Kevin M Warsh: The promise and peril of the new financial architecture

Speech by Mr Kevin M Warsh, Member of the Board of Governors of the US Federal Reserve System, at the Money Marketeers of New York University, New York, 6 November 2008.

The original speech, which contains various links to the documents mentioned, can be found on the US Federal Reserve System's website.

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Overview

The financial markets did not observe the August anniversary of the onset of turmoil with even a hint of fondness.[1] Instead, market participants seemed to mark the occasion as a kind of coming-of-age opportunity to act out. The subsequent despair among market participants, disrepair in credit markets, and disregard for proper market functioning was more pronounced than witnessed in generations. Significant market dislocations disrupted credit flows to households and firms and impaired economic growth. All and all, these conditions demanded – and received – a forceful response from monetary, fiscal, and financial policymakers.

There are some notable signs of improvement. Short-term funding spreads are retreating from extremely elevated levels. Funding maturities are being extended beyond the very near term. Money market funds and commercial paper markets are showing signs of stabilization. And credit default swap spreads of banking institutions are narrowing significantly.

Nonetheless, financial markets overall remain strained. Risk spreads remain quite high and lending standards appear strict. Indications of economic activity in the United States have turned decidedly negative. The economy contracted slightly in the third quarter, and the recent data on sales and production suggest that the fourth quarter will be weak.

Still, the depth and duration of this period of weak economic activity remain highly uncertain. The financial turmoil revealed that the old financial architecture is broken. But its successor is not yet established.[2] In my view, the prospects for robust economic growth over the intermediate term are likely to be determined, not principally by the trajectory of housing prices, but by the speed with which a new financial architecture emerges and the form that it takes. This challenge of creating a new financial architecture is hardly unique to the United States. The difficult choices made by policymakers and market participants around the globe will have real implications for future growth prospects.

What do I mean by a new financial architecture? Recent travails contributed to a consensus that the financial regulatory framework requires fundamental reform. But, in my view, the financial architecture is necessarily broader than the government's regulatory and supervisory response. The new financial architecture, properly understood, must account for the dynamic relationship between private-market actions and public-sector strictures. The economy's financial architecture is a function of the relationship among financial institutions and market participants that transfer capital and risk between borrowers and savers. But the architecture is also informed by the mix of prescriptions and postures of the Congress, the

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[1] The views expressed herein are my own and do not necessarily reflect the views of other members of the Board of Governors or of the Federal Open Market Committee. I am grateful for the assistance of Nellie Liang and Bill English of Board staff, who contributed to these remarks.

[2] In these remarks, I will elaborate on some topics I discussed when I last spoke here at New York University. (See Kevin Warsh (2008), "Financial Market Turmoil and the Federal Reserve: The Plot Thickens," speech delivered at the New York University School of Law Global Economic Policy Forum, New York, April 14.)

Administration, and the financial regulators, including the Federal Reserve. This circumstance is particularly the case during times of financial turmoil.

In my remarks today, I will first advance a plain assessment of what is afflicting global financial markets. Many observers judge that weaknesses in housing finance, and the associated boom and bust in the housing sector, are the principal cause of the market turmoil and economic malaise. In my view, however, recent market developments – in the United States and abroad – strongly indicate that the causes of the turmoil are broader and more fundamental than the problems in the mortgage markets.

Second, I will highlight actions by financial market participants in the transition to a new financial architecture. Financial institutions are being fundamentally transformed by the events of the last several quarters. Massive changes in business models, corporate forms, and funding sources are taking place faster than could be imagined even a few months ago. There is no going back to the old arrangements, nor should there be. And a new equilibrium will take shape only when financial institutions seize new opportunities and the changes in the rules of engagement and the relationship with the official sector are more clearly understood.

Third, I will discuss actions of the official sector during this period of turmoil. Most of these policy actions have been taken in vigorous pursuit of financial stability – that is, to reduce financial stresses, shore up credit intermediation, and thereby support economic activity. And that makes good sense. Some material lessening of financial instability is essential so that markets can function properly and the economy can avoid more substantial weakness. But stability in and of itself should not be the be-all and end-all of policy. Rather, actions fostering financial stability should be temporary, providing a bridge to a new, more effective financial architecture. And that architecture should aspire to increase, not decrease, potential output through an economic cycle.

