William J McDonough: The role of financial stability

An address by Mr William J McDonough, President and Chief Executive Officer of the Federal Reserve Bank of New York and Chairman of the Basel Committee on Banking Supervision, at the XIII International Frankfurt Banking Evening, Frankfurt, Germany, 3 May 2001.

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Mayor Roth, President Duisenberg, and distinguished guests…

It is an honor to address the thirteenth International Frankfurt Banking Evening in a setting so rich in history and tradition. I have been told that this stately building is more than just the busy town hall for a major European city, it is also an ever-present witness to culture and history, having hosted banquets and celebrations for almost six hundred years honoring coronations and the visits of Presidents and Prime Ministers.

Indeed, it seems highly appropriate that our dinner this evening, which recognizes the importance of banking and finance to this distinguished city's heritage, is being held here, so close to one of Europe's most historic marketplaces. Since medieval times, merchants have traveled great distances to participate in Frankfurt's many fairs and markets. The wealth that those markets produced no doubt assisted in the development of increasingly sophisticated financial institutions and a stock market as early as the 16th century, plus several of the most storied banking houses in history. Those institutions, in turn, contributed to Frankfurt's ascent to prominence by financing additional trade and commerce here and abroad.

Framed by this historical perspective, I would like to share with you some of my thoughts on how the public sector can and should work with private financial institutions to maintain financial stability. In particular, I would like to discuss the work that we bank supervisors, and other organizations, do to promote and protect the safety and soundness of our financial systems and institutions. In a complementary fashion, I would also like to discuss the roles of the private and public sectors in preventing and resolving international financial crises.

The supervisor's charge to promote financial stability

One does not need to remind bankers in Frankfurt, or for that matter in any country, of the importance of stability to financial markets and organizations. We've been reminded of this necessity many times in the modern age, including by the global financial turbulence triggered by the recent crises in emerging countries.

Regardless of whether financial systems and institutions face serious and protracted crises or just temporary downturns, bank supervisors in every country have a special responsibility to safeguard the sound operation of their banking systems. This charge consists of two duties.

- To promote stability, supervisors must first encourage banks to manage their risks appropriately to ensure proper safeguards are in place that limit an organization's vulnerability. This is the duty of prevention. It is critical for supervisors to remember that the primary responsibility for the safe and sound operation of a banking organization rests with its board of directors and senior management. As a former commercial banker, I know that competent, capable leaders at the enterprise level, supported by a well-trained staff and a robust system of risk management processes and controls, make up the first line of defense against financial instability within an economy. As a supervisor, I believe that there should be sufficient market and supervisory incentives to encourage banks toward responsible behavior.
- The supervisor's second duty is to assist in the resolution of problems when they do occur, so that banks can continue to serve as intermediaries of credit, the lifeline of an economy, to businesses and consumers. This represents the duty of action. From the experience of the savings and loans crisis in the United States, to more recent regional financial emergencies elsewhere, we've seen that when disaster looms, prompt and decisive supervisory action is imperative to containing the damage that severely troubled financial institutions can wreak on the economy. In those extreme circumstances, supervisors must restore confidence

quickly so that consumers and businesses do not lose access to credit necessary for the economy to grow.

How the delicate balance of responsibilities of bank management and supervisors is accomplished, particularly in a period of stress, is crucial to the outcome of country's economic performance.

The philosophy of prevention: assist banks to govern themselves

In developing regulations and practices that help to prevent financial crisis, supervisors must not lose sight of the inherent self-interest that banks have to retain the public's confidence by maintaining safe and sound operations. No responsible firm seeks to fail, and no responsible bank would willingly engage in practices that would cause the market to doubt its long-term viability.

Consequently, our role as regulators is not to limit banks' opportunities for growth and profit. Instead, it is to help banks to improve continuously their abilities to manage their businesses and their risks, thereby ensuring that, across the financial system, banks can maintain their financial health. At the same time, if we are to encourage responsible behavior, we must not create the illusion that we will rescue every institution that does not succeed.

In this regard, you will recall Goethe's view: "What government is the best? That which teaches us to govern ourselves." Similarly, one of the best ways for supervisors to carry out the duty of prevention is by developing regulatory structures that encourage banks and their managers to govern themselves and control their risks.

