

William C Dudley: Financial regulation nine years on from the GFC - where do we stand?

Remarks by Mr William C Dudley, President and Chief Executive Officer of the Federal Reserve Bank of New York, on the Panel "Financial Regulation Nine Years on from the GFC - Where Do We Stand?", at the G30's 76th Plenary Session, Federal Reserve Bank of New York, New York City, 3 December 2016.

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Thank you for the opportunity to participate in this panel discussion. As always, what I have to say reflects my own views and not necessarily those of the Federal Open Market Committee or the Federal Reserve System.

In assessing where we are eight years after the financial crisis, I would make three broad observations. First, we have made considerable progress in bolstering the safety and soundness of the global financial system. In the U.S., which was the epicenter of the crisis, the risk of a failure of a systemically important financial firm has declined considerably. Second, although significant progress has been made toward ending "too big to fail," there is still much more to do. While the risk of failure of a global systemically important financial institution has diminished, it has not been eliminated. Without a well-functioning resolution process, the consequences of such a failure could still be catastrophic. Much headway has been made in the U.S. in developing a Single Point of Entry resolution regime with a layer of total loss-absorbing capacity (TLAC) that would facilitate recapitalization and enable an orderly resolution. However, significant challenges remain, especially on managing resolution on a cross-border basis. Third, bank leaders still have much to do to rebuild the trustworthiness of their industry. Long after the financial crisis, conduct failures have persisted. We need financial firms to foster cultures that are intolerant of bad conduct and that are attentive to incentive structures that may encourage such behaviors.

So, let me begin with the good news. The U.S. financial system is much more resilient now than it was a decade ago on the eve of the financial crisis. This progress reflects a number of initiatives—some focused on the ability of firms to absorb shocks, and others oriented at reducing structural vulnerabilities within the financial system that spanned the activities of firms and their counterparties.

Changes made to capital and liquidity requirements in the U.S. and globally have made banks more resilient and robust. The major U.S. banking organizations today have much more capital, much higher-quality capital, and much larger liquidity buffers than prior to the crisis. On the capital side, we have taken a belt-and-suspenders approach. The Basel III risk-weighted capital standards framework has been significantly strengthened—a stronger belt—and a supplemental leverage ratio requirement has also been imposed on large banks and bank holding companies to restrain overall leverage—the suspenders. In addition, and perhaps most importantly, the capital requirements have now become much more forward-looking. Each year a bank's capital dividend and share-repurchase plan is assessed against the amount of capital the bank would potentially have under an extremely stressed economic and market environment given its portfolio of assets. The annual Comprehensive Capital and Analysis Review (CCAR) process has pushed U.S. banks to improve their capital planning processes and forced them, when needed, to retain more earnings and to build up their capital. As a result, these banks are much less risky now than they were prior to the financial crisis, when their vulnerability was masked by a high, but unsustainable, level of profitability.

On the liquidity side, there has also been significant improvement. The Liquidity Coverage Ratio and the Net Stable Funding Ratio requirements have forced banks to hold more high-quality liquid assets and have reduced the scope for maturity transformation. The ability and willingness of banks to finance illiquid, hard-to-value assets with short-term funding was an important element that contributed to the financial crisis.

In addition, I believe that supervisory oversight has improved. There is more attention on horizontal evaluations across the systemically important firms and a greater emphasis on bank governance, risk management, cyber security, and bank data and technology capabilities than in the past.

But the progress has not just been in terms of enhancing the strength of individual institutions. The system as a whole is also stronger because of a number of important initiatives. Due to time constraints, I cannot be exhaustive today. But, there are four important structural changes to the financial system that are worth highlighting. First, the tri-party repo system—which matches institutional investors with bank dealers that need to fund their securities portfolios—has been made much safer. Before the crisis, each morning the two large clearing banks provided huge amounts of intraday credit to their tri-party repo borrowers when cash invested overnight was returned to lenders. These temporary extensions of credit have been largely eliminated. This is an important structural reform because these exposures had proven to be destabilizing during the financial crisis. In particular, when a major dealer became stressed, the clearing banks were motivated to reassess their large overdraft exposures to the dealer, and that turned out to be an important channel of contagion.

Another important change has been the shift in over-the-counter derivatives activity from bilateral settlement to central clearing. Although this shift was already underway at the time of the financial crisis, it has now been underpinned by important changes to the capital and collateral regime, which has accelerated the process by strengthening the incentives to structure and clear trades centrally.

