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Regulation for financial stability: the essentials

We are in a critical phase of the regulatory responses to the global financial crisis. The basic elements and structure have been agreed internationally by the Basel Committee on Banking Supervision and the Financial Stability Board and by Dodd Frank (DF) in the US and legislation elsewhere, and those elements are being implemented by regulators here and around the world.

However, here in the U.S., questions are being raised: Have new financial stability safeguards gone too far? Have they imposed costs on the private sector that exceed the benefits to society of reducing the risk of future crises? Has the approach to resolution of systemically important firms truly reestablished market discipline, protected taxpayers, and safeguarded financial stability?

Such a reconsideration can be a healthy exercise. It's been nine years since the depths of the crisis, and seven since DF was passed. Financial systems are considerably more stable and resilient than they were in the years leading up to the crisis. However, the substantial increase in the level and complexity of regulatory requirements and their interactions very likely has produced costs and benefits that weren't anticipated.

So now is a good time to take stock. The Core Principles put forward by the Trump administration to guide reconsideration of regulations provide a useful framework; they include such things as preventing taxpayer bailouts and more rigorous regulatory impact analysis that fosters growth and addresses systemic risk and market failures. [1]. Had I been drafting them, though, I might have put even more emphasis on maintaining financial stability as the primary objective of much of the new legislation and regulation. And it's the preservation of financial stability that I'll be discussing today. My focus will be on the US, though my perspective also has been shaped in part by my experience as an external member of the Financial Policy

[1] Those principles are: empower Americans to make independent financial decisions and informed choices in the marketplace, save for retirement, and build individual wealth; prevent taxpayer-funded bailouts; foster economic growth and vibrant financial markets through more rigorous regulatory impact analysis that addresses systemic risk and market failures, such as moral hazard and information asymmetry; enable American companies to be competitive with foreign firms in domestic and foreign markets; advance American interests in international financial regulatory negotiations and meetings; make regulation efficient, effective and appropriately tailored; and restore public accountability within Federal financial regulatory agencies and rationalize the Federal financial regulatory framework.

Committee at the Bank of England, tasked with "protecting and enhancing the resilience of the UK financial system." [2]

In this talk I'll give my take on what elements of the new regulatory structure that has been put in place are essential for maintaining financial stability, and indeed, what new elements or modifications would insure even better against a repeat of the recent crisis.

Let's start by briefly reminding ourselves of the benefits of regulation to maintain financial stability—that is the costs of instability. The recent financial crisis was hugely costly in the US and around the world. It resulted in deep recessions, with unemployment topping 10 percent in the US, and threats of deflationary spirals that would have intensified an already difficult and costly situation. The slow recovery kept unemployment high for some time, and the episode appears to have left a lasting imprint on the level and perhaps the rate of growth of potential GDP as discouraged workers left the labor force and productivity-enhancing capital spending was postponed. And in these regards it was typical of a recession that follows a financial crisis. This time was not different.

The recession was triggered and amplified by financial fragilities in banks and in securities and securitization markets in the mid 2000s. The widespread buildup of leverage in the financial sector, the increase in short-term wholesale funding of long-term asset holdings, the growth of complex and opaque instruments and interconnections, left the financial system very vulnerable to an adverse shock, like the unexpected drop in real estate prices in the US, Ireland, and Spain

The authorities didn't see it coming and partly for that reason didn't act quickly or robustly enough to head it off by demanding more resilient and transparent financial institutions and structures. But the private sector didn't see the risks either. Bank equity values were twice book just before the first tremors hit in 2007; spreads on bank and investment bank debt were historically narrow, and even supposedly sophisticated investors accepted the flawed assessments of the credit rating agencies on risks of tranches of mortgage derivatives. To a considerable extent, the lack of prescience by public and private actors reflected the complacency that naturally built up in the long stretch of good times that preceded the crisis. And that was an environment in which "light-touch, principles-based" regulation was all the rage, and in which regulators in the US got considerable push back from industry, other regulators, and legislators when they tried to take even small steps to bolster bank defenses against tail events.