I believe that three important elements in a supervisory structure can help to create such incentives and thereby promote stability. The first consists of the relatively new "risk-focused" approach to bank supervision that is being adopted in financial centers around the world. It embodies a forward-looking perspective focusing most heavily on the risks that each individual bank faces. The second element is for supervisors to conduct independent reviews of a bank's capital adequacy relative to its risk profile, while the third is to help improve the ability of market forces to exert discipline on management behavior. These last two elements, which I will address in more detail in a moment, have been adopted by the Basel Committee as key parts of our proposal to revise the international standards on capital regulation.

Risk-focused supervision

In terms of the "risk-focused" approach to supervision, many of my colleagues would agree that what makes bank supervision so challenging is the need to keep pace with such a dynamic, fast-moving, and diverse industry.

Consequently, supervision must be **adaptive**. The banking industry is intensely competitive and firms must constantly identify new markets, new products, and new ways to do business. Innovative products and technologies can quickly alter a bank's exposure to risk. Continuous innovation in the industry and increasingly rapid changes in risk profiles demand that supervisors, too, keep up with the latest developments and work to anticipate them to ensure that our regulatory framework remains relevant and timely.

Likewise, supervision needs to be **flexible**. We all know that the banking sector encompasses organizations that vary greatly in scope, size, and risk appetite, so it's obvious that regulations that are useful for small, community mortgage banks will not apply equally well to massive, multinational trading banks, and vice versa. In the United States, the risk-focused approach that the Federal Reserve and other bank supervisors have adopted over the past five years allows us to tailor a supervisory plan appropriate for each bank.

This marks a radical shift in the way that we evaluate a bank's condition in the United States. Rather than reviewing mainly the quality of individual loans and other items on a bank's balance sheet, for example, our bank examiners now try to identify the most important risks to which each bank is exposed – and then determine whether bank management employs robust processes to control those risks.

This is a much more "top-down" approach to supervision, as we are evaluating the integrity of the managerial process in a bank rather than only testing the strength and quality of individual transactions. This helps us to determine whether a bank that is healthy today will continue to be so in the future. I’m pleased to note that banks have welcomed this change in approach, as we have enhanced our ability to compare the quality of one bank’s control structure to those of other banks that face similar risks. We thus are better able to share our views of the "best practices" we see in industry risk management.

Supervisory review of capital

Supervisory review and market discipline are two other elements that can create incentives for responsible behavior, and are of such importance to contemporary supervisory thinking that they have also been adopted as two of the three "pillars" of the Basel Committee’s proposal to revise the international standards on bank capital requirements. There’s been a good deal of public discussion about the first pillar, in which the Committee recommended changes to the guidelines that set minimum capital requirements for banks. Tonight I will concentrate on the importance of the other two in promoting financial stability.

Adequate capital is, of course, the foundation of a safe banking system, as it provides banks with a "cushion" against unexpected losses. Supervisors aim to ensure that banks set aside sufficient capital relative to the underlying risks that each institution faces, including whether the banks are addressing the relationship between different kinds of risk. This will be no easy task, as banks under the new Capital Accord will increasingly rely on their own internal models to determine the kinds of risk they face and to what degree.

The Basel Committee proposed that supervisors review the methodologies through which banks set their capital levels to ensure that banks have an incentive to develop effective processes for aligning their capital levels with their risks. When supervisors engage in a more active dialogue about those processes, we expect that banks will apply greater resources to identify and analyze more comprehensively the risks that they face, seek more accurate measures of the potential costs of those risks to their businesses, and develop more sophisticated mechanisms to mitigate those risks, including maintaining sufficient capital funds.

I must emphasize that the supervisory review of capital is intended neither to replace the judgement and expertise of bank management nor to shift responsibility for capital adequacy to supervisors. On the contrary, the Committee recognizes that bank managers are in the best position to understand and react to the particular risks that their institutions face. Supervisory review seeks to evaluate the quality of management’s judgement.

As an added benefit, better dialogue through supervisory review will strengthen supervisors’ understanding of the risks that banks face. When problems do occur, having greater insight into the risk profiles and the control mechanisms in place will help supervisors to understand which institutions are most exposed and enable more rapid corrective action to protect systemic financial stability.

