Roger W Ferguson, Jr: Financial regulation - seeking the middle way

Remarks by Mr Roger W Ferguson, Jr, Vice Chairman of the Board of Governors of the US Federal Reserve System, at the Institute of International Finance Spring 2006 Membership Meeting, Zurich, 31 March 2006.

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I am pleased to participate in the panel discussion at this Institute of International Finance Spring 2006 Membership Meeting. As I will make clear, I think meetings of this sort, by contributing to the dialogue between the leaders of financial institutions and policymakers, can play a critical role in increasing mutual understanding and improved decisionmaking by both groups. The financial environment can best be described as "dynamic." Financial innovations have been coming at a rapid pace in recent years; new financial products have been introduced and are expanding rapidly, and new institutions have taken on prominent roles in key financial markets. Financial technologies have improved as well and have the potential to contribute to the efficiency and resilience of financial markets. However, with new products and institutions comes the potential for new risks to financial stability. As a result, we policymakers are likely to be torn. On the one hand, we may want to encourage welfare-improving innovations by limiting the extent of regulation. On the other hand, because of possible systemic concerns, some policymakers may want to regulate innovative instruments and institutions even as they are developing. In my view, policymakers can best balance these goals by expending the effort needed to understand financial innovations as they emerge and by avoiding overregulation that may stifle valuable innovations.

When I talk about financial innovations, I have in mind several types of developments. A far-reaching set of innovations is the development and increasing popularity of products for the transfer of credit risk. Prominent among such innovations are credit derivatives, asset-backed securities, and secondary-market trading of syndicated loans. Another important development has been the rapid growth of the hedge fund industry and its expanded role in the financial system. On the retail side, we have seen a proliferation of new lending products in the United States, including home-equity lines of credit, interest-only and even negative-amortization mortgages, and subprime mortgages and consumer loans.

Today, I will discuss briefly the potential benefits and drawbacks associated with new products and institutions and spend most of my remarks on a middle way that regulators might pursue as these new products and institutions emerge.

Benefits and drawbacks

Financial innovations hold the promise of improved efficiency and increased overall economic welfare. For example, new products and markets can open the door to new investment opportunities for a variety of market participants. And improved risk-measurement and risk-management technologies can contribute to an improved allocation of risk as risk is shifted to those more willing and able to bear it.

Financial innovations also have the potential to boost financial stability. Risk-transfer mechanisms can not only better allocate risk but also reduce its concentration. Improved efficiencies and increased competition may result in substantially lower trading costs and may consequently improve liquidity in many markets. Better liquidity, which is instrumental to faster and more accurate price discovery and therefore to more-informative prices, can also be brought about by an increased presence of new institutions in new or existing markets. The entry of those new institutions into new markets can, so long as the institutions prove resilient, increase the availability of funds to borrowers in times of stress and may thus reduce the likelihood of credit crunches.

Although financial innovations have the capacity to improve economic welfare overall, it is natural for policymakers to worry that innovations may have unexpected and undesirable side effects and may even represent new sources of systemic risk. For example, policymakers may be concerned about unexpected price dynamics or problems in infrastructure or operations. Market participants estimate how prices and investment flows are likely to behave for new instruments, but their understanding becomes more detailed and more accurate only as behavior under a variety of economic conditions is observed, and the development of that understanding obviously takes time. Under turbulent conditions, or when new information causes market participants to question their own investment strategies, their behavior may change rapidly, leading to rapid price changes that may seem outsized relative to changes in economic fundamentals. That was briefly the case recently in the market for synthetic collateralized debt obligations. Market participants did not anticipate the sharp decline in implied default correlations that followed the downgrades of Ford and General Motors debt. Prices moved quite a bit for a short time as portfolios were rebalanced, but spillovers to other markets were limited, and market volatility subsequently eased.

Problems with the infrastructure or operations that support an innovation--including the underlying legal documentation and accounting--are also likely to be revealed only over time, as exemplified by the technical difficulties with restructuring clauses in credit default swaps that became apparent a few years ago. In that case, default events and related payoffs sometimes did not occur as expected, and so actual exposures differed from those investors had intended. The result was a change in the value of existing contracts and a period of market adjustment as new restructuring clauses were developed and implemented.

