# Timothy F Geithner: Systemic risk and financial markets

Testimony of Mr Timothy F Geithner, President and Chief Executive Officer of the Federal Reserve Bank of New York, before the Committee on Financial Services, US House of Representatives, Washington DC, 24 July 2008.

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Good morning, Chairman Frank, Ranking Member Bachus and other members of the Committee. Thank you for giving me the opportunity to testify today.

I very much welcome the opportunity to appear before you with Chairman Cox of the Securities and Exchange Committee (SEC). The Federal Reserve and the SEC are working very closely together in navigating through the present challenges, and my colleagues at the Fed and I very much appreciate his, and his colleagues', support and cooperation.

The U.S. and global financial systems are going through a very challenging period of adjustment. The critical imperative today is to help facilitate that adjustment and to cushion its impact on the broader economy. The forces that made the system vulnerable to this crisis took a long time to build up, and the system will need some time to work through their aftermath.

Looking forward, the United States will have to undertake substantial reforms to the framework of policy, regulation and oversight of the financial system. There was a case for reform before this crisis. The regulatory framework in the United States was designed in a different time for a very different type of financial system than the one we have today. Nonetheless, many observers believed that this framework, although messy and complex, worked reasonably well. It is harder to make that case today.

The financial system plays a vital role in long-term economic growth by helping to efficiently allocate the resources of savers to those individuals and firms with ideas and the capacity to put those ideas into action. And the financial system plays a critical role in economic stability by affecting the capacity of the real economy to withstand shocks and the ability of macroeconomic policy to mitigate the impact of those shocks.

The challenge is in achieving the right balance between efficiency and resilience, between innovation and stability. Our financial system has many strengths, and we need to examine ways to build on those while making the system more resilient to future shocks. Achieving this balance will involve a very complicated set of policy choices. Until we get through this crisis, it will be hard to make definitive judgments about the appropriate scope and nature of the changes that will be necessary.

Any reform must offer the prospect of a substantial improvement in outcomes relative to potential costs. And those trade-offs will have to be evaluated against, among other things, the potential distortions created by differential treatment across regulated and unregulated entities, the magnitude of the tax imposed on the overall level of financial intermediation, and the extent of the safety net and the potential for moral hazard.

I would like to offer some observations, from my perspective at the Federal Reserve Bank of New York, on some of the broad considerations that should guide this process.

### Changes to the structure of the U.S. financial system

It is useful to start with a brief review of the changes in the structure of the financial system that should motivate reform.

Our system was once organized around banks—defined narrowly as institutions that take deposits and make loans. Over time there has been a gradual but pronounced decline in the share of financial assets originated and held by banks, and a corresponding increase in the share of financial assets held across a variety of non-bank financial institutions, funds and complex financial structures.

The lines between banks, investment banks and other institutions have eroded over time, as have the lines between institutions and markets. Loans made by both banks and non-banks were increasingly sold by the originating institution and packaged into securities. And these securities were repackaged into even more complex instruments and products, many of which resided off the balance sheets of the major financial institutions.

Innovations in credit derivatives over this period made it easier to trade and hedge credit risk. Access to credit was extended on a dramatic scale to less creditworthy borrowers, without a commensurate increase in the risk premiums on the securities that embedded this more risky credit. Risk accumulated in institutions that operated at the margin of the explicit safety net, such as mortgage affiliates of thrifts, structured investment vehicles and the GSEs.

These changes within U.S. financial markets were complemented by a rise in global financial integration as technology and deregulation made it easier for savings to flow across international borders.

As a consequence of this basic evolution of our financial system, a large share of financial assets ended up in institutions and vehicles with substantial leverage, and in many cases these assets were being funded with short-term obligations. And just as banks are vulnerable to a sudden withdrawal of deposits, these non-banks and funding vehicles are vulnerable to an erosion in market liquidity when confidence deteriorates and concerns about default risk increase.

These changes in the structure of the financial system were probably not the only causes of the financial boom that preceded this crisis, but they may have amplified the dimension of the boom and they were important to how the crisis unfolded and to how policy has responded.

