Containing Risk in the New Global Financial Landscape

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After the Crisis: Planning a New Financial Structure

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Any opinions expressed here are my own and do not necessarily reflect those of the Federal Open Market Committee participants.

TOPICS FOR TODAY

- Main idea: Try to assess the state of the regulatory reform debate.
- Consider some of the origins of the financial crisis.
- Ask two questions of current financial regulatory reform proposals:
  - Could these proposals have prevented the most recent financial crisis?
  - Would they prevent a *future*, unknowable crisis?

Preview of main conclusions

- Only a few of the most recent financial regulatory reform proposals are likely to help prevent future crises.
- As the nation's lender of last resort, the Fed will be at the center of managing any future financial crisis.
- This argues for the Fed playing the lead role in the new regulatory structure.
- *A Fed with appropriately broad regulatory authority provides the nation with the best chance of avoiding a future crisis.*

Origins of the Crisis

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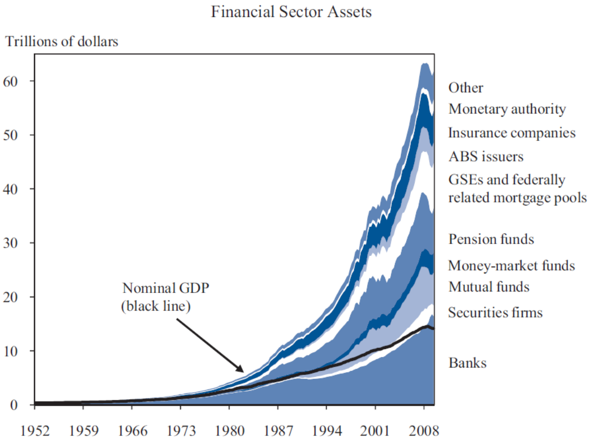
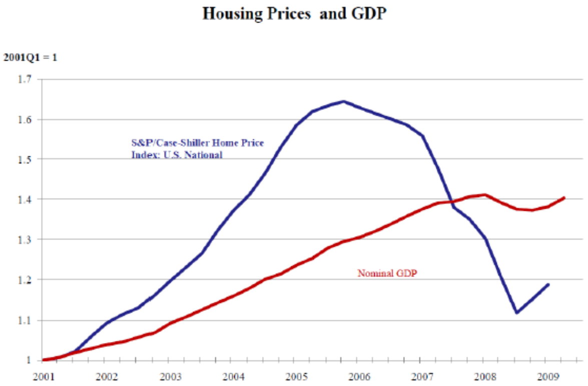
- Fundamentally, the crisis was caused by a failure of financial engineering.
  - First, a securitization boom.
  - Second, a housing boom followed by a dramatic decline in housing prices.
  - Securitized products did not take the possibility of a decline in housing prices into account appropriately.
    - It could have been done correctly. There is nothing wrong with securitization *per se*.
  - Securitized paper was worth much less than most anticipated, and it was held by financial entities worldwide, who had to accept large losses.
  - Firms were naturally unwilling to reveal losses.
  - This created a panic.

Financial sector assets boom



Sources: Federal Reserve Board, Flow of Funds; Department of Commerce (Bureau of Economic Analysis), National Income and Product Accounts Table 1.1.5.

Housing boom and bust



Source: S&P, Fiserv, and MacroMarkets LLC and Bureau of Economic Analysis. Quarterly Data. Last observation is 2009:Q3 for Price Index and 2009:Q4 for GDP.

The panic produced run-like events

- The crisis caused runs in the shadow banking sector.
  - These are institutions that did not take deposits and so were not thought to be susceptible to a run.
- The solution to *bank* runs is deposit insurance plus prudential regulation.
  - Reserve requirements are not enough.
  - Deposit insurance removes the incentives of depositors to run.
- There is no analog of deposit insurance for *shadow* banks.
  - Capital requirements, the analog of reserve requirements, are not enough.
- I do not see this issue being addressed.
- I think the nation will remain vulnerable to runs in the shadow banking sector.

Allowing sudden failure

- The crisis showed that large financial institutions worldwide were "too big to fail." (TBTF)
- We can let large financial firms fail suddenly ...
- ... but then global panic ensues.
    - *Reform proposals have to face this fact*.
    - Chicago-style vows to not intervene in the future will not solve this problem.
    - Vows like this are not credible. (See Feldman and Stern, 2004).
    - The TBTF problem is harder than that.