Market discipline

The third pillar of the new capital adequacy framework, market discipline, is an important ally of official supervision and can create powerful incentives for banks to manage their risks appropriately. Marketplace participants, including investors, creditors, and other financial counterparties, can reward sound management or penalize weak management through their influence on the value of a bank’s equity and debt and on its access to credit.

Such discipline is not possible without meaningful public disclosure of a bank’s financial condition. I think we would all agree that there is no greater enemy to a stable financial marketplace than a lack of confidence, and surely nothing undermines confidence more than a lack of reliable information. Discipline by the market is not always pleasant – a lesson many companies have re-learned recently. Yet better quality information, or what we often call transparency, can boost the confidence of depositors, investors, and creditors, and it can contribute to stability by encouraging banks to adopt a more proactive approach to managing their risks.

In this regard, just last month the Basel Committee published the results of a two-year study on public disclosure practices of internationally active banks as a guide to the industry and accounting standards setters on areas where disclosure can be improved.

While many countries have made great progress over recent years to improve the quality and level of disclosure, disclosure practices have not kept up with the changes in how banks manage their businesses and in how they measure and mitigate their risks.

To improve this situation, I believe that the notions of what is public versus proprietary information must change. It is critical to approach the question of disclosure as users of financial statements. Shareholders, creditors, and counterparties cannot understand the risks of their own exposures to a bank until they first understand that bank's appetite for risk and its approach to, and methodologies for, managing risk. What should drive this debate is market participants' need for information to make sound and secure credit and investment decisions, rather than the concerns some have about what was once considered secret.

Transparency promotes confidence, and in light of the increasingly international nature of markets, we must ensure that disclosure in different countries is sufficient and broadly consistent to promote greater financial stability across markets. That will no doubt require additional harmonization of accounting standards so that supervisors, bankers, and other market participants alike can better understand and act appropriately to manage their exposures to markets or institutions abroad.

Managing international financial crises

Our efforts to promote stronger banks through changes in the capital accord, while crucially important, also need to be seen in their broader context. The capital accord is part of a broader series of initiatives to promote stronger financial systems globally, and more generally to reduce the likelihood of future financial crises.

During the latter part of the 1990s the international financial system has endured perhaps its greatest stress in the post-war period, and currently, we again are seeing signs of strain associated with the global slowdown in growth. The experience of recent years has reinforced old lessons and brought home new insights about maintaining financial stability and sustained growth. In particular, a broad consensus has developed on ways of strengthening the institutional framework at the national and international level to create more robust, and thus more crisis-resistant, economies. There is general agreement that in order for countries to enjoy sustained and stable growth, the following are crucial:

- a sound and stable macroeconomic environment, and
- well-functioning and robust financial systems in both capital exporting and capital importing countries.

Moreover, both of these are most effective when supported by a dynamic and adaptive policy regime.

There is considerable agreement on many of the elements needed to achieve these goals, for example the importance of attaining and sustaining price stability. This agreement has been reflected, in part, in the development and promulgation of globally accepted codes and standards for best practice in areas ranging from transparency in fiscal policy and in monetary and financial policy, to public debt management, and core principles for bank supervision. Guiding themes across these various standards have included the importance of transparency—indeed the whole New Architecture initiative has been as much about putting in more and better windows as about laying in sturdier foundations—and of building stability up from the firm and sector level. The latter is accomplished by encouraging sound risk management and stronger balance sheets, and creating efficient systems of market, legal, and regulatory discipline.

Unfortunately, there is no comparable degree of consensus on how best to handle international financial crises once they do erupt, or the proper roles of public institutions and the private sector in containing and resolving such crises. In particular, there is unease that the current approach to crisis management that has evolved out of the experiences in Mexico and Asia, notwithstanding its successes in some cases, entails solutions that:

- are potentially too costly, given the repeated reliance on large-scale financial support packages,
- introduce adverse incentives, or moral hazard, and
- are in themselves a source of uncertainty, and potentially of instability.

But the alternatives look even more unpalatable in their implications. Notwithstanding considerable efforts at the public and private level to search for a better way, no magic bullet or formula has been found.

Nor is one likely to be available. Experience and a reading of the historical record suggest that the seductive allure of grand solutions must be resisted. Cases differ greatly with respect to what is possible and desirable in terms of their implications for the interests of the public and private sectors. Moreover, if history is any guide, new developments in markets and practices quickly will render obsolete those measures that might seem well attuned to today's circumstances.

