William J McDonough: Promoting financial resilience

Remarks by Mr William J McDonough, President and Chief Executive Officer of the Federal Reserve Bank of New York, at the Cato Institute's 20th Annual Monetary Conference on "International Financial Crises: What Role for Government?" cosponsored with The Economist, New York, 17 October 2002.

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- Good morning. It is a pleasure to have the opportunity to join you on the occasion of this timely conference, and to share with you my thoughts on promoting financial resilience.
- Despite the fact that periodic surges in volatility are a fact of life in financial markets, I think there is general acknowledgment that recent years have been extraordinary in this regard. This has been a period of historic change and remarkable volatility in markets, going well beyond the emerging markets, and carrying with it important implications for political, social, and institutional stability in significant segments of the globe.
- The experiences of recent years have reinforced old lessons and brought home new insights about maintaining financial stability and sustained growth. In particular, a broad consensus continues to develop 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.

- The simple reality is that countries with robust financial systems, strong fiscal accounts, low inflation, credible and coherent monetary and exchange rate policies, moderate external and internal indebtedness, reasonable current accounts, and adequate domestic savings rates are less likely to be buffeted by financial and economic turbulence. Moreover, when shocks do occur, such countries tend to be far more resilient.
- There is also considerable agreement on many of the elements needed to achieve these goals. This agreement has been reflected, in part, in the development and promulgation of globally accepted standards and codes for best practices in areas ranging from transparency in fiscal, monetary, and financial policies, to public debt management, and core principles for bank supervision. Guiding themes across these various standards have included the importance of consistent disclosure practices 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.
- But the learning process continues. For example, in this country, recent experiences have brought to light the need to do more to strengthen corporate accounting and disclosure standards, particularly with regard to guarantees and complex financial arrangements, such as those funded offshore or through special-purpose entities.
- Our ongoing efforts to revise the Basel Capital Accord also reflect a learning process. We embarked on this voyage in the late 1990s because we realized that the original 1988 Basel Accord had been overtaken by advances in the financial sector – and in the broader economy. While the 1988 Accord represented an important advance, new technology, the globalization of financial markets, and innovative financial products and services have changed the way that banks monitor and manage credit, market, and operational risks in a manner that the 1988 Accord could not anticipate and does not address.
- To ensure that the New Accord remains flexible, forward-looking, and appropriate for the risks and capital needs of internationally active banks of the twenty-first century, the Basel Committee established several goals for its work, goals that the industry has embraced.

- First, we intended to develop a framework that encompasses the "three pillars" necessary to support an effective system of regulatory capital: the appropriate measurement and minimum requirements, supervisory review, and market discipline.
- Second, we wanted to align the minimum requirements more closely with the actual underlying economic risks to which banks are exposed, which should help allocate capital resources effectively.
- A third goal was to encourage banks to refine their measurement and management of risk over time. By creating incentives in the New Accord for banks to re-evaluate and enhance their tools constantly, we expect that banks themselves will adopt a forward-looking perspective on risk.
- I'm pleased to say that, through the Committee's efforts and the cooperation and support of other supervisors and the industry, it appears that the proposed framework will attain each goal. We can now count them among the milestones we've achieved.

