

The Financial Crisis and the Federal Reserve's Response

Tom Hoenig, president of the Federal Reserve Bank of Kansas City, delivered this speech May 6 in Denver, Colo. To read the entire speech, visit KansasCityFed.org/TEN.

I am pleased to be in Denver and I appreciate the opportunity to talk with you about current economic and financial market developments. As you know, the past several months have been a very difficult period for the U.S. economy. A sharp slowdown in growth has put the economy at the brink of a recession while, at the same time, rising commodity prices have caused inflation pressures to rise considerably. And, to make matters worse, these events have occurred against the backdrop of a collapse in housing markets that has shaken financial markets around the world.

The Federal Reserve has responded to these developments aggressively. It has taken unprecedented actions to provide increased liquidity to banks and other financial market participants to maintain the functioning of financial markets. And, it has eased monetary policy considerably to try to ensure that the disruptions in financial markets do not spread to the broader economy.

Despite current difficulties, in my view there is room for optimism about the near-term outlook for the U.S. economy. Financial markets appear to have stabilized somewhat, and the economy should pick up in the second half of the year as fiscal and monetary stimuli takes hold. The damage to financial markets is severe, however, and it is likely to be some time before they are able to function normally. Indeed, I believe that major changes in industry practices and a significant rethinking of financial regulation will be required if we are to avoid similar problems in the future.

Market turmoil

Let me provide a more detailed discussion of the disruptions in financial markets that have occurred over the past several months and the

Federal Reserve's response to these events. It is a simple fact of history that, over a business cycle, markets tend toward excess optimism in which risk is seriously underestimated. In some cases, public policy is required to "bail out" undeserving parties so as to minimize the broader impact on the economy. It is also a fact that no matter the source of the financial problem, no matter the size of the institution or the region in which the problem emerges, the Federal Reserve will be part of any solution that is developed. This was the case in the '70s, '80s and '90s during the foreign debt, farm, real estate and energy crises, and is the case today. As a necessary principal party in prudential supervision and as the lender of last resort, the Federal Reserve is best positioned for this task.

Most in this room are by now well aware of the role that subprime lending played in the creation of the housing bubble and its collapse. However, the problems in the financial system are much broader and deeper than subprime lending. Over the past several years, we have seen the emergence of easy credit availability, new complex financial instruments and reduced credit standards by many financial institutions. This left the U.S. financial system dangerously exposed to an economic or financial shock that could cause widespread defaults and erosion of asset values. Rising subprime delinquencies provided the spark that started the financial conflagration, but there was a lot of dry tinder to spread the fire and an absence of firewalls and a sprinkler system to contain the blaze.



In recent years, subprime mortgages, like other mortgages, have been packaged into mortgage-backed securities, and these securities then served as collateral for more complex asset-backed securities. When subprime delinquencies rose unexpectedly last summer, investors in many types of asset-backed securities fled these markets, causing severe valuation declines and losses to the holders of these securities. Although banks did not make many of the original subprime loans, they held many of the affected securities and made loans to other institutions that created and held these securities. What resulted was a tremendous liquidity squeeze for the banking system and financial markets as well as large losses as the value of mortgage and other asset-backed securities declined. These strains were felt not only in the United States but also in Europe, Canada, and some other countries where banks and other financial institutions had also invested in U.S. mortgage and asset-backed securities.

To meet panic demands for liquidity, the Federal Reserve and central banks in a number of other countries have taken extraordinary steps to maintain the functioning of the financial system. In the United States the Federal Reserve has made funds available to banks and other depository institutions through its discount window and has lowered the cost of these funds. It has created a new discount window program, the Term Auction Facility, to provide additional funds to depository institutions at a market-determined rate.

The Federal Reserve also has taken a series of unprecedented actions to provide support to financial markets more generally. For example, it has broadened the range of collateral in its open market operations and security lending program. More recently, it has created a new discount window facility for the banks and investment banks that operate as primary dealers. These institutions play a key role in the Treasury securities market, and their health is important for the Federal Reserve's ability to conduct monetary policy through open market operations and for Treasury debt management operations. And, the Federal Reserve recently chose to provide direct support to Bear Stearns, a primary dealer, to facilitate its purchase.

As I indicated earlier, financial markets have stabilized recently, in part because of the Federal

Reserve's timely actions. However, many of these actions were short-term in nature, and it is important that more permanent approaches be developed so that a similar crisis does not happen again. In my remaining time, I will discuss the longer-term approaches necessary to restoring and maintaining financial stability.

Steps toward financial and regulatory reform

The current financial crisis has revealed weaknesses both in the private mechanisms that financial markets employ to provide internal discipline and in our system of financial regulation and oversight. From the standpoint of private market discipline, this crisis has provided the first major test of securitization, complex financial instruments, risk modeling, and our new and broader market structure. Recent events indicate dismal test results: Many financial institutions and investors did not adequately judge, price or control the risks they assumed and did not prepare well for changing financial conditions. All of this occurred despite the wide array of new financial instruments for hedging risks and the substantial advances many market participants claimed to have made in their risk management processes.