When banks settle their trades with central counterparties (CCPs), it reduces risk in the system. Exposures can be netted, and the counterparty risk is shifted from many individual firms to the single CCP that clears the trades. Although this shift in clearing activity still has some way to go, the proportion of centrally cleared trades will continue to rise as legacy trades mature.

A third important structural change is the increased focus on the strength and resiliency of CCPs. Because CCPs are now going to play a more significant role, they must be strong and resilient. There have been many important initiatives in this regard. Foremost, perhaps, is the promulgation of the international standards embodied in the Principles for Financial Market Infrastructures (PFMI)—which were developed when I chaired the Committee on Payment and Settlement Systems (CPSS)—and the work currently underway on financial market infrastructure resolution.

A fourth significant structural change has been reform of the U.S. money market mutual fund industry. The October 14th implementation of floating net asset values (NAVs) for prime institutional money market mutual funds has dramatically reduced their use and has encouraged banks and other borrowers to find sources of funding that are less prone to runs.

The financial crisis exposed two important flaws of the money market mutual fund industry. First, the fixed NAV structure created a first-mover advantage that encouraged runs. That is, if a fund came under stress, investors who quickly withdrew their funds received par value. Second, although money market mutual fund investments are often collateralized, the funds themselves have no desire to take possession of the collateral in a crisis. Instead, they tend to head for the exits at the first sign of trouble, which makes the financial system less stable.

Much progress has been made in making the U.S. financial system safer and less prone to

panics. Still, there is more to do before we can say that we have ended “too big to fail.” This is work that we absolutely must complete. In particular, U.S. bank holding companies must do more to make their organizations resolvable under either Title I bankruptcy or Title II resolution. This requires having clean parent holding company structures, less corporate complexity, and essential service and support operations that are able to continue to operate even when the parent company becomes non-viable.

Also, while there has been significant progress in terms of developing a workable resolution regime—the Single Point of Entry regime established under Title II of the Dodd-Frank Act—we still have to ensure that this regime can be safely utilized on a cross-border basis. This requires fully implementing the TLAC framework, and defining more explicitly the expectations and responsibilities of the different supervisory and regulatory oversight bodies that would have to work together internationally. In particular, this includes how liquidity would be provided to an insolvent firm during the early stages of resolution, so that the firm’s operations could be wound down in an orderly way without destabilizing the global financial system.

Finally, I would like to address the issue of bank culture and conduct. Although there has been considerable effort here, there is still much more to do. Banks must restore their trustworthiness. Only then can they effectively perform their critical financial intermediation role in funneling funds from savers to borrowers, and in helping firms and households manage their finances and risk exposure.

As I see it, incentives drive behavior, and behavior establishes the social norms that define culture. This means that bank leaders need to take a close look at the incentives they put in place with respect to compensation and promotion in particular.

In addition, bank leaders must foster an atmosphere that encourages people to speak up when they witness questionable behavior. Preet Bharara, the U.S. Attorney for the Southern District of New York, highlighted the importance of getting people to speak up when he spoke at the New York Fed’s conference on bank culture in October. He argued—and I agree—that big problems can be nipped in the bud when people speak up and senior management responds appropriately. Therefore, bank leaders ought to recognize and reward those who speak up. Actions speak louder than words in shaping culture. Establishing appropriate incentives and fostering an environment in which people feel they can speak up would go a long way toward bolstering bank culture.

I am gratified that many bank leaders and boards of directors are working hard to improve their firms’ cultures, and I very much appreciate the G30’s efforts in this area. I think most leaders recognize that good culture is fully consistent with strong financial performance, and that it helps enable banks to attract the talent needed to sustain such performance. Yet, we could make greater progress more quickly if this effort were coordinated across the industry. I think bank leaders could benefit from sharing best practices and participating in surveys that would allow them to benchmark their strengths and weaknesses versus others on an ongoing basis.

Building a financial system that is more resilient and robust, having a bank resolution regime that credibly ends “too big to fail,” and building strong cultures that restore the trustworthiness of the financial industry are all goals we must continue to pursue. Without success on all three fronts, I don’t think we can say that we have fully addressed the problems made evident by the financial crisis.

Thank you for your kind attention.