Of course, we should not want to prevent rapid price changes or changes in investment flows, as such changes may be appropriate as new information about fundamentals emerges. And the occurrence of glitches in new markets and institutions need not reflect policy failures or provide evidence that an innovation is undesirable. Preventing all such occurrences would probably require us to stop all innovation. But neither is it desirable that growing pains in one market or at a few institutions spill over so strongly that the financial system as a whole could be destabilized.

A middle way in regulation

Policymakers have a range of strategies available for dealing with innovation. At one extreme, in theory we could take a completely hands-off approach, allowing new financial markets and instruments to develop without restrictions and indeed without any scrutiny, trusting private market participants to do everything necessary for stability and efficiency. At the other extreme, policymakers theoretically might be quite heavy-handed, either imposing regulations on virtually every market and instrument to stop any innovations that, in their judgment, could cause harm or, conversely, actively fostering or subsidizing innovations seen as desirable.

Obviously, these are extreme positions, and I do not know of any practicing policymaker who seriously wants to pursue either extreme course. Today I wish to argue for a middle ground in which markets are allowed to work and develop and in which policymakers work hard to understand new developments and to help market participants see the need for improvements where appropriate. In my view, regulations should be imposed only when market participants do not have the incentive or the capability to effectively manage the risks created by financial innovation. For example, explicit or implicit subsidies of some institutions could limit market discipline of their risk-taking, leading to a concentration of risk so large that even the most sophisticated institutions would find it next to impossible to manage the risk under stressful circumstances. Or policymakers may be concerned that some potential parties to innovative contracts, especially in the retail arena, are insufficiently knowledgeable to understand or manage the associated risks. I believe such instances are rare. Making a case for early regulatory intervention is particularly difficult when the private parties involved in an innovation are sophisticated because, in many cases, they will be the first to recognize possible problems and will have strong incentives to fix them and also to protect themselves against fraud or unfair dealing.

So how should policymakers proceed down this middle path? First of all, we need to learn--we need to understand and evaluate the innovations that are taking place in financial markets. This process should include information sharing with other authorities, including those in other nations, in order to benefit from the experiences in other markets and regions. The resulting improved understanding is often enough to prepare policymakers to deal with any breakdowns that do occur and to avoid having the breakdowns turn into systemic problems. The U.S. response to the century date change is an example from a different context that fits into this category. In that case, policymakers worked hard to understand the complex practical issues and to share that knowledge with financial firms. Those firms independently evaluated the risks they faced and took appropriate action to manage them effectively.

Improved understanding may also ease concerns about potential risks. For example, in light of the effects of financial consolidation on the number of firms acting as dealers in the market for dollar interest rate options, the Federal Reserve became concerned about possible risks to the functioning of that market. These concerns included questions about the adequacy of risk management at the remaining dealers and about the possible effects that problems at one of those dealers could have on its counterparties and market liquidity. However, further investigation by Federal Reserve staff suggested that market participants were generally managing their market and counterparty risks effectively and that those hedging risk in the options market would not unduly suffer from a temporary disruption in liquidity. Our wariness about concentration in this market has not disappeared as a result of our improved understanding, but it has diminished. In general, improved knowledge about financial innovations may prevent the imposition of unwarranted restrictions and is surely a precursor to intelligent regulation in the event it is warranted.

A second step for policymakers walking the middle path should be to ensure that market participants have the proper incentives and the information they need to protect themselves from any problems related to new products, markets, or institutions; by so doing, policymakers can perhaps mitigate those problems. Policymakers should insist that regulated firms effectively manage the risks associated with new activities and markets, thereby fostering effective market discipline of risk-taking, including risk-taking by unregulated firms. Such an insistence generally does not require new regulation but rather is an application of existing regulation in a potentially new context. One of the lessons of the difficulties at Long-Term Capital Management (LTCM) was that the hedge fund had been able to achieve very high levels of leverage because some regulated counterparties had not appropriately managed their counterparty risk exposures. Subsequently, both banks and supervisors had to reassess what such management entailed. Clearly, supervisors should strongly encourage institutions to know their risk posture and to be able to control it and react appropriately as circumstances change. Policymakers should insist on similarly high risk-management standards for regulated financial institutions that provide retail products. As a case in point, bank supervisors in the United States recently issued guidance about the management of risks related to home-equity lines of credit. This guidance did not involve new regulation of these instruments but rather reminded institutions offering such products that they have an obligation to manage the resulting risks appropriately.

