

Next Time Can Be Different

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I am very pleased to be here to discuss financial system reforms. Over the past few years, significant policy reforms have been adopted in many countries in an attempt to address problems that arose during the financial crisis and that in many respects continue to plague our financial systems. As financial supervisors, we are now in the process of deciding how to implement the new reforms, while also thinking about what else should be done.

I am pleased to see this conference focus on the challenges we now face in supervising financial institutions and in creating a more resilient and stable financial system—both domestically and globally. In fact, the organizers of the conference have structured this important policy debate around the key questions that we should be asking ourselves. Among these are: What policy tools will be effective, which tools will function as intended, are there alternative steps we should consider, and what reforms might remain “works in progress” for the foreseeable future?

Following the theme of this conference, I will provide a high-level context for the steps taken in the United States to address the financial crisis—many of which mirror actions being taken around the world or by international authorities. Then I will offer my own views on whether these policy steps can be expected to contribute to a more stable financial system while addressing what went wrong in the crisis.

Financial Crisis and Reform in the United States

The financial crisis in the United States was unique in the sense that it was one of the more severe crises in U.S. and global history. It also involved a deep and widespread collapse in the housing sector that had never occurred before in our country, except perhaps during the

1930s. The cost of this crisis has been exceedingly large and continues to grow. From the standpoint of direct costs, the conservatorships of Fannie Mae and Freddie Mac—our two main government sponsored enterprises for housing—have so far cost taxpayers \$187 billion. The estimated losses to the Deposit Insurance Fund from failures of depository institutions between 2008 and 2011 have been more than \$85 billion, and federal authorities provided more than \$245 billion in capital support to depository institutions through the Troubled Asset Relief Program (TARP)—all but \$10 billion of which has been paid back with interest and fees.

These direct costs, though, are just the tip of the iceberg. The crisis led to a reduction in home equity in the United States of nearly \$7 trillion. The International Monetary Fund estimated that the crisis could result in write downs of loans and securities in U.S. banks of as much as \$1 trillion. Among other costs related to the crisis, the fiscal stimulus authorized by our federal government in 2008 and 2009 totaled more than \$1 trillion, and we have also suffered from large federal deficits, protracted unemployment and slow economic growth. Finally, the combination of massive public assistance and outsized executive compensation has created widespread mistrust and anger directed at large financial institutions, their regulators and government officials.

All of these costs justifiably created substantial pressure for major reform of our financial regulatory system. Much has been written about the crisis and its spread on a global basis, so I will turn to the key reforms we are adopting in the United States as we try to enhance supervisory focus and create a stronger financial system.

Two years ago, the U.S. enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act in the hope of bringing greater stability to its financial system. This act has many components and introduces a macroprudential perspective by creating the Financial Stability

Oversight Council. This Council is chaired by the Secretary of the Treasury Department, with nine other voting members drawn largely from the federal financial regulatory agencies and five nonvoting members. A major responsibility of the Council is to identify and monitor emerging risks or regulatory gaps that might threaten financial stability and to make recommendations for corrective action. The Council issued its first annual report on financial stability in 2011, and another report was issued in July of this year. These reports have provided a starting point, but there is still much to be done with regard to the very challenging task of monitoring financial trends and threats to stability and developing timely and effective responses.

The Council is also charged with identifying nonbank financial institutions whose activities, financial distress or failure could pose a risk to financial stability. The Council has yet to identify the specific nonbank companies that will be designated in this manner. Under other authority, the Council has identified eight systemically important financial market utilities that will be subject to enhanced risk-management standards.

Any nonbank companies that are identified as systemically important and all banking organizations with more than \$50 billion in total assets will be subject to heightened supervisory standards and prudential supervision by the Federal Reserve, including risk-based capital, liquidity, overall risk-management and credit exposure reporting, concentration limits, resolution plans or living wills, and standalone risk committees. The Dodd-Frank Act also requires the Federal Reserve to conduct annual stress tests of these companies using three different scenarios with the companies further conducting their own stress tests.

These standards are in various stages of the rulemaking process with the resolution plan requirement being the only one that has been finalized. Resolution plans have been submitted by

the largest banking organizations, and the Federal Deposit Insurance Corp. and the Federal Reserve are currently evaluating them.

