Crisis: Reaction and Resolution

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I am honored to be asked to provide some opening comments for this conference.

Over the past year, we have all been heavily involved in the global financial crisis. As policymakers and regulators, our mission during this turmoil is twofold. We are responding to emerging events, but at the same time we are also challenged with making the changes necessary to protect the financial system from a similar crisis in the future.

So, the urgency on all sides is certainly warranted. The time it takes to resolve these issues only increases the cost and further delays the potential for a full global economic recovery. Unfortunately, urgency often creates an environment where quick decisions prevail over well-thought-out solutions. The focus in times such as these is often on proximate causes instead of underlying problems. The current crisis, unfortunately, has been no different.

There were many events involved in this crisis, and as I react to them and consider what they mean from a regulatory perspective, I would suggest three key areas that need to change.

First, regulation must be based on a clear set of simple, understandable and enforceable rules rather that a set of broad principles open to interpretation.

Second, this has been the first real test of Basel II, and it has failed to achieve its objective.

Third, we must produce a means for resolving firms that some would deem "too-big-to-fail." These institutions do fail and we must allow them to do so in a way that controls damage to the entire financial sector.

Principles-Based vs. Rules-Based Regulation

In recent years, there have been increasing calls for the United States and many other countries to shift toward a risk-focused and principles-based approach to supervision and

regulation. Unlike a rules-based system, which might establish maximum loan-to-value ratios or limit the amount an institution can lend, a principles-based system specifies desired outcomes and allows the regulated firms extensive control over how they achieve those results.

As a regulator responsible for ensuring stability, I can sum up the argument of principles versus rules very simply in my mind: Principles provide financial institutions with opportunities to debate; rules provide supervisors with the best chance to properly enforce sound practices.

Those who support a principles-based system say that with rapid growth in the financial markets, supervisors no longer have the resources to monitor compliance with every rule and regulation. They say the principles-based approach gives institutions more flexibility in adapting to a rapidly evolving financial environment, thereby making a country's financial markets more attractive, innovative and competitive on a worldwide basis.

To that I would respond that a carefully crafted rules-based approach does not hamper financial innovation. Good rulemaking incorporates public comment, thus giving institutions an opportunity to suggest less burdensome and more effective ways to achieve regulatory goals. In a rules-based environment, supervisors cannot just mechanically impose the rules on regulated firms, but must rely on a good dialogue with the firms as an important part of the supervisory process.

Because principles must constantly be interpreted, a principles-based approach by its very nature fosters an environment of less clarity and reduced transparency in the regulatory system. With issues open to interpretation, supervisors also have less power to enforce regulations when an institution disagrees. This problem is particularly serious when an economy is strong and questionable activities may appear to be successful in the environment of the time. The result is likely to be a gradual erosion of regulatory standards during prosperous times and greater harm

to institutions and the broader financial system when the economic cycle reverses direction. If there is one thing that we have learned from the current crisis it is that we must have a strong set of rules in place to limit any erosion in regulatory standards over the cycle.

My final concern with principles-based regulation is that for it to be effective, regulators and firms must have consistent goals and incentives. There must be mutual trust. Although I think we would all like for this ideal to be attainable, we know in reality that it is extremely difficult to achieve.

Given the events that led to our current crisis, it strikes me that we must reemphasize longstanding and proven rules-based standards to limit excessive risk-taking. There must be a firm framework for enforcing and achieving our supervisory objectives.

Basel II

Many of the same issues surrounding principles-based regulation versus a rules-based system also apply to Basel II. The main "principle" underlying the Basel II framework is that capital requirements should be closely aligned with the risk assumed by the financial institution.

Basel II relies on institutions making detailed assessments of the risks they have assumed so a more precise capital requirement can be assigned. Basel II, in fact, allows banks to use credit ratings and their own internal risk models to measure these risks and calculate their capital needs.

In this regard, Basel II would replace a system that was based on broad "risk buckets" and a set of "rules" that determined what should go in these risk buckets and what capital would need to be held against these specific risk-asset measures.

Whether this shift to a more principles-based capital framework under Basel II is beneficial will depend on a number of the points that I noted previously.

These points include:

- Will the flexibility provided to banks in using their own risk models lead to better outcomes, or will they create greater supervisory enforcement and compliance problems?
- Will it be more difficult to get banks to build up and maintain higher levels of capital during more prosperous times?
- Can supervisors ensure that all banks operating under the Basel II framework follow a consistent approach in measuring capital needs?

The difficulties with using models to measure risks are well-known to all of us. They have become painfully apparent in the current financial crisis. Consequently, we must be cautious in how we set capital requirements and limit financial leverage. Models and credit ratings don't anticipate shifting risks very well.

Models calibrated during periods of stress can overestimate risk and reinforce the procyclical effects of capital regulation.

