have important implications for financial stability. However, the experience of the financial crisis has drawn attention to the need to identify threats to financial stability and address them promptly and to create the institutional arrangements that ensure that need is met. The result has been an effort to strengthen the focus on financial stability as a mandate and provide the necessary powers to address it in national statutes.

The policy discussion now describes three realms of relevant policy: macroeconomic, such as monetary policy; microprudential, such as financial institution supervision; and macroprudential. At least two issues figure prominently in discussion of these realms: who is responsible for financial stability and which policies and policy tools should be considered macroprudential?

I'd like to offer an analogy that might be helpful. A major financial loss in a financial institution almost always reflects the breakdown of multiple sets of controls. The supervisory program the supervisor would have liked to have had in place before the loss would involve asking the firm to take multiple corrective actions to have prevented the breakdown.

I would posit that instances of financial instability result similarly from the coincidence of several failures or breakdowns requiring policy intervention. Financial instability events are by definition systemic; their scope and size cause them to impact real and financial activity across multiple sectors. The financial crisis that began with the U.S. boom in residential mortgage financing grew to be so destructive because of increased leverage in the household and financial sectors and a series of poor and risky practices in the marketing, mortgage underwriting and securitization of housing loans.

This view has two implications. It means that coordination is essential to financial stability and it also means that several measures will likely be necessary to address emerging financial instability. Thus, the full range of macroeconomic, regulatory and market conduct policies need to be available to deal with the emergence of instability. Coordination involves quickly laying out the sources of stress and the transmission paths of that stress as clearly as possible and then calibrating a response across the complete policy toolkit available.

Such an approach may lead to a concern that conflicts could arise among the goals of macroeconomic, macroprudential, and microprudential objectives. In many cases, the overarching goal of stability will create alignment because the stabilization goals of monetary policy and financial supervision are prerequisites for financial stability. But where conflict exists or targeting is needed, coordination and a sufficiently large toolkit allow the authorities to craft a response to a systemic threat that minimizes any short-term conflicts among goals.

The focus on coordination also forces us to ask what structures and mechanisms create strong incentives for coordination and address conflicts within the group of policymakers. In some countries, much of the coordination of policy tools could be led and overseen by the central bank—for example, one that serves as both monetary authority and a primary microprudential supervisor. In a country like the United States, with our numerous regulators, the coordination mechanism Congress has put in place is the Financial Stability Oversight Council, known as FSOC, chaired by the Secretary of the Treasury.

What guarantees that the ten or so agencies at the U.S. Financial Stability Oversight Council, table will coordinate? The requirement to publish an annual assessment of financial stability risks, that is, shared concerns, is one such incentive. A second

is the escalation processes built into the FSOC process, should the members disagree. A recent example of disagreement arose when the U.S. Securities and Exchange Commission (SEC) did not approve a proposal asking for comment on possible avenues to reduce the risk of runs on money market mutual funds, a source of concern highlighted in FSOC's financial stability report. Many FSOC members thought it important to move forward with reform in this important area. The FSOC process offers a range of options, exerting peer pressure to formal actions that could involve imposing new requirements. With further deliberation, the SEC put out a new proposal for comment.

Finally, I believe we need in the official sector a bias toward action and a willingness to take risk in confronting emerging financial instability. It will almost always be uncertain whether an emerging problem will become systemic. Any supervisory actions taken will have an immediate impact, curtailing someone's profitable opportunity; moreover, the results of an action might not be discernible for some time. Yet we need to overcome the inclination to wait, especially in light of the rapid rate of deterioration of financial firms and markets we observed in the financial crisis. To respond timely and with sufficient force, policymakers need to be agile; observing the impact of their actions, they need to able to adjust their program to improve its impact. Given the need for agility, we may also need much more flexibility in our policy instruments and processes.

To sum up, I've highlighted three challenges we need to address to continue to foster international financial integration and reap its benefits:

- We need to complete the reform agenda dealing with large financial institutions.
- We need to manage and contain complexity
- We need to coordinate more fully on meeting threats to financial instability.

We have plenty of work ahead.

Thank you for attention today.

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