Other provisions of the Dodd-Frank Act with a macroprudential or financial stability focus include a new resolution authority for financial companies whose failure would pose a significant risk to financial stability in the United States. This authority would be an alternative to our standard bankruptcy process, and the FDIC would act as receiver. Other provisions include reform of the derivatives market to increase its transparency, the Volcker Rule limits on proprietary trading and sponsorships of hedge and private equity funds by banking organizations, and risk retention requirements for entities issuing asset-backed securities. In addition, the act mandates countercyclical capital requirements calling for institutions to build up a capital buffer during strong economic periods in order to provide an additional layer of protection during periods of financial stress.

Overall, the Dodd-Frank Act attempts to establish a framework for closer monitoring of threats to financial stability, heightened oversight of systemically important institutions and a countercyclical approach to capital and liquidity.

Will These Steps Contribute to a More Stable Financial System?

Without question, the United States needed a strong response to the financial crisis, and many of these new or enhanced supervisory approaches could be useful if done well. Even so, the magnitude and cost of the crisis demands that we ask ourselves if these steps are sufficient. Have we addressed the fundamental sources of the problems, and if not, What are the unintended consequences?

First, the misaligned incentives and the expansion of federal safety net protections codified parts of the financial system as “too big to fail.” Public safety nets were extended far beyond anything that we, as supervisors and policymakers, had done previously, thus adding further to moral hazard. In the United States, deposit insurance coverage was substantially increased during this crisis, bank debt instruments were guaranteed, and a variety of special discount window programs were created by the Federal Reserve to expand this lending and reach a wider range of institutions. The outcome of all these actions was to protect creditors and stockholders of financial institutions from having to bear the full cost of their decisions while shifting this burden to taxpayers. These actions further raise the question of whether we have provided even greater incentives to take on added risk in the future.

We have attempted to address these issues through the Dodd-Frank Act. Although unintended, reforms that call for designating firms as systemically important may reaffirm their status as “too big to fail.” Additionally, the enormous volume of new regulations may not effectively address the weaknesses.

As we have just seen during a crisis, public officials face real concerns about creditor or depositor panics, market breakdowns and losses in public confidence, and possible connections among large institutions. We should acknowledge that such concerns could be more intense during the next crisis if we do not take steps now to strengthen the foundation of the financial system. We will have to deal with the escalating safety net and associated moral hazard issues left over from this crisis as well as the continued concentration of the industry. Since the end of 2007, total assets held by the five largest banking organizations in the United States have risen by over \$1.7 trillion, a more than 25 percent increase.

Thus, reforms must focus on limiting public safety nets and the moral hazard issues they create and restoring a strong governance framework to ensure that the various participants in financial markets bear full responsibility for the decisions they make. With regard to safety nets, we must take a closer look at what they should cover and what activities are appropriate for the institutions that receive such protection. In the United States, this discussion is focused on the Volcker Rule limits for proprietary trading, as well as other proposals for restricting insured institutions to more traditional activities. As shown in this crisis, we also must be sure that we have an appropriate regulatory and governance framework in place for institutions and markets that operate outside of this safety net protection.

Unfortunately, governance and market discipline mechanisms are at risk of being diluted by a panoply of regulations. Nowhere is this more obvious than in the Dodd-Frank Act. This act contains many provisions that legislate things bankers should naturally do with the right incentives in place. For example, the act states that bankers cannot make a mortgage loan to a person that does not have the ability to repay the loan. The act also requires bankers to build up a capital buffer in prosperous times to prepare for more stressful times.

Rather than adding regulation, we could better align incentives by allowing stockholders, unsecured creditors and bank management to bear full responsibility for losses incurred by their institutions. We must also develop the resolve not to give bank stockholders and creditors a restart with capital injections and other assistance when their institutions get to the brink of failure. Likewise, managers and key employees should have a notable financial stake tied to the success or failure of their institution. Specifically, incentive-based compensation and other remuneration for executives should not be a one-way street that only goes up and fails to extract a price for financial losses. All of these steps are necessary for a more resilient financial system.