The nature of the financial market turmoil

Many observers maintain that the boom and bust in the housing market are the root cause of the current turmoil. No doubt housing-related losses are negatively affecting household wealth and spending. Moreover, the weakness in housing markets and uncertainty about its path have caused financial institution balance sheets to deteriorate. This situation has further accelerated the deleveraging process and tightened credit conditions for businesses and households.

When liquidity pulled back dramatically in August 2007, housing suffered mightily.[3] For reasons well documented, including expectations that home prices would invariably increase, housing proved to be a highly vulnerable asset class. Many homeowners, particularly those that purchased properties during 2005 through 2007, are suffering. And many banks and other financial firms that extended mortgage credit or purchased mortgage-related assets have written down sharply the value of those assets. Public and private policy actions have been taken to help cushion the blow to many homeowners and financial firms.[4]

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[3] See Kevin Warsh (2007), "Financial Intermediation and Complete Markets," speech delivered at the European Economics and Financial Centre, London, June 5; see also Kevin Warsh (2007), "Financial Market Developments," speech delivered at the State University of New York at Albany's School of Business, Albany, New York, September 21.

[4] To help homeowners, the Hope for Homeowners program enacted as part of the Housing and Economic Recovery Act of 2008 (HERA) allows the Federal Housing Administration (FHA) to facilitate mortgage refinancings. HERA also established a first-time homebuyer tax credit and appropriated funds to provide housing counseling assistance. FHA Secure is another refinancing option available to some borrowers. In addition, the Hope Now Alliance is an industry-based effort of mortgage servicers, housing counselors, and investors committed to establishing industry guidelines to facilitate loan modifications.

While housing may well have been the trigger for the onset of the broader financial turmoil, I have long believed it is not the fundamental cause.[5] Indeed, recent financial market developments strongly indicate that housing, as an asset class, does not stand alone. Indeed, the problems associated with housing finance reveal broader failings, including inadequate market discipline, excessive reliance on credit ratings, and poor credit and liquidity risk-management practices by many financial firms.

During the past several months, this domestic housing-centric diagnosis has also been subjected to a natural experiment. Among U.S. financial institutions, asset quality concerns are no longer confined to the mortgage sector. At the same time, non-U.S. financial institutions – including some with relatively modest exposures to the United States or their own domestic housing markets – appear to be suffering substantial losses. Equity prices of European banks declined more on average during 2008 year-to-date than their U.S. counterparts. Moreover, economic weakness among our advanced foreign trading partners is increasingly evident, even among economies with more modest exposures to the housing sector.

If the challenges to the economy were predominantly about the value of the housing stock, my focus today would be far narrower than the establishment of a new financial architecture. So, what diagnosis, beyond housing weakness, is consistent with the unprecedented levels of volatility and dramatic financial market and economic distress? I would advance the following: We are witnessing a fundamental reassessment of the value of virtually every asset everywhere in the world.

Short-term funding markets have become suspect. Roll-overs of existing maturities reveal systematic underpricing of once seemingly benign risks – credit, liquidity, counterparty, and even sovereign risks – which demand reassessment and recalibration. Indeed, wide-ranging assessments of these risks are being crudely incorporated into the pricing of virtually all assets. In some cases, at present, the risks do not appear to be reliably quantifiable, and trading has become impaired. Until these assessments are more cleanly refined and more broadly understood, we are likely to observe elevated levels of volatility and unwillingness by many investors to participate in certain asset markets virtually at any price.

This phenomenon is proving quite detrimental to global economic growth. In my view, the speed and success of a new financial architecture is likely to be more consequential to economic growth than the design and implementation of well-intended housing policies alone. The establishment of a new financial architecture, thus, is the essential policy response to the greatest economic challenge of our time.

Financial institution response in pursuit of survival and success

In a speech about seven months ago, I noted that the transformation of financial institutions would be among the key variables that would affect the path of the real economy, but "the changing paradigm of financial intermediation" is happening even more abruptly.[6] The largest investment banks chose a different fate, or had one chosen for them. Many of the largest nonbank financial companies are no doubt reviewing their regulatory status. Large numbers of hedge funds, recently perceived as central to a well-diversified asset allocation program, are struggling for survival. Their investors are being rudely reminded that alpha-returns cannot, by definition, be universally achieved. Large money center banks are casting a keen eye on their sources and uses of funding. And traditional community-based banks are adapting to a dramatically different competitive dynamic with respect to deposits and lending opportunities alike.