As we reconsider the post-crisis reforms and regulations, we need always to remember one key fact: In finance, the private sector left to its own devices will never fully price the consequences of its actions. Although externalities exist in many markets and industries, those in finance seem especially large—contagion within the financial sector to other borrowers and lenders from interconnections and panics and fire sales, and the aggregate demand externality from the responses of heavily indebted households and businesses to shocks to income, interest rates or credit availability. Those externalities damage innocent third parties in the form of unemployment and lost income when the financial sector can't perform its normal intermediary functions and credit dries up.

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[2] These are my personal views and do not necessarily reflect those of my colleagues on the Financial Policy Committee.

Forcing markets and institutions to internalize the externalities, reducing the inherent procyclicality of financial markets, and especially greatly reducing the odds that a small probability event will interrupt delivery of essential financial services to households and businesses must be primary goals of financial regulation. That regulation should be subject to cost-benefit type of analysis where possible, and I would be surprised if such analysis didn't point to some areas in which costs could be reduced without significantly increasing the risk to society of financial instability. I constructed my list to identify elements that are in my view essential to preserving stability and for which I would be skeptical that substantial reversal would pass a cost-benefit test, provided the benefits properly include greatly reducing the odds that a future generation will live through anything like the financed-related global recession we endured. And I have a few suggestions where the US would benefit from extending the tool kit we now have.

<u>Making sure any adjustments in what we have protect financial stability</u>

We should retain more robust capital and liquidity and risk management requirements for broad elements of the financial system.

A lot of the work since the crisis has been focused, appropriately, on making the system considerably less vulnerable to problems in systemically important institutions. Indeed, that was a main focus of DF, and understandably so after regulators identified the potential failure of some bank and nonbank SIFIs as enough of a threat to the economy to justify extraordinary actions, often involving taxpayer risk, to keep them alive and functioning when they otherwise would have failed.

But weaknesses were everywhere and it wasn't just the largest institutions that created the conditions that led to the crisis. Smaller and medium-sized banks and thrifts were fueling the boom by loosening credit standards in real estate lending and taking risks they didn't understand on thin capital bases. Many toxic loans were originated by large west coast S&Ls—not SIFIs by themselves. The troubles and in some cases failures of a wide range of banks and thrifts cut off credit to their communities; if it weren't for TARP capital injections into hundreds of small and medium-sized institutions, the economic damage would have been far worse.

Investment banks and other nonbank players encouraged and greatly profited from the distribution of these toxic loans. In addition, they took on considerable risk themselves, and the failure or threatened failure of Insurance companies, broker dealers, and other nonbanks also spread panic, drove down asset prices, and disrupted financing for households and businesses..

Considerable progress has been made in bolstering the capital and liquidity and changing risky practices across the banking system and in some key nonbank players. Strong capital and liquidity levels not only make the system safer when trouble starts, but the perception that banks are liquid and well capitalized, by bolstering confidence, reduces the odds on a panic even starting. To be sure, a more nuanced and graduated set of requirements for banks as size and complexity increases could well reduce costs for those institutions that are not themselves systemically important without substantially increasing risks of financial

instability.[3] But if many small and medium-sized banks have similar business models, take on similar risks, and are therefore vulnerable to the same shocks, in the aggregate they can pose a significant threat, so care must be taken to fully consider the costs and benefits when easing off regulations.

Moreover, nonbank institutions and markets remain potential sources of financial instability; we need to be careful not to step away from identifying systemic risks wherever they arise in the financial system and keeping, or possibly even enhancing, the authority to deal with them should that become necessary.

We should retain especially rigorous requirements for very large, complex, and interconnected financial institutions—both banks and nonbanks--whose individual retrenchment or failure can have broad economic effects; and the resilience of these institutions must be tested against frequent, rigorous, concurrent, regulator-run stress tests.

I'm going to concentrate on the stress tests. Concurrent stress tests for these financial market participants are among the most important new tools for micro and macroprudential regulation. They seek to assure that the system can keep on performing its essential functions even after a very bad shock. They provide important information to the regulators and the senior executives of the companies about the risk profile of individual institutions and the system. The responses allow the supervisors to evaluate management information systems and risk management capabilities; a bank that can't handle a stress test is probably a bank that doesn't understand all the risks it is taking. Transparency of scenarios and results on an individual basis is critical to holding banks and regulators accountable and helping market discipline.