Then what is the right path? The solution is neither a single piece of financial engineering nor a compact between the official lenders and private creditors. Rather, it is a process incorporating a number of elements. Essentially, I would suggest that our current case-by-case approach to crisis management needs to evolve in ways that are market-based and adaptive, yet strategic, creative, and principled. Allow me to explain.

To be successful in today's environment, a case-by-case approach needs to be **market-based and adaptive** to the particularities of the case at hand, as well as the global financial and economic context. This requires seeking, as far as possible, to work with the grain of a given situation, as a good artisan works with the grain of the wood.

- The approach needs to be market-based in part because that is what the game is all about. Today, the relevant considerations for crisis management relate more to markets and the problem of restoring market confidence, than to individual borrowers and creditors. To the extent that systemic concerns pertain, they more often relate to the risks of market disruption and over-adjustment than to potential domino effects caused by the failure or impairment of key institutions.
- Also, in today's environment, a market-based approach is much more feasible. Financial recoveries can proceed more rapidly than in the past, because market participants generally have the ability—and many have little choice, because of the prevalence of mark-to-market accounting—to digest losses and move on.
- Working with the grain means recognizing the realities and limitations inherent in the current market structure and its functioning, and tailoring approaches accordingly. This involves acknowledging that attempts to impose solutions are unrealistic and potentially counterproductive. Instead it involves identifying ways to induce and encourage desired behaviors. I would also suggest that it means avoiding departures from normal market functioning whenever possible. Interventions should seek not to override or suspend market functioning, but rather to guide market processes.

A case-by-case approach by definition is supremely tactical, but it also needs to be **strategic** in orientation as well, if it is to be successful in the longer run. In particular, we in the public sector would be well served to maximize the complementarity between efforts to prevent crises and efforts to contain and resolve crises when they do arise.

- The consensus on sound preventative policies includes precepts that public sectors should limit the scale of their involvement in the domestic economy, and that borrowers, public and private, should be encouraged to follow best practices in the management of their liquidity and foreign exchange risk. Indeed, as I discussed earlier, this is the essence of what we are trying to do under the revised capital accord. Moreover, countries are being encouraged to strengthen their legal and regulatory regimes for insolvency resolution to better deal with cases when private sector borrowers get it wrong.
- Progress in these areas, even if only incremental, will have important implications for what is possible and necessary in the future. For example, having stronger banks and corporate balance sheets, with lower leverage, expands the scope for using interest rates, and asset price adjustments as stabilizing devices. Better liquidity management at both the micro and macro level—longer maturities, and greater reserve coverage and back-up financing—will create margins to ride out financial shocks. And better insolvency regimes would make decentralized workouts more feasible.
- As part of the strategy to match better preventive and management efforts, it would be useful to encourage market-based mechanisms that help build time back into the system. While numerous accounting, regulatory, technological, and structural market changes that have

occurred over the past dozen years have generally made financial systems more resilient, they have also had the effect of accelerating market processes, and thereby removing time—and its shock-absorbing and beneficial aspects—from the system.

The approach to crisis management and resolution also needs to be **creative**. In part this can be accomplished by relying as much as possible on the efforts of debtors and private creditors to work things out on their own. The perception in some circles that private creditors are not interested in resolving payment problems expeditiously is mistaken, and stands at odds with recent experience. If nothing else, investors are interested in restoring liquidity to debt instruments in order to move on to new opportunities. There is also scope for exploring creative market-based ways to lever in private participation and stretch the impact of public sector funds.

Finally, a successful market-based, case-by-case approach also needs to be principled. I would suggest that the essence of an effective case-by-case approach is the development of viable plans that link broader, generally acceptable principles to the particulars of a given situation.

- To achieve this, a clearer and more transparent articulation of the public sector's objectives is necessary. Greater emphasis and clarity are needed as to the purposes and limits of public intervention, and the extent to which those interests warrant different degrees, modes, and timing of public and private sector involvement, depending on the particular country and circumstances. In this way all parties will be better placed to understand current developments and how the international community might react to future strains.

The argument against standstills

There are of course other points of view. I would note that some have suggested that perhaps we should go in a different direction, that we should seek to build time back in by calling a **time out**. In particular, it has been suggested that an early recourse to comprehensive payment standstills (suspensions of debt service perhaps amplified or reinforced by capital controls) would increase the manageability of crises and enhance predictability.