A pervasive lack of awareness about the risks embedded in new financial products certainly increases the likelihood that users of those products may face difficulties and that those difficulties may become systemic. One way policymakers can help prevent this possibility from happening is by supporting increased transparency and disclosure. Although counterparties in wholesale markets should generally be expected to demand and obtain the information they need to evaluate their risks, policymakers can no doubt help establish high standards. In the case of retail transactions, support for efforts to foster the basic financial literacy of households is a useful complement to efforts to promote appropriate disclosure. The more consumers are equipped to interpret disclosures, the more effective those disclosures are likely to be.

A third feature of the moderate approach I am trying to chart is an active dialogue between policymakers and market participants. In my view, policymakers should serve as a voice for the development of infrastructure and sensible standards and practices. Ideally such steps would be taken by market participants of their own volition, but sometimes informal interventions by policymakers can help foster cooperative efforts by market participants. For example, partly in reaction to the report of the second Counterparty Risk Management Policy Group, the Federal Reserve Bank of New York recently hosted a meeting with representatives of major participants in the credit default swap market, as well as with their domestic and international supervisors, to discuss a range of issues, including market practices with regard to assignments of trades and operational issues associated with confirmation backlogs. The result was an industry commitment to take concrete steps to address issues of concern.

A fourth dimension of my proposed middle path is the ongoing monitoring of key markets and institutions. Policymakers should be aware of any emerging stresses in the financial system, including those related to new instruments and institutions. Indeed, some central banks have created "financial stability" staff groups to oversee such monitoring and, in some cases, to publish regular financial stability reports. In the event that such monitoring suggests that the operations of some institutions or markets are under significant strain and, importantly, that the resulting pressures on businesses and households could have a material adverse effect on the real economy, the central bank may want to respond by adjusting the stance of monetary policy.

Finally, financial innovations may on occasion warrant new regulations because financial institutions either cannot or will not manage the associated risks appropriately. Indeed, regulation should be seen as part of the broader "infrastructure" that supports both financial stability and innovation, and like other more traditional infrastructure, regulatory regimes have to keep up. For example, developments in financial markets and advances in the ability of banks to measure and manage their risks have increasingly made the existing capital regulation of the largest banks, the 1988 Basel Accord, look antiquated. Basel II is a more flexible framework than Basel I and is intended to better permit capital regulation to keep up with financial market innovations in the future.

To conclude, I wish to emphasize that policymakers should have a bias toward trusting financial markets to manage the introduction of new products and the development of new institutions smoothly and without undue stress to the financial system. However, we cannot take such an outcome for granted: Financial firms may not consider the effects of their decisions on the stability of other firms or on the broader financial markets, and some may lack the incentives and ability to learn about and manage the risks induced by financial innovations. In such cases, policymakers may need to work with markets and their participants, and on occasion regulate them, to achieve the desired outcomes. However, policymakers should, wherever possible, avoid premature regulation that could stifle innovation. I would note that a significant number of substantial shocks to financial markets have occurred in recent years--including, for example, the difficulties at Long-Term Capital Management and the unexpected and massive fraud at some high-profile companies--and yet the broader effects on the real economy have ultimately been quite small. Our financial markets are flexible and resilient, and they can absorb shocks surprisingly well. As a result, most risks caused by new developments in financial markets should be manageable without heavy-handed regulation. This meeting is a good example of what my middle course suggests we should be doing: working hard to understand innovations and their possible implications. Alertness and knowledge on the part of policymakers would go a long way toward ensuring that our positive recent track record will carry on amid what I am sure will continue to be a rapidly changing financial landscape.