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[5] See Warsh, "Financial Market Developments," in note 3.

[6] See Warsh, "Financial Market Turmoil," in note 2.

The business of banking – and credit intermediation, more broadly – is fundamentally changing. Wholesale funding models are severely stressed. Heavy reliance on interbank funding and short-term indebtedness is proving highly detrimental to a financial institutions' health and society's welfare. Some of the highest-rated financial products, ironically, are suffering the greatest diminutions in value. Selling volatility and insuring tail risks are far riskier propositions than many imagined. These products and practices are proving to be a significant source of large, uncapped losses threatening to impair once-hearty franchises.

We are witnessing perhaps the fastest, most significant structural shift in the history of the financial services sector. The direct share of value added in the finance and insurance sector approximated 8 percent of U.S. gross domestic produce (GDP) in recent years. This is about 3 percentage points higher than the contribution of financial services to GDP only a generation ago. Similarly, profits of the Standard & Poor's 500 attributable to the finance sector peaked at more than 21 percent during this cycle, 5-1/2 percentage points greater than a decade ago. As the financial sector continues to delever and many financial products disappear altogether, the sector's shares of GDP and profits will shrink further. This reduction could involve many firms shrinking largely in tandem or, more likely, the orderly unwinding or sale of inefficient or unwise firms.[7] The markets are fearful, in part I suspect, because of the swiftness of the reallocation of resources in the financial sector.

The official sector response in pursuit of financial stability

The turmoil of the past several quarters coincides with further erosion of confidence in what financial institutions and other market participants knew – or thought they knew – about the environment in which they were operating. It is no surprise, then, that those bearing the brunt of the turmoil are pining for calmer times, a period of less volatility, when market prices again comport with historical regressions and newfangled financial models. To wit, a return to financial stability.

Government officials, in the U.S. and abroad, are not unsympathetic to this aspiration for calmer times.[8] But policymakers are prudent to balance the near-term imperative to take actions to achieve financial stability with the objective – just over the horizon – of facilitating the development of a new financial architecture in which market participants re-engage, provide credit to the real economy, and yes, succeed or fail.

The Fed has a long and proud tradition, not solely as the monetary authority, but also as a regulator, supervisor, and lender of last resort to help foster financial stability.[9] The Fed is in the financial stability business. But it's not our only business. The Federal Reserve's financial stability responsibilities are not, in my view, an independent goal of policy. They are best understood through the lens of our broader objectives for the economy. The conduct of monetary policy, banking supervision and regulation, and the provision of liquidity are regular

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[7] See, for example, Kenneth Rogoff (2008), "The World Cannot Grow Its Way Out of This Slowdown," *Financial Times*, July 29.

[8] Central bankers, finance ministers, and others have convened the world over to ponder the causes and consequences of the recent period of financial instability, its impact on the global economy, and the actions that might be taken to avoid future outbreaks. The President's Working Group on Financial Markets, the Financial Stability Forum, the Basel Committee on Banking Supervision, the Committee on the Global Financial System, the Institute for International Finance, the Counterparty Risk Management Group, and many other public and private groups are making significant contributions to the discussion.

[9] The Federal Reserve was created in response to the periods of panic and bank runs that affected the United States in the late 19th and early 20th centuries. The Federal Reserve regularly responded to financial crises by extending credit and by using its expertise and credibility with market participants to address market strains.

Federal Reserve activities that contribute to financial stability, and in so doing, help achieve improved macroeconomic performance.

During this period of turmoil, the Fed has increasingly been called upon to be a steadying influence. When appropriate, and after due consideration, the Fed has chosen to employ its balance sheet, authority, and credibility to lessen the harm to the real economy. That is our role and responsibility. But we should resist the temptation to play a larger role than statutorily mandated or economically prudent. Good-faith pleas for relief in the name of financial stability will continue for some time, and the Fed should carefully consider the facts and circumstances. That period of consideration may require us, however, to be cognizant of the perils of popularity and decline to take action, including when it may be more properly considered or better addressed by the fiscal authorities. So it is, financial stability has become the watchword of the global economy. But its frequency in our lexicon should not be confused with clarity as to its meaning or the timing of its achievement. Nor should it be construed as the sole beacon of policy.