Even more disastrous are calibrations performed during good times that can cause models to underestimate the risks of turbulent conditions and leave banks holding insufficient capital. An example is provided by the experience of Britain's Northern Rock. At the time of its collapse, Northern Rock had calculated that it had substantial surplus capital under Basel II and was close to receiving regulatory approval to dividend out the "extra" capital to its shareholders.

Models can fail to measure adequately a bank's exposure to macroeconomic shocks and will not measure risks not previously experienced. For example, many risk models clearly failed to anticipate the downturn in housing prices that we have seen over the last several years. A more specific example is the counterparties to AIG's credit default swaps, who took steps to protect

themselves from credit risk by including collateral requirements in their swap contracts. However, the counterparties did not anticipate that AIG's overall risk would exceed the amount of collateral it could provide. Consequently, the counterparties' models did not indicate that capital was needed for this exposure or that the institutions should shift their business away from AIG.

Another important problem is that models make enforcement of capital adequacy more difficult. Examiners must try to understand and evaluate very complex mathematical models, and when these models appear to understate capital needs, examiners will have a difficult time arguing the technical merits of their views and convincing bank management of a need to add capital. In too many cases, because management's ROE depends on reducing capital, the result will be insufficient capital and excessive bank leverage.

Banks have strong competitive and financial incentives to increase leverage. Leverage increases profitability during good times, but it necessarily increases risk. We have seen the broad systemic effects of excessive leverage in the current environment. In many ways, the Basle II model-based capital regime provides banks with a rationale, a defense and an opportunity for taking excessive leverage.

Overleveraging has been a major problem during the current market meltdown – both among the institutions now operating under Basel II and among those that will soon come under this framework.

To limit such problems in the future, we must maintain limits on financial leverage through strict rules that set a minimum capital-to-assets ratio. This type of rule would be the easiest, most equitable and clear-cut way to set capital requirements for all sizes of banks and for a broader range of firms throughout our financial markets.

A leverage standard would also be much harder to evade than capital standards based on an institution's own estimates of risk exposure. I am particularly concerned that institutions that underestimate their risk exposures under the Basel II framework will invariably hold less capital than they need and be the first to have serious problems during a crisis. Consequently, as we discuss how we might strengthen the Basel II framework today, I believe we should also give attention to how we can underpin this approach with a strict rule on the amount of leverage an institution can assume. While leverage requirements are not a panacea for supervising financial firms, it is clear that if you want to direct your resources to where you are most likely to have problems, you can direct them to the more highly leveraged and weakened firms.

A Resolution Framework for Institutions Deemed "Too Big to Fail"

Finally, this meeting will be looking at how we should deal with institutions that are systemically important or what many call "too big to fail." Although discussions about supervisory framework and capital regulation are vitally important, the idea that some institutions can be too big to fail, and thereby receive special treatment, is the most immediate concern and the area where the actions so far have been most troubling.

There are very real and rapidly escalating costs that are being absorbed by the U.S. taxpayers. There are also some very important questions that, in the name of "urgent," have been pushed to the side rather than addressed in a systematic fashion. In recent weeks, you have seen outrage in the United States over bonuses paid to some employees of AIG, which has received substantial government funding. We must think through carefully the consequences of well-intentioned but rushed decisions. Although the extreme costs of the bailout have received much

of the attention, there are other fundamental questions about competitive fairness, capitalism and financial markets that must be considered as well.

In the interest of time, I will raise only one example right now. Currently, the stock prices of some of these "too big to fail" financial companies are trading for a fraction of their pre-crisis levels, although billions of government dollars in the form of capital, loans and guarantees are being pumped into these firms to avoid either capital or liquidity insolvency. If the government stays the current course and it works, the stock prices will rise. For a shareholder buying in at current levels, a return to even half of what the shares traded at a couple of years ago could generate very large returns. So, not only are taxpayers picking up the tab for making these firms viable, they are also taking on an inordinate amount of the risk and leaving the rewards for private investors. And I suspect that as the markets become more confident that the government will continue its support for "too big to fail," the price of such shares will indeed bring handsome returns.

With issues like this in mind, I recently gave a speech on this topic, titled, "Too Big Has Failed." I would like to take a few moments to reiterate some of the key points concerning how we might address this issue.

One comparison I drew was between Japan and Sweden. As you may recall, Japan took a very gradual and delayed approach in the 1990s to addressing its banking problems and put off dealing with a critical shortage of capital in its banks. In contrast, after a severe real estate collapse in the early 1990s, Sweden took decisive steps to identify losses in its major financial institutions. The viable Swedish banks were soon recapitalized, largely through private sources, and public authorities quickly took over two large insolvent banks and spun off their bad assets to be managed within a separate entity. Sweden was able to quickly restore confidence in its

financial system at little cost to taxpayers, while Japan continued to have a weakened banking system for much of the 1990s.

