William C Dudley: The US financial system – where we have been, where we are and where we need to go

Remarks by Mr William C Dudley, President and Chief Executive Officer of the Federal Reserve Bank of New York, at the Reserve Bank of Australia's 50th Anniversary Symposium, Sydney, 8 February 2010.

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Today, my remarks will focus on the U.S. and global financial systems:

- What went wrong to produce the worst financial crisis in the past 70 years?
- Where are we now?
- What should be our top priorities to ensure that this never happens again?

As always, my views are my own and do not necessarily reflect those of the Federal Open Market Committee or the Federal Reserve System.

With respect to what went wrong, it is important to recognize that the financial crisis occurred for a host of reasons and, thus, there is no single silver bullet to avoid such crises in the future. At the heart of the crisis was a tremendous buildup in leverage, which our regulatory framework failed to prevent. Large amounts of opaque, illiquid, long-term assets were financed by short-term liabilities, and much of this financing occurred in the shadow banking system. When the housing bubble burst, financial asset prices fell and exposed the deep linkages and overall fragility of our system. Interbank funding markets seized up, the shadow banking system crumpled and several major financial firms – banks and nonbanks alike – collapsed or approached the brink of collapse. Extraordinary interventions of governments and central banks around the world were necessary to prevent a complete collapse of the financial system and the broader economy.

As a general matter, regulators did not appreciate beforehand how vulnerable the system was to shocks. In particular, there was a failure to appreciate the important interconnections among the banking system, capital markets, and payment and settlement system. For example, the disruption of the securitization markets caused by the poor performance of highly rated debt securities led to significant problems for major financial institutions. These banks had to take assets back on their books, backstop lines of credit were triggered, and banks could no longer securitize loans, thus increasing the pressure on their balance sheets. This reduced credit availability, which increased the downward pressure on economic activity, which caused asset values to decline further, and in turn, increased the degree of stress in the financial system.

Moreover, regulators did not adequately understand how the dynamics of the system tended to exacerbate shocks, rather than dampen their impact. For example, with respect to capital, firms under stress had incentives to continue to pay dividends to show that they were strong. These dividend payments actually depleted capital, making the firms weaker and vulnerable to credit rating downgrades. When credit ratings were indeed cut, that increased collateral calls, which intensified the pressure on scarce liquidity resources.

Regulatory gaps were another important factor in causing the crisis. American International Group, Inc. (AIG) is a case in point. AIG Financial Products, a subsidiary of the AIG parent company, provided guarantees against default on complex collateralized debt obligations, leveraging the AAA rating of the AIG parent company in the process. This activity was conducted with inadequate regulatory oversight, poor risk management and insufficient capital.

Finally, many of the incentives built into the system ultimately undermined its stability. The problems with incentives were evident in a number of areas, including faulty compensation

schemes and risk management that was too narrowly focused on one business area without regard for the broader entity. These incentives created important externalities in which participants did not bear the full costs of their actions.

Turning to where we are now, the U.S. financial system is in much better shape today than it was a year ago. The capital markets are generally open for business – with the important exception of some securitization markets – and the major securities dealers that survived the crisis have seen a sharp recovery in profitability. The largest U.S. bank holding companies, which went through the Supervisory Capital Assessment Program exercise, have more and better quality capital, having raised more than $100 billion of common equity over the past year in the capital markets and generated nearly as much common equity via preferred stock conversions and from gains on asset sales.

However, many smaller and medium-sized banks remain under significant pressure. This reflects several factors. First, such institutions hold assets that are carried mainly on the books on an accrual basis. Compared with mark-to-market assets, such assets adjust much more slowly to changes in market conditions and the economic environment. Second, many of these banks have a much more concentrated exposure to commercial real estate, a sector that remains under considerable pressure. Not only have capitalization rates risen sharply – meaning the investors will pay much less for a dollar of rental income than before – but the rental income streams on these properties also have declined as the performance of the U.S. economy has declined. Together, these two factors have pushed U.S. commercial real estate prices down by about 40 percent to 50 percent from the peak reached in 2006. Loan losses in commercial real estate and consumer and mortgage loans seem likely to continue to pressure smaller banks for some time to come. This in turn means that credit availability to households and small businesses will still be curtailed.

The improvement in the overall health of the financial system and in market function has allowed the Federal Reserve to phase out many of the special liquidity facilities that were enacted in response to the crisis. These facilities were generally successful in achieving their objectives – helping to restore confidence and rebuild market liquidity in a way that safeguarded the taxpayers' interests. When a full accounting of the special liquidity facilities is complete, it seems likely that the facilities will have generated substantial incremental earnings that the Federal Reserve will remit to the Treasury. Although these incremental earnings were not the objective of these facilities, they are a pleasant outcome relative to the alternative.