What is financial stability? It is perhaps easier to define by its absence.[10] Financial instability is a situation in which stresses on markets and institutions are sufficiently severe that the intermediation between borrowers and savers is threatened, with the prospect of significant risks to the broader economy. Financial stability, moreover, should not be equated with an absence of volatility. If some unexpected news arrives, markets adjust, often sharply. Generally, these adjustments are not cases of financial instability. A healthy and well-functioning financial system will reward well-managed risk-taking and punish imprudence, sometimes harshly. Such outcomes are not pretty and can be marked by large and pervasive losses, but most do not necessitate extraordinary policy interventions.

Nonetheless, circumstances of pronounced financial instability, while rare, do arise. In the most recent episode, we policymakers deemed it necessary to take significant actions to mitigate the risks to the real economy. Financial firms became highly protective of their balance sheets and sought to disengage en masse from the provision of credit. The Fed responded, introducing lending facilities designed to support liquidity in overnight and short-term funding markets. With the approval of the Congress, Treasury also took significant action, making large capital injections directly into banks to help jump-start the credit intermediation process. This action was supplemented by various forms of government guarantees. But bold official policy responses, even when successful in combating financial instability, may not be enough to support the resumption of trend economic growth over the medium term.

Why is government action aimed at financial stability not sufficient to usher in a new era of prosperity? Because the broader financial architecture remains in substantial flux, as is sometimes unavoidable. Confidence in markets and institutions cannot be demanded or forced by edict. Confidence in a new architecture cannot be jury-rigged, even by well-designed government actions. Nor can confidence be rushed.

Comprehensive policy prescriptions to address financial instability are now being delivered to the ailing patient. But a dose of patience itself may be equally important to help the recuperative process. Time is required for the medicines to be administered and their efficacy to be judged. New prescriptions, however well intentioned, can prove unsettling to a patient who is searching to find his footing. Of course, policy must respond to serious situations as they arise; and, during the past 15 months, these developments have been difficult to anticipate with precision. But, if the framework for policy decisions is not viewed as clear, consistent, and predictable by market participants, the resulting actions run the risk of contributing to, rather than reducing, market volatility – at the most inauspicious of times.

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10 See Kevin Warsh (2007), "Financial Stability and the Federal Reserve," speech delivered at the New York State Economics Association 60th Annual Conference, Loudonville, New York, October 5.

Finally, actions intended to help achieve financial stability should not be allowed to interfere with the establishment of a sturdy, new financial architecture.

Concluding remarks

I am reminded of a certain Omaha-based investor who says that his investment style is to be greedy when other investors are fearful, and be fearful when others are greedy.[11] I would modify the advice somewhat to make it applicable to policymakers: We should be steady when financial market participants are fearful, and fearful when markets appear steady.

This call for steadiness is not some nostrum, implying that the government should be passive during times of significant economic turmoil. Quite the contrary. But comprehensive policy prescriptions are most effective when they establish new rules of engagement that are clear in intent, consistent in application, and reasonably predictable in effect. This policy formulation should allow financial firms to regain their footing and market participants, more broadly, to take new, constructive actions to facilitate the availability of credit. Perhaps in this way, policymakers and market participants alike can best contribute to the development of a reformed and robust financial architecture.

I see more promise than peril over the horizon. The speed of these changes in the financial architecture understandably brings fear to some market participants, but it may equally sow the seeds of recovery. Policymakers are keenly observing the pulse of private financial institutions and other market participants to gauge their ability to take up the cause of reform and renewal. If financial institutions readily and steadily approach new ways of intermediating credit, the real economy might recover sooner and with more vigor than expected. If not, if private market participants prove unable or unwilling to establish new business models, then the effects of the current financial market turmoil may be a significant drag on economic growth long after stability is ostensibly achieved. Getting the architecture right is essential to address the central challenge facing our economy.

[11] See Warren Buffett (2008), "Buy American. I Am." an op-ed in *New York Times*, October 17.