In many respects, financial innovation over this period outpaced the system's capacity to measure and limit risk, to manage the incentive problems in the securitization process and to provide for an appropriate degree of transparency through meaningful disclosure. Once the performance of the underlying assets began to deteriorate, these weaknesses in the system magnified the uncertainty about the scale of potential losses and added to the intensity of pressures that accompanied the crisis.

The growth in leverage and liquidity risk outside of banks made the system vulnerable to a sharp erosion in liquidity, but without the protections established to limit the risk of classic bank runs. The large share of financial assets held in institutions without direct access to the Fed's traditional lending facilities complicated the ability of our traditional policy instruments to contain the damage to the financial system and the economy.

This crisis provides a stark illustration of how hard it is for a supervisory and regulatory framework designed principally around banks to contain the impact of financial shocks in a manner that mitigates the risks to the broader economy.

## Elements of reform

What broad principles and objectives should guide reform?

I would like to outline some of the key elements of a stronger framework of regulation and oversight, and identify some of the harder questions we will need to answer to implement this framework. These questions are more fundamental than questions of the allocation of responsibility across supervisors, market regulators and central banks and thus must be resolved before turning to those questions. I focus here on the issues related to financial stability, and do not try to address the equally important areas of consumer and investor protection, market integrity or the role of the government-sponsored entities in housing.

I believe the most important imperative is to build a financial system that is more robust to very bad outcomes and more resilient to shocks. This means (1) a system in which the major institutions are less vulnerable to shocks; (2) a system that is less vulnerable to margin spirals and a generalized pull-back in liquidity and funding; and (3) a system that is more able to withstand the effects of failure of a major financial institution.

Looking past the immediate crisis, a more resilient system must be built on stronger and better designed shock absorbers, both in the major institutions and in the infrastructure of the financial system.

At the level of the financial institution, the key financial shock absorbers are capital and reserves, margin and collateral, liquidity, and the risk management and control regime. Financial stability starts with ensuring that individual institutions in periods of expansion and relative stability hold adequate resources against the losses and liquidity pressures that can emerge in economic contraction or instability.

For the infrastructure of the financial system, these shock absorbers include the resources held against the risk of default by a major market participant across the set of private sector and cooperative arrangements for the funding, trading, clearing and settlement of financial transactions.

Simplifying and consolidating the regulatory architecture will be instrumental to these efforts by establishing a common framework of rules, clear responsibility and authority, and by reducing opportunities for arbitrage. Through close coordination across central banks, supervisors and market regulators, we need to adopt an integrated approach to the design and enforcement of capital standards and other prudential regulations critical to systemic stability. In this context, prudential supervisors, working with those responsible for setting accounting standards and capital market regulations, need to systematically examine the interaction among capital, accounting, tax and disclosure requirements to assess their effects on the overall levels of leverage and risk across the financial system.

As we change the framework of regulation and oversight, we need to find ways to strengthen market discipline over financial institutions, and to limit the moral hazard that is present in a range of different forms in any regulated financial system.

The liquidity tools of central banks and the emergency powers of other public authorities were created in recognition of the fact that individual institutions, including those central to payments and funding mechanisms, cannot protect themselves fully from an abrupt evaporation of access to liquidity or ability to liquidate assets. The existence of these tools and their use in crises, however appropriate, creates moral hazard by encouraging market participants to engage in riskier behavior than they would have in the absence of the central bank's backstop. To mitigate this effect on risk-taking, strong supervisory authority is required over the consolidated financial entities that are critical to a well-functioning financial system.

A more resilient financial system will also require a framework for dealing with the failure of financial institutions. For entities that take deposits, we have a formal resolution framework in place. As Secretary of the Treasury Henry M. Paulson, Jr., Federal Reserve Chairman Ben S. Bernanke and others have stated, we need a companion framework for facilitating the orderly unwinding of other types of regulated financial institutions where failure may pose risks to the stability of the financial system.

The elements I just outlined need to be accompanied by a clearer structure of responsibility and authority over the payments system. Payment and settlement systems and central counterparties play a critical role in financial stability. Our current system is overseen by a patchwork of authorities, with responsibilities diffused across several agencies in a manner that leaves significant gaps. We need a more formal and integrated framework of oversight, one that establishes and enforces standards and continuously monitors the conditions in these markets.