Another important example is the Reconstruction Finance Corporation (RFC), which was used to deal with banking problems in the United States in the 1930s. The RFC proved to be highly successful in using public funds to recapitalize banks with no net cost to taxpayers. This success was based on the RFC's adherence to a sound set of principles, beginning with writing down the bad assets at a bank to realistic economic values and making any needed and appropriate changes in bank management before injecting public equity into the bank.

A final example is the failure of Continental Illinois National Bank in 1984. Although Continental Illinois was essentially deemed "too big to fail" and was handled through an open bank assistance program, it showed that U.S. banking authorities could take over a very large bank, replace its management and wipe out stockholders, and then restore the bank to sound condition and return it to private ownership.

There are several lessons that we can draw from these past experiences.

- First, the losses in the financial system won't go away – they will only fester and increase while impeding our chances for a recovery.
- Second, we must take a consistent, timely and specific approach to major institutions and their problems if we are to reduce market uncertainty and bring in private investors and market funding.
- Third, if institutions – no matter what their size – have lost market confidence and can't survive on their own, we must be willing to write down their losses, bring in capable management, sell off and reorganize misaligned activities and businesses, and begin the process of restoring them to private ownership.

The question that supervisors in all countries must ask themselves is: How can we best resolve problems at financial institutions that are deemed to be “too big to fail”?

One guide to how we could proceed in the United States is the process we use for failing banks. This approach – albeit far from perfect in dealing with “too big to fail” banks – has been developed over time in response to previous crises and deals with many of the issues that need to be resolved in today’s environment.

Our bank resolution process focuses on timely action to protect depositors and limit spillover effects to the economy and the rest of the financial system. For instance, insured depositors at failed banks typically receive immediate access to their funds, while uninsured depositors often receive quick, partial payouts based on expected recoveries or, in systemic circumstances, may be fully protected.

Also, we have a variety of means for resolving failed banks and ensuring a continuity of essential services, including selling all or part of a failed bank to a bank in sound condition or operating the bank under regulatory oversight through a bridge bank, conservatorship or open bank assistance. These options focus on bringing in capable management, while putting the shareholders at failed banks first in line to absorb losses. The FDIC, as receiver for failed banks, must pursue the least costly option – except in systemic circumstances – in order to protect the deposit insurance fund and taxpayers.

I support constructing a similar resolution program that we could apply consistently to all “too big to fail” institutions, including banks, bank and financial holding companies, and nonbank financial institutions.

Without going into details, I think a resolution plan for “too big to fail” institutions should be based on several principles.

First, it must be equitable and consistent when compared to how other failing financial institutions and their customers are treated. Giving any type of institution special treatment will undermine confidence in the fairness of the financial system, increase moral hazard problems and provide incentives for taking greater risk.

Second, a plan must ensure timely action to protect customers and provide for a continuity of essential financial services, much like many countries have done in giving depositors at failed banks immediate access to all or a major portion of their funds. I would also argue for establishing a clear priority for handling claims, with shareholders and large unsecured creditors having to bear the full risk of the positions they have taken. In addition, to prevent delays and political interference, I believe it is important to have a source of public funds that can be tapped for resolutions and for this resolution authority to be put largely under the control of independent supervisory agencies.

While some have criticized this type of approach on the grounds that we would be "nationalizing" our financial system and that regulators are ill-equipped to take over and operate a large institution, this is not what I believe or advocate.

Resolving problems at failing institutions is something that public authorities have done many times in the past. While it may take more time to work out the problems at larger institutions and return them to private ownership, this is still a temporary step that would be taken with a limited number of institutions. Moreover, the experience of banking agencies in dealing with significant failures indicates that regulators are capable of bringing in qualified management and finding specialized expertise when needed.

If we don't take decisive steps to resolve major banking problems, I believe we will face a much more serious set of issues. In fact, leaving failing institutions to continue their operations

with a failed management team in place is certain to prove more costly in the long run and less likely to restore public confidence and get us back on the path to recovery.

Firms that rely on significant infusions of public funds have failed. We need to stop propping them up and start taking them apart in an orderly manner.

Conclusion

Before I conclude, I would like to make one final comment. There is no doubt that the months to come will be filled with talk about sweeping regulatory changes. The actions of the last several months, rather than solving the problem, seem to have added only more questions to the debate. I hope, in this instance, instead of being led down a path of "urgent" action, we carefully consider solutions. In the United States, there is talk about the need for a financial stability regulator and who should fill that role. I believe that the Federal Reserve, by design, has that responsibility and must start filling that role. Instead or rewriting the rule book, I think we need to first enforce what is already there and do it in a fair and evenhanded manner that is not influenced by circumstances we decide are "special" because of the nature of the problem or the size of the firm involved.

The current financial crisis is providing a very comprehensive test of our financial systems and supervisory frameworks. We are all clearly interested in identifying what went wrong, what can we do to work our way out of today's problems, and what we should do going forward. I am certainly looking forward to this meeting and hearing everyone's views on the challenges we face.