Very likely ways can be found to reduce the burdens of stress tests, especially, but not only, for the institutions below the very largest and most systemically important. Moreover, the evaluation criteria for qualitative aspects of the tests applied to the most systemic institutions at a minimum could be made more transparent so the subjects of the tests better understand what is expected.[4] But gauging the resilience of the financial system and considering what actions might be necessary to keep it resilient requires frequent, rigorous, concurrent, regulator-run stress tests for the most important elements in that system

Frequent: Should be annual; too much changes too quickly in financial markets to have less frequent checks on its critical elements.

Rigorous: Scenarios should be severe, countercyclical, and incorporate feedback loops that would be expected to operate in a severe crisis.

Concurrent: Running tests simultaneously allows comparisons across institutions and identification of common exposures.

Regulator-run: We can't rely on banks alone to identify scenarios and run stress tests; they won't take account of externalities, interconnections, correlated risks and amplification. We may be able to rely more on the banks running their own models,

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[3] Governor Daniel Tarullo had some useful ideas for streamlining capital requirements for community banks and for making the supplementary leverage ratio applied to G-SIBs in the US more graduated. https://www.federalreserve.gov/newsevents/speech/tarullo20170404a.htm

[4] In the same speech, Tarullo suggested the qualitative aspect even for the G-SIBs might eventually be divorced from the annual stress test and folded into the regular supervisory process, albeit after the capital requirement for those banks was raised further.

which have themselves been vetted by the supervisors, with regulator-chosen scenarios, but with robust regulator cross checks; that's the way it is done in the UK. The scenario building, the cross checks, the data gathering all need to take account of macroprudential concerns that go beyond the safety and soundness of individual institutions.

Proposals have been made to eliminate or greatly alter the orderly liquidation authority of DF, but we must have a process in which systemically important institutions can be resolved without endangering financial stability.

In the crisis, the lack of such a process was an important factor behind the convoluted lending arrangements of some Fed discount window facilities for nonbanks that ended up as Maiden Lane special purpose vehicles, the need for public capital in TARP and for guarantees of bank and bank holding company debt by the FDIC. There may well be ways to make the triggering and implementation of the resolution process outside bankruptcy more systematic and to better assure that taxpayer funds will not be put at risk without Congressional approval. But some orderly liquidation process is essential to financial stability, and confidence that it will work and will be utilized is key to ending too big to fail. Such a process should have the following elements:

Considerable preparation well ahead of time. That preparation includes: (1) ample explicitly bail-in-able debt to re-capitalize strongly the going concern left after the overall institution has failed; (2) living wills to help the authorities map failure in bankruptcy or orderly liquidation; (3) cooperation, collaboration, and planning with authorities overseas to give those authorities confidence that the interests of their residents will be equitably treated and the stability of their financial system protected.

Access to a source of liquidity for the resolution authority. An aim of the recapitalization is to maintain or restore access to *market* sources of liquidity for the surviving entities, but access to another source may be required until confidence is restored.

A financial stability objective for whichever authority is making the decision about whether to trigger special resolution versus bankruptcy.

And that authority should have sufficient expertise in the financial sector to make the judgments on the systemic importance of the troubled institution and the choice of resolution mechanisms, and to oversee the process in a special resolution authority.

Extending the toolkit

The US needs tools to counter strong procyclicality in real estate and mortgage markets.

Real estate cycles have been at the root of episodes of financial instability and its amplification into the economy in the US even before the 2000s. Many of the issues faced by the US financial system in 2007-09 arose from a marked loosening of standards on mortgage loans earlier in the decade and then the financing of holdings of the resulting low-quality, long-term loans with short-term, wholesale funding.

To be sure, a number of steps have been taken to deal with some of the structural issues highlighted by the build up of vulnerabilities in the mortgage market and its subsequent collapse. Affordability criteria have been established with limits on debt payments to income; risk retention rules have been imposed on securitized mortgages that don't meet minimum safety requirements; bank capital requirements have been raised for securitized loans and for mortgage servicing; stress tests include severe real estate market melt downs to gauge the

resilience of larger banks. These should make the market safer for both borrowers and lenders, and provide some protection against a massive easing of lending terms such as occurred in the early to mid-2000s.