From a regulatory perspective, existing policies and supervisory oversight came up short in several areas, most notably in identifying and addressing the exposures institutions had in certain off-balance-sheet activities and in their mortgage lending and securitization activities. These exposures, along with shortcomings in bank risk management systems, led to inadequate capital and liquidity levels and to inaccurate disclosures of risk positions to investors. Other complaints about the regulatory framework have included its failure to prevent fraudulent and abusive practices in some areas of the subprime market.

One other important regulatory concern is that many of the steps public authorities have taken over the last year to stabilize the financial system seem likely to weaken market discipline and extend moral hazard problems to a much wider financial marketplace. A key example of this, the recent sale of Bear Stearns, seems to indicate that

in a crisis situation, public authorities will not be in a position to let market discipline play out when larger financial institutions encounter problems. Bear Stearns' collapse indicates that such phrases as "systemically important" and "too-big-to-fail" can even be applied to investment banks below the top tier.

The danger from a public policy perspective is that a much broader group of managers and creditors may now believe and act as if they have an added layer of protection from the risks they pursue. Beyond "too-big-to-fail" concerns, other market discipline and moral hazard problems may be inherent in some of the recent and more expansive proposals to support housing markets and in the actions the Federal Reserve had to take to provide liquidity to the market and expand discount window access.

All of these questions about our financial system are eliciting many suggestions for reform. Some have suggested that we should turn back the clock when it comes to our efforts to deregulate financial markets, and others are suggesting significant changes in the regulatory structure. However, I believe a more fundamental issue is at the heart of our problems and should remain the focus of our efforts: How can we strike an appropriate balance between risk and return in our financial marketplace, while developing the public policy steps necessary to support this framework and promote financial stability?

In a longer-run context, we have two basic means by which to strengthen and reform our financial system: promote more effective market discipline and implement an improved and more countercyclical regulatory framework.

Steps toward more effective market discipline

For our financial markets to work well, market participants must serve as a strong disciplinary force in rewarding successful ventures and curtailing funding for nonviable projects and investments. However, as shown by the current crisis, market discipline failed to prevent an overexpansion in the markets for mortgage finance and allowed a significant mispricing of the underlying risks.

Some of the factors that contributed to this

market breakdown include the emergence of extremely complex and hard-to-understand financial instruments; shortcomings in regulatory oversight and poor disclosures; financial conflicts of interest; and shortcomings in corporate governance. For instance, evaluating the more complex mortgage-backed securities and collateralized debt obligations taxed the abilities of most investors. These investors were then left to rely on the credit assessments of loan originators, rating agencies, traders, and the managers of hedge funds and other investor vehicles, most of whom had competing financial incentives. Of course, the perennial factor in boom-and-bust cycles—greed-induced myopia—also played a central role as many market participants assumed that we could not have a nationwide decline in housing prices and that a continuous flow of funds would be available.

What steps should market participants take to restore their disciplinary role in the financial system and prevent the depth of problems we have recently experienced? In the near term, investors can be expected to show a preference for simpler and more readily understood financial instruments, while showing a reluctance to put their money in the types of markets and investment vehicles that have caused much of the recent turmoil. They can also be expected to exert more "due diligence" and to favor the originators, rating agencies and fund managers that demonstrate a reputation for providing sound credit analysis and accurate disclosures. These are certainly some of the most apparent "lessons to be learned," and it will take some time for our financial markets to regain the confidence of investors and meet this revised set of expectations.

Experience tells us, however, that as time passes and memories fade, market participants will always be tempted to relax their ongoing disciplinary role, particularly as any corrective steps begin to appear outmoded in a more prosperous time and as new and seemingly more profitable opportunities and investment vehicles are developed. For market discipline to be most effective over an entire cycle, it will thus be important for investors and institutions to work to establish a more resilient financial framework.

Some key areas for market participants to work on are: improving financial disclosure practices and

developing risk management processes and models that reflect a full range of economic experiences. Other needed reforms include establishing stronger corporate governance steps—including a better set of incentives for financial agents to reduce the conflicts of interest they now face—and fostering better control of liquidity risk, clearing and settlement risks, and counterparty risk.

A stronger, more countercyclical regulatory framework

Weaknesses in our regulatory system revealed by the current financial crisis also require careful thought and action. This crisis, in fact, is raising questions about such traditional supervisory issues as bank liquidity analysis, capital standards, risk management practices and off-balance-sheet exposures. Because many financial activities are gravitating beyond the banking system and into less-regulated capital markets, questions about the scope of regulation and how it can best support market discipline must be addressed.

One area where a number of large banking organizations and securities firms have fallen short is in the amount of capital they were holding against their risk exposures. It is clear that many organizations underestimated such risks and, accordingly, the amount of capital they would need. This was particularly true for a number of new off-balance-sheet activities of larger banking organizations. With the transition to Basel II international capital standards for large banks and the reliance this system will place on banks' internal risk models, it is particularly important that we make sure this approach addresses the type of problems recently encountered.