My reading of the record convinces me that trying to freeze market processes would do the opposite. I would like to share with you my thinking on this point.

- The desire for certainty and control which seems to underlie standstill proposals is understandable, as it offers the promise of using less public money, and seemingly entails less risk that creditors will be bailed out for poor credit decisions. But the control and manageability that might result may be more seeming than real.
- For one, a perceived disposition to preemptively lock the door seems likely to send investors heading for the exits all that much sooner. As a result many avoidable crises soon may become inevitable. And the problem of contagion, whereby difficulties in one case spread to many, would seem likely to worsen.
- Moreover, a perceived weakening of the international community's commitment to voluntary, market-oriented approaches and its support for honoring contractual commitments would likely create deep distrust, making it harder to encourage cooperation between debtors and creditors in ultimately resolving the crisis.
- An overly quick recourse to payment suspensions also risks discouraging precisely the types of flows that we should wish to encourage, that is, longer maturities with better risk sharing characteristics, such as long-term bonds and equities. In a crisis, the hottest money leaves first—by definition. It seems counterproductive to seek to penalize those who stay.
- Finally, I would suggest that preemptive attempts to "freeze markets" also undermine market discipline of and ownership by the local authorities.
  - Increases and decreases in financial flows, and the fluctuations in pricing that naturally accompany positive or negative trends in policies and economic and financial performance are a reflection of, and act as a natural brake on the development of imbalances.
  - But an assertion of control by international community, by preemptively calling a time out, risks diverting attention from the policies of the local authorities. As a result, denial and delay, aggravating factors in almost every crisis, may well continue and be exacerbated. And then, as a practical matter, once market processes have been stopped, how and when do

you get things started again, particularly if needed corrective policies still have not been convincingly and transparently implemented?

– To sum up, I believe the one size fits all disposition inherent in the standstills approach risks making situations much worse than they need to be. The only thing that strikes me as predictable under such an approach would be that market access would be harmed across the board. Just as bail-outs may encourage too much risk taking, efforts to orchestrate preemptive bail-ins may encourage too little.

A minimalist approach to payment suspensions

This is not to say that payment suspensions always can and should be avoided, or that ever-larger bailouts are desirable or feasible. I would note that in December 1997, we at the New York Fed played an important role in encouraging creditors from around the world to begin working with the Korean authorities to find a solution that complemented the courageous policy actions of the then new government. This effort, which began with commitments to maintain inter-bank credit lines and culminated in a refinancing of these claims, was but one of many times we have helped borrowers and creditors find mutually beneficial solutions.

But in such instances, when payment interruptions truly are unavoidable, experience has shown that minimalist approaches, where only certain payments are suspended or delayed, and only where absolutely necessary, generally offer the best prospects for minimizing spillover effects and for rapidly restoring market access.

- We should not forget we are living in a world of private flows. Nor should we forget that a crisis is not over when capital outflows have been halted and prices stop falling. Emerging market economies depend on regular access to international capital market and bank credit, and economic recovery and restoration of growth depend on confidence being reestablished, so that the necessary financing, beyond emergency lending, can be obtained.
- The scope for a minimalist approach hinges crucially on the adoption of strengthened policies--fiscal, monetary, and financial--to address the fundamental concerns that are leading investors to pull back in the first place. In this regard, the IMF has a crucial role to play as a guardian of sound policy and crisis mitigator. IMF support should provide an unambiguous signal of the international community’s confidence in the capacity of crisis-affected countries to take the measures necessary to restore economic health.

Concluding remarks

Underlying the suggestions that I have made is a firm belief that the success of our approaches to crisis management needs to be viewed and assessed with a wide focus. Certainly there is the question of efficacy in containing the crisis at hand, and the balance between this and the costs, actual and potential to the public sector. But we also must keep in mind the implications for the functioning of the global financial system in the near and medium term. This requires consideration of prospects for restoring normal market functioning and access, and the creation of appropriate incentives. When difficulties arise, the challenge remains, as always, to encourage and work with countries that are ready and able to implement strong corrective actions and to find financial solutions best suited to both the specific case and the broader functioning of the global financial system. A flexible case-by-case, managed-market approach represents the best bet—and the only realistic option—for achieving those goals as we face a challenging future.