A second reason for altering our supervisory approach is that we risk adding complexity to financial regulation without increasing the effectiveness of our supervision. The Basel capital requirements are emblematic of this with the estimation and calibration of thousands of parameters—all of which are likely to be based on a limited range of past samples and cycles. The complexity inherent in these standards continues to give the most sophisticated financial companies considerable opportunities to arbitrage the process. Experience shows that assets that regulators felt were relatively safe and deserving of low-risk weights—such as mortgage-backed securities and sovereign debt—instead served as trigger points for the crisis. And by giving such assets low-risk weights, regulators may have encouraged greater industry-wide concentration in these instruments and, accordingly, a more severe crisis. A number of the capital measures that regulators included in Tier I capital also failed to provide a ready means of support when needed.

Others have found that simple capital measures, such as leverage ratios, typically do a better job of separating strong banks from weak banks when compared to more complex, risk-based measures.¹ Our existing regulatory capital ratios also have proven to be far less responsive to and reflective of financial crises and economic downturns than capital measures based on the market capitalization of institutions.

The Dodd-Frank Act itself is full of complexity. This law is hundreds of pages long and its mandated rule-making by some estimates could run to as much as 30,000 pages. In contrast, one of the most significant pieces of U.S. banking legislation, the Banking Act of 1933, is only 37 pages long, and it included such noteworthy steps as the creation of federal deposit insurance and the separation of commercial and investment banking.

¹ Andrew Haldane and Vasileios Madouros, "[The Dog and the Frisbee](#)," Bank of England, given as a speech by Haldane at the Federal Reserve Bank of Kansas City's 36th Economic Policy Symposium, Jackson Hole, Wyoming, August 31, 2012.

Will more complex regulations contribute to a more stable financial system? After having spent most of my career as a bank supervisor, I have my doubts. Supervisory lapses exposed during the crisis were not the result of inadequate regulation. Instead, these lapses reflected the failure of supervisors and market participants to ask and pursue answers to the most basic and simple questions: Are credit standards declining, and if so, what are the implications? What happens when the surge in housing prices becomes unsustainable? What will be the outcome when the compensation of key players does not reflect the risks and losses they might impose on their institutions? Or, What is the likely result when the creditors and stockholders of financial institutions are protected against losses? One could argue that posing and answering these simple questions might have given supervisors far better insight into the fate of the financial system.

This brings me to my third and final reason to evaluate our supervisory response. As we strive to be macroprudentialists, we must not diminish the importance of microprudential supervision. In fact, we should increase our emphasis on traditional supervision for the largest financial firms even as we pursue the new and unproven concepts of macroprudential supervision.

From a supervisory perspective, examiners perform such critical tasks as verifying the quality of a bank's assets, understanding the bank's business model, and evaluating lending standards and other factors that determine its risk exposure. The judgments and decisions by examiners typically provide the earliest warning signal of problems at both the bank level and across the entire financial system, and we must continue to provide examiners with the independence, authority and resources to fulfill this role.

Experienced examiners, especially those who have been through previous crises, are well-positioned to recognize the type of risk exposures and conditions that could have

macroeconomic implications. There is no substitute for the judgment of experienced examiners and for their ability to distinguish between institutions that can withstand significant distress and those that are no longer viable. In addition, such examiners are in the best position to ask and answer the simple set of questions posed earlier about lending standards, unsustainable trends, corporate governance shortcomings and improper incentives.

The breakdown of risk models and risk-management practices serves as a reminder that stress tests and other forms of quantitative analysis, as well as the tools and conclusions of macroprudential supervisors, are useful complements to supervision but should not substitute for examiners and onsite supervision.

Conclusion

Given the cost of the financial crisis, policymakers must be determined to make the financial system more resilient and stable. My own diagnosis is that we must address the misguided incentives that set the stage for this crisis. These include ever-expanding safety nets, “too big to fail” policies, and other incentives that inadvertently shift the threat of losses away from responsible parties.

Adding new and more detailed regulations focuses on addressing the specific weaknesses exposed in the last crisis. Digging deeper to address the misaligned incentives offers the potential for more fundamental change to the system. Only when financial institutions and market participants have to fully consider the risk and consequences of their decisions—verified with strong supervisory regimes—will we be assured that next time can be different.