And finally, as we adapt the U.S. framework, we have to work to bring about a consensus among the major economies on a complementary global framework. Given the level of financial integration globally, we cannot achieve a reasonable balance at home between efficiency and stability, without a complementary framework of supervision and regulation across the other major financial centers.

To make it operational, the framework I just laid out will require a complicated set of choices.

- What level of conservatism should be built into future prudential regulations over capital and liquidity?
- Which types of institutions should be subject to these requirements?
- Can direct regulation over a limited set of institutions effectively protect the system from distress among the unregulated?
- How should responsibility for different dimensions of financial regulation be allocated, and how centralized or decentralized?
- What institutions should have access to central bank liquidity under what conditions?

## The role of the Federal Reserve

The Congress gave the Federal Reserve broad authority to address risks to financial stability. Because the financial landscape has changed so substantially, many observers have pointed out the need to revisit the scope and nature of Federal Reserve's authority. Secretary Paulson has outlined a number of important proposals for reform, many of which would broaden the responsibility and the authority of the Federal Reserve. I want to identify some issues that are critical to our current responsibilities and will be important in defining an appropriate role in the future, with the most effective mix of responsibility and authority. There is more continuity than change in these suggestions, and they assume, as is the case today, that we will have to work closely with other functional supervisors to make the system work.

First, the Fed has a very important role today, working in cooperation with bank supervisors and the SEC, in establishing the capital and other prudential safeguards that are applied on a consolidated basis to the institutions that are critical to the proper functioning of financial markets.

Second, the Fed, as the financial system's lender of last resort, should play an important role in the consolidated supervision of those institutions that have access to central bank liquidity and play a critical role in market functioning. Our ability to directly oversee the risk profile of these institutions is essential to our capacity to make the judgments necessary for using our lender of last resort tools, including critical judgments about liquidity and solvency for individual institutions and for the system as a whole. Those judgments require the knowledge that can only come from a direct, established role in supervision. And replacing our ongoing role as consolidated supervisor with stand-by, contingent authority to intervene would risk exacerbating moral hazard and adding to uncertainty about the rules of the game.

Third, the Federal Reserve should be granted explicit responsibility and clear authority over systemically important payment and settlement systems, and the ability to continue to encourage broader improvements in the over-the-counter derivatives markets.

Fourth, the Federal Reserve Board should have an important consultative role in judgments about official intervention where there is potential for systemic risk, as is currently the case for bank resolutions under FDICIA.

And, finally, the responsibilities for market and financial stability that are accorded the Fed in current and any future legislation will require that the Fed adopt a more comprehensive approach to financial supervision and market oversight. Given the changes in the structure of the financial system, maintaining financial stability requires us to look beyond just the stability of individual banks. It requires us to look at market developments more broadly, at the infrastructure that is critical to market functioning, and at the role played by other leveraged financial institutions.

Over the past four years, the Federal Reserve has led a number of initiatives with our supervisory colleagues in the United States and in the other major financial centers to improve the OTC derivatives infrastructure, to strengthen the systemically important payment and settlement systems, to improve counterparty risk-management practices with respect to hedge funds, and to place greater emphasis on ensuring robustness to low probability, high severity instances of stress. This forward-looking, cross-institution approach, integrating prudential supervision with market oversight and payment system expertise, offers the best model of broad financial oversight focused on systemic risk.

I want to emphasize in conclusion that we are working now, in close cooperation with the SEC, other U.S. bank supervisors, our international counterparts and market participants to improve the capacity of the financial system to withstand stress. These initiatives include joint efforts with the SEC to bolster consolidated oversight of the investment banks, formalized in our recent Memorandum of Understanding. These institutions have made substantial changes over the past several months to bring down overall leverage and risk-weighted assets and to reduce liquidity risk. In addition, we have undertaken a broad based program of initiatives to build a more robust over-the-counter derivatives infrastructure through, among other measures, a central clearing house for credit default swaps; to strengthen the financial cushions held by central counterparties against the risk of default by a participant; and to reduce vulnerabilities in secured funding markets.

These initiatives will take time, but we expect to see substantial progress over the next two quarters.

I look forward to your questions today and working with you as we move ahead in building a more effective financial regulatory framework for the United States.

Thank you.