As the crisis has abated, our attention has shifted to what we need to do to prevent another crisis in the future. We need to take the necessary steps to build a strong and resilient financial system. In my opinion, three broad sets of actions are needed:

- Effective macroprudential supervision. By this, I mean conducting supervision not just vertically institution by institution, but also horizontally across institutions and markets. We need to better understand how the system operates as a whole and how problems in one area can affect financial stability elsewhere. This means both how the overall system affects individual firms and how the activities of a single firm or market affects the entire financial system.
- Make financial institutions and market infrastructures more robust to withstand shocks and become less prone to failure.
- Change the system so that no financial firm is "too big to fail."

Macroprudential supervision is essential for two reasons. First, it addresses the problem of gaps in the regulatory regime and the regulatory arbitrage that such gaps can encourage. Second, macroprudential supervision is needed because the financial system is interconnected. Siloed regulatory oversight is not sufficient. Supervisory practices must be revamped so that supervision is also horizontal – looking broadly across banks, nonbanks, markets and geographies. This also means that regulatory standards need to be harmonized

across different regions. Without harmonization, there will inevitably be a "race to the bottom" and regulatory arbitrage will be encouraged, rather than inhibited.

Many steps are needed to make financial institutions and infrastructure more robust. For example, we need to strengthen bank capital requirements, improve liquidity buffers and make financial market infrastructures more resilient to shocks when individual firms get into trouble.

In terms of capital requirements, many changes are needed, including global capital standards that put more emphasis on common equity, establish an overall leverage limit and better capture all of the sources of risk in the capital assessment process. Improved risk capture, for example, includes the trading accounts of banks. Some institutions had clearly not set aside adequate levels of capital given the risks that were embedded in their trading positions.

It would also be very desirable to develop a mechanism to bolster the amount of common equity available to absorb losses in adverse economic environments. This might be done most efficiently by allowing the issuance of debt instruments that would automatically convert to common equity in stress environments, under certain pre-specified conditions. Such "contingent capital" instruments might have proven very helpful had they been in place before and during this crisis. Investors would have anticipated that common equity would be replenished automatically if a firm came under stress, and this knowledge might have tempered anxieties about counterparty risk. At a minimum, contingent capital instruments might have enabled common equity buffers at the weaker firms to be replenished earlier and automatically, thereby reducing uncertainty and the risk of failure.

On the liquidity front, there are a host of initiatives underway. The Basel Committee on Banking Supervision is working on establishing international standards for liquidity requirements. There are two parts to this. The first is a requirement for a short-term liquidity buffer of sufficient size so that an institution that was shut out of the market for several weeks would still have sufficient liquidity to continue its operations unimpaired. The second is a liquidity standard that limits the degree of permissible maturity transformation – that is, the amount of short-term borrowing allowed to be used in the funding of long-term illiquid assets. Under these standards, a firm's holdings of illiquid long-term assets would need to be funded mainly by equity or long-term debt.

With respect to financial market infrastructures, the Federal Reserve is working with a broad range of private-sector participants, including dealers, clearing banks and tri-party repo investors to dramatically reduce the structural instability of the tri-party repo system. Similarly, over-the-counter (OTC) derivatives clearance activity is being pushed toward central counterparties and exchanges. In addition, the Federal Reserve and others are evaluating how greater transparency with respect to OTC derivatives prices would improve financial stability. The Committee on Payment and Settlement Systems and the Technical Committee of the International Organization of Securities Commissions are doing a review of standards for payment, clearing and settlement systems. This work will inform the efforts of the Financial Stability Board to strengthen such standards.

There is also work underway on the problem of how to ensure that financial institutions have compensation structures that curb rather than encourage excessive risk-taking.

Finally, it is critical that we ensure that no firm is too big to fail. This is about both fairness and having proper incentives in the financial system. Having some firms that are too big to fail creates moral hazard. These firms are able to obtain funding on more attractive terms because debt holders expect that the government will intervene rather than allow failure. In addition, too big to fail creates perverse incentives. In a too-big-to-fail regime, firms have an incentive to get large, not because it facilitates greater efficiency, but instead because the implicit government backstop enables the too-big-to-fail firm to achieve lower funding costs.

To solve the too-big-to fail problem, we need to do two things. First, we need to develop a truly robust resolution mechanism that allows for the orderly wind-down of a failing institution and that limits the contagion to the broader financial system. This will require not only domestic legislation, but also intensive work internationally to address a range of legal issues involved in winding down a major global firm.

Second, we need to reduce the likelihood that systemically important institutions will come close to failure in the first place. This can be done by mandating higher capital requirements, improving the risk capture of those requirements and by requiring greater liquidity buffers for such firms.

Although the raging crisis appears to be over, our work is not close to being complete. Making sure this work keeps moving forward and is coordinated internationally is hugely important. Differences in views across countries and regions should not divert the international community from the more important prize – taking the actions collectively that will ensure a robust and resilient financial system.