It's Mostly Shadow Banking

It's mostly shadow banking

Large S&P 500 Financial Firms (As of 2007:Q4)

Firm	Total Assets, Bill. (2007:Q4)	Pct. of Tot. Assets in S&P 500 Fin.	Cum. Percent	Type of Firm (2007: Q4)
Citigroup Inc.	$2,187	10.9%	10.9%	BHC
Bank of America Corp.	1,715	8.5	19.5	BHC
JPM Chase & Co.	1,562	7.8	27.3	BHC
Goldman Sachs Grp.	1,119	5.5	32.9	Inv. Bank
AIG	1,060	5.3	38.2	Insurance
Morgan Stanley	1,045	5.2	43.4	Inv. Bank
Merrill Lynch	1,020	5.1	48.5	Inv. Bank
Fannie Mae	882	4.4	53.9	GSE
FHL Mortg.	794	3.9	56.9	GSE
Wachovia Corp.	782	3.9	60.8	BHC

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Firm	Total Assets, Bill. (2007:Q4)	Pct. of Tot. Assets in S&P 500 Fin.	Cum. Percent	Type of Firm (2007:Q4)
Lehman Bros.	691	3.4	64.2	Inv. Bank
Wells Fargo	575	2.8	67.1	BHC
MetLife Inc.	558	2.7	69.9	Insurance
Prudential Financial	485	2.4	72.3	Fin. Adv./Ins.
Hartford Financial Svcs.	360	1.8	74.1	Insurance
Washington Mutual	327	1.6	75.7	Thrift
U.S. Bancorp	237	1.1	76.9	BHC
Countrywide Financial Corp.	211	1.0	78.0	Thrift
Bank of NY Mellon Corp.	197	0.9	79.0	BHC
Lincoln National	191	0.9	79.9	Insurance

Summary of the table

- As the crisis started in Fall 2007, 20 firms accounted for about 80 percent of financial sector assets in the U.S.
- About 1/3 of this total was in bank holding companies.
- About 2/3 was non-bank financials: Government-sponsored enterprises (Fannie Mae and Freddie Mac), investment banks, insurance companies, and thrifts.
- A large fraction of financial assets in U.S.-based firms were not in the bank regulatory system, and not under the regulatory authority of the Fed.

Nearly all firms were affected

- The non-bank financials in the table provide a who's-who of the most nettlesome entities during the crisis!
- *All of these firms faced severe stress during the crisis, regardless of the type of firm or the nature of regulation.*
- This is generally true globally as well.
  - All were taken in by the allure of securitized products in various ways.
- The shock was to the entire global industry, not so much to particular firms.
- How can we prevent an entire industry from adopting the same strategy?
- I do not see this being addressed.

The financial landscape

- The crisis encompassed a far larger segment than just commercial banking.
- We need to think in terms of the *financial landscape*.
- Many non-bank financial firms, outside the banking sector, were at the heart of the crisis.
- These firms were not regulated by the Fed.

A "Wall Street Only" Fed

Community banks

- Regulation works well for the thousands of community banks in the U.S.
- The system features deposit insurance plus prudential regulation.
- The system allows failure—capitalism at work—but prevents bank runs and the associated panic.
- *Community banks did not cause the crisis and do not need to be re-regulated.*

The Fed and community bank regulation

- Some regulatory proposals seek to create a "Wall Street only" Fed.
- The Fed should remain involved with community bank regulation so that it has a view of the entire financial landscape.
  - It is important that the Fed does not become biased toward the very large, mostly New York-based institutions.
- One critical role of regulation is to provide a level, competitive playing field for institutions of all sizes.
- Community banks tend to fund smaller businesses, an important source of job growth for the economy.
- Understanding this process helps the Fed make sound monetary policy decisions.

A Broader Regulatory Role for the Fed

Main theme

- The Fed had access to a limited view of the financial landscape coming into the crisis: that for which it had supervisory authority.
- This made it harder to perform the lender of last resort role.
- This led to a lot of *ad hoc* decision-making.
- The Fed will again play the lender-of-last-resort role in the next crisis.
- This will go much more smoothly if the Fed has broad regulatory authority.

The Fed and banking supervision

- The U.S. has a primary regulator system for the nation's 8,000+ commercial banks and thrifts.
- The primary regulator has the key authority for the regulation of the bank.
- Before the crisis (as of January 2007):
  - The Fed had primary regulatory responsibility for about 12 percent of the banks.
  - About 14 percent by assets.
- The remaining 85 percent of banks and assets had non-Fed primary regulators.