But that protection is not complete; there are exceptions to most of those rules, and the new structures haven't been tested in very exuberant markets against the innovative genius of the US financial system to get around regulation when profit beckons. I believe they should be supplemented by explicitly countercyclical tools if the US is to avoid a repeat of past cycles.

Some regulatory authority needs the power to put limits on loan-to-value and debt-to-income measures when loosening standards, perhaps occurring outside the banking system, threaten financial and economic stability. Many countries have such tools and have deployed them to restrain deterioration in lender and borrower resilience to unexpected developments as real estate prices rise. In the UK, when increases in house prices outstripped growth in income and that pattern was expected to persist, we put in place limits on easing in loan-to-income to insure against a buildup of heavily indebted and vulnerable households.

The US needs back-up liquidity facilities adapted to the diverse intermediation channels of the 21st century.

Securities and securitization markets have become increasingly important channels for delivering credit to US households and businesses. The availability of alternative sources of funds generally supports financial stability—if one source of credit is impaired, another can take over some the provision of credit. However, we also saw in 2008 that disruption to the provision of liquidity to key elements in the securities and securitization markets can in turn severely disrupt the provision of credit overall and become a powerful source of instability for the economy.

That development is what led the Federal Reserve to activate section 13-3 of the Federal Reserve Act in 2008 to allow it to lend to nonbanks. That section of the Act requires that, in effect, a panic already be underway before lending can take place (circumstances need to be "unusual and exigent" and credit "not otherwise available".) Congress in DF further restricted 13-3 lending, and put in requirements for approval by the secretary of the Treasury and for release of borrower identities to the Congress and public that could further constrain the ability of this lending facility to maintain financial stability.

At a minimum, Congress should not limit access to the Fed's discount window any more, as some have advocated. To be sure, expected access to liquidity insurance provided through the central bank carries moral hazard, so maintaining very restrictive criteria for lightly regulated entities makes public policy sense. But we need to decide what institutions and markets are essential to the functioning of our diversified financial system and then how to both regulate those segments and grant them less restricted access to back up liquidity.

I can imagine a three-tiered system for access to the Fed's discount window—banks, systemically essential nonbanks, and everyone else, with credit being available to the middle category when need has been established, but before the system is already melting down. We could get a long way toward where we need to go by putting systemically important financial market utilities (FMUs) and the broker-dealer subsidiaries of bank holding companies in this middle category. Two systemically important investment banks became BHCs during the crisis and their broker-dealers are now subject to much tighter oversight and more demanding capital and liquidity requirements. FMUs became subject to closer oversight in DF, especially

those designated as systemically important. If necessary, the regulation of these middle-category institutions could be further adjusted to take care of any new moral hazard concerns that might arise from a slightly less restrictive access to the discount window.

Engaging in global standard setting.

Finally, robust, globally agreed, standards are required to protect financial stability in every jurisdiction around the globe.

In globally integrated financial markets, no location can be immune to financial instability originating elsewhere. Each jurisdiction can protect itself to some extent by holding its own institutions to high standards, stress testing them against shocks originating overseas, and requiring subsidiaries of important foreign institutions operating on its territory be themselves resilient. But, despite these steps, we have seen repeatedly in recent years, widespread spillovers from concerns about developments in Europe, China, etc. And further efforts to insulate one market from another would, by raising the cost of cross border financing flows and discouraging foreign entry into markets, reduce market competition and liquidity and result in a less efficient allocation of finance and capital globally.

For the US we need to give great weight to financial stability considerations in any changes to DF or regulation, as I've been arguing in this talk, conditioned to be sure on cost-benefit assessments. Failure to do so risks not only the resilience of the US financial system when shocks hit, but also foreign jurisdictions taking steps now to protect their own stability that would leave everyone worse off. And the US should continue to work cooperatively with foreign jurisdictions and international committees to set strong standards globally to protect financial stability in the US. Over the long run, no one benefits from inadequate capital and liquidity, and many can lose, as we have been so painfully reminded over the past almost 10 years.