In this regard, I have a number of concerns and believe we need to be cautious as we implement the new standards. First, banks have had a fairly short history with their risk models and much of the data going into these models reflects only the period of prosperity before recent events. In fact, tests run on these models over the past few years have suggested that most large banks could safely reduce the amount of capital they hold—a premise which has now been shown to be overly optimistic. In addition, recent capital problems for larger banking

associations were tied, in part, to their off-balance-sheet operations, and it is not clear whether Basel II will address these practices, as well as future banking innovations, any better than Basel I.

A final concern is that Basel II has the potential to be procyclical as bankers update their risk models to reflect new events. Consequently, if we want banks to have the capital to withstand future crises, I believe it is important for our capital standards to incorporate a longer-term view of risk and for banks to maintain a base of capital or a leverage ratio sufficient to support all their operations. A countercyclical, rules-based approach to control leverage is needed. It must be simple and observable and, thereby, enforceable.

Liquidity has been another problem for many institutions, particularly with breakdowns in the commercial paper and other funding markets, difficulties in valuing asset-backed securities and other investment vehicles, maturity mismatch problems, and questions about the financial condition of some institutions. As I mentioned previously, the Federal Reserve has taken a number of new approaches through the discount window to address these liquidity issues. We will certainly reevaluate these steps in the near future and decide what worked and whether such innovations as the liquidity facility should be continued.

We will also have to take a careful look at the moral hazard issues that might have been created by the expansion in discount window access and consider what we can do to change such perceptions. Other suggestions for reforming the discount window have also been made, such as converting some of the lending to a "line of credit" format, under which institutions could pay a fee for standby access to the window. It is also of critical importance for banking and other financial supervisors to review and strengthen their policies on liquidity; otherwise we will face many of the same problems in the future.

Because many of our current financial problems can be tied to asset-backed securities, beginning with the subprime market, we should ask ourselves what can be done to strengthen the regulatory framework surrounding securitization and to address the asymmetric information problems in this market. This is a particularly important question given the

benefits that securitization can bring to our credit markets in terms of attracting new funding sources and distributing risk across a broader marketplace.

Among the ideas now being suggested are: (1) tighter registration requirements for loan originators; (2) improved disclosures by originators and securitizers on the underlying loans; (3) new limits on the types of asset-backed securities regulated institutions can hold; (4) greater liability, risk exposure or equity positions for originators and securitizers; and (5) new regulations for the agencies rating these securities.

Other regulatory steps may be necessary. For example, some have questioned whether the regulatory framework has kept up with the movement of securities firms into a broader range of activities. Where such firms once concentrated on brokerage and underwriting activities, the recent market collapse has shown that the most significant risks securities firms face are now in other areas. In regard to subprime lending regulation, the Federal Reserve has proposed a number of regulatory changes under Regulation Z and the Home Ownership and Equity Protection Act to provide greater protection to consumers and to eliminate certain deceptive or abusive practices on higher-priced mortgage loans. These amendments would also extend other protections to all mortgage loans, including additional disclosures when lenders advertise loan rates and features.

A final and very important regulatory issue is what we do with firms that might be considered "too-big-to-fail." With a growing number of large firms linked to each other through clearing and settlement systems, capital markets activities, and counterparty risks, it is becoming more difficult to avoid supporting such entities during crisis periods. In fact, we are rapidly creating an environment in which the investors, creditors and managers at such institutions take it for granted that they will have this added measure of protection when taking risk.

There are no easy answers in dealing with this "too-big-to-fail" issue, but we need to take some strong steps if we are to restore the proper balance between financial risk and return and make market discipline effective. But we must be certain that whenever a bailout cannot be avoided, it should follow that public authorities assume senior positions

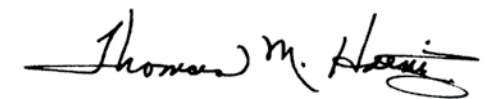
with respect to stockholders and other creditors at these "too-big-to-fail" institutions.

Conclusion

The Federal Reserve, as the nation's central bank, has responsibility and accountability for overall financial stability. It has been given the tools of authority in monetary policy, and regulatory and payments system oversight in a decentralized structure insulated from politics to achieve its mission. Doing what must be done to facilitate financial stability has always been the independent Federal Reserve System's role. It will be difficult. One has to look no further than recent news media headlines about the strong opposition to the proposed regulatory changes in the mortgage industry that I just mentioned to know this is true. But this environment is not much different today than at the Federal Reserve's founding. Thus, as we take on these new challenges, I'll leave you with this quote from 1930 to illustrate my point. It is from Paul Warburg, who was appointed a member of the first Federal Reserve Board by President Woodrow Wilson:

"In a country whose idol is prosperity, any attempt to tamper with conditions in which easy profits are made and people are happy, is strongly resented. It is a desperately unpopular undertaking to dare to sound a discordant note of warning in an atmosphere of cheer, even though one might be able to forecast with certainty that the ice, on which the mad dance was going on, was bound to break. Even if one succeeded in driving the frolicking crowd ashore before the ice cracked, there would have been protests that the cover was strong enough and that no disaster would have occurred if only the situation had been left alone."

There are many challenges ahead, many choices to make. Some I suspect will be desperately unpopular.



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