The Fed had limited information

- Non-bank financial firms turned out to be the most troublesome entities in this crisis.
- The Fed had no supervisory authority over these entities:
  - Investment banks like Goldman Sachs and Bear Stearns.
  - Insurance companies like Prudential and AIG.
  - Financial hybrids like GE Capital and GMAC.
- The Fed had access to limited information coming into the crisis:
  - Primary regulatory authority for only some of the banks, and none for the troublesome non-bank financials.
- Bottom line: *Due to its narrow regulatory authority, the Fed had a severely limited view of the financial landscape as the crisis began.*

The crisis unfolds

- As the crisis began, all eyes turned to the Fed as the lender of last resort.
- This always happens in a crisis—only the central bank can play the lender-of-last-resort role.
- But the Fed had detailed knowledge only of part of the financial landscape: that for which it had supervisory authority.
- The Fed had limited access to information on institutions outside its supervisory authority, especially non-bank financial firms.
- Many of the critical lending decisions involved the controversial non-bank financials like Bear Stearns.

The reform response

- The clear lesson is that the Fed had insufficient access to information about the financial landscape going into the crisis.
- Neither the Fed nor anyone else fully understood the potential for feedback between the financial sector and the rest of the economy.
- The Fed will be at the center of all future crises because of its lender-of-last-resort role.
- The central bank, as lender of last resort, must be well-informed about the entire financial landscape.
- The reform response should be to provide the Fed with an appropriately broad regulatory authority.
    - *A future Fed, with an appropriately broad regulatory responsibility, provides the U.S. with the best chance to head off a future crisis.*

Reform Proposals

Systemic risk

- The House bill creates an interagency Financial Services Oversight Council (FSOC) to monitor systemic risks posed to the financial system.
  - In the House bill, the Federal Reserve would serve as the "agent" to the Council and not as the systemic risk regulator.
  - Other debate has suggested investing the Council with more direct authority.
- Would this prevent a future crisis? I think the evidence is far from clear.

More on systemic risk

- Not likely that this Council, had it existed in the past, would have advocated aggressive action to control systemic risk.
- It seems like it would be difficult for an interagency Council to come to agreement on a specific risk and an associated action when times are good.
- The role of the Council would be to "take away the punch bowl as the party gets started."
- This type of decision may be better suited to the Fed.
  - The Fed is more politically independent than a Council.

A RESOLUTION REGIME

- In the House bill, the FDIC is granted expanded authority to put systemically important firms into receivership.
  - Other debate has suggested a special bankruptcy court for large financial firms.
- Would this prevent a future crisis? It might.
- This reform goes in the direction of strengthening market incentives.
- A resolution regime is a way of putting market discipline on very large financial firms—we really could allow failure without creating panic.
- The fear of failure would then prevent firms from taking excessive risks and from being able to borrow at low rates.

A resolution regime: Key concerns

- Key concern: How credible will the regime be?
- If it is not credible and the government is going to come in after all, then it is useless.
  - "Funeral plans" for the firm in the event of failure do not strike me as credible.
- Key concern: How much global cooperation can be expected?

Restrictions on 13(3) lending

- In the House bill, significant restrictions are placed on Fed lending to non-banks under the "unusual and exigent circumstances" clause.
- Would this prevent a future crisis? No.
- This will probably exacerbate a future crisis.
- A future Fed may be hamstrung and forced to let the crisis roll on.

Consumer protection

- The House bill creates a separate Consumer Financial Protection Agency (CFPA) with rule-writing authority for all banks and non-banks that extend consumer credit.
  - This has been very controversial in the Congress.
  - Other debate has suggested putting this in agencies other than the Fed.
- Would this prevent a future crisis? I don't think so.
- A fair playing field is certainly desirable in all consumer products.
- But the housing boom was a classic gold rush: most people bought the houses because they thought the prices would keep rising.
- A CFPA would not have changed the gold rush dynamic.

Sins of Omission

- GSE reform not addressed in current legislative proposals.

Conclusions

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- This argues for the Fed playing the lead role in the new regulatory structure.
- *A Fed with appropriately broad regulatory authority provides the nation with the best chance of avoiding a future crisis.*
- Only a few of the current financial regulatory reform proposals are likely to help prevent future crises.

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