- However, though we have covered quite a bit of territory over the past three years, the last miles of any marathon are the toughest to finish. I'd like to turn now to the status of the New Accord and of the issues we are still resolving.
- Since the Second Consultative Document's release 21 months ago, the members of the Basel Committee have worked collaboratively and publicly with supervisors, banks, and others to revise the proposals so that they best serve the needs of modern banking. We've published and discussed thousands of pages of proposals and studies with the industry and the public. I'd like to share with you the latest news on how we are resolving the key challenges and concerns that have surfaced in this process.
- One general issue raised is that the New Accord's increased sensitivity to risk will reinforce procyclical behavior by banks, leading to increased cost of credit during cyclical downturns. While we are working to address this concern, I would note that banks already are expected to operate above minimum capital requirements, manage to their economic capital needs, and evaluate how their risk profiles may change over time. Along those lines, the Committee recently agreed that banks adopting the "internal ratings based" approach to credit risk will be required to conduct appropriate credit risk stress testing, which should help to contain procyclical behavior.
- Another concern raised about Basel II is its complexity. If the New Accord is to be more risk-sensitive, however, it must involve an irreducible degree of complexity, which parallels the changes in bank practices and market instruments. Indeed, some of this complexity stems from the various options the New Accord provides to address the wide range of risk profiles, strategies, and systems that banks maintain.
- The treatment of operational risk has been a more specific area of concern. While operational risk cannot be quantified with the same degree of precision as credit or market risk, the Committee believes that introducing a separate charge for operational risk will bolster efforts to find better ways to address it. In this vein, we have seen encouraging progress in operational risk measurement, although we recognize that the industry has not settled on particular methodologies or principles. Accordingly, the New Accord will permit an unprecedented amount of flexibility to accommodate a spectrum of approaches to operational risk. Toward that end, under the "advanced measurement approach," the most sophisticated institutions will be free to experiment with a great variety of methodologies.
- The Basel Committee expects that we will achieve our goal of not raising in aggregate the capitalization required of the banking industry, though clearly and appropriately those banks that engage in higher risk businesses may see their requirements rise, and vice versa.
  - To help ensure this, the Committee launched its third Quantitative Impact Study on October 1, 2002, involving, to date, 265 banks from nearly 50 countries. The banks will assess how the proposals will affect them and submit their findings by December 20, 2002. These results will allow us to ascertain the need for adjustments prior to the release of an updated proposal for public comment in the

second quarter of 2003, followed by finalization of the New Accord in the fourth quarter of 2003, and implementation at year-end 2006.

- While much work clearly remains to be done over the next three years - including evaluating banks' readiness, training supervisory staff, and working towards consistent implementation across supervisors - in my view, both the journey and the ultimate destination of a New Accord will contribute substantially to a more resilient international financial system.
- Unfortunately, while there is a deepening consensus on key elements about how to promote resilience ex ante, 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. Notwithstanding considerable efforts at the public and private level to search for a better way, no magic bullet or formula has been found, although at times some have been asserted.
- 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, history tells us that new developments in markets and practices quickly will render obsolete those measures that might seem well attuned to today's circumstances.
- Allow me to explain how I think progress can be made by first focusing a bit on the problem that confronts us. I would like to highlight some of the important changes that have taken place over the past two decades in the patterns and instrumentation of capital flows to the emerging world, and in the nature of crises that can arise associated with these flows.
    - First, it is important to keep in mind that the constellation of investors and the range of instrumentation have broadened considerably over the past two decades. Equity investors (both direct and portfolio) are now the principal source of net inflows for emerging market countries, and most medium-term debt is held in tradable form by a broad array of diversified, well-capitalized, fixed-income investors.
    - Second, there have been equally important changes in the destination of flows. Reflecting the predominance of private-to-private flows since 1990, today sovereign foreign debt often represents only a relatively small part of maturing debt in crisis cases. Most maturing debt is owed by private borrowers and/or is locally issued.
    - Third, the context has been fundamentally altered by broad institutional change. Accounting, regulatory, technological, communications, and structural market changes have fostered an environment characterized by mark-to-market accounting and much more liquid and actively managed balance sheets. Investors are focused on financial performance, and on their fiduciary responsibilities to their largely private clients and shareholders, rather than on long-term strategic relationships with sovereigns. Today this is as true for banks, which remain important providers of credit, as it is for other providers of capital.
    - Last, the new environment entails new and complex linkages - - between domestic and international markets, and within and across countries - - reflecting the internationalization of local banking, equity, debt, and currency markets, and the greater complexity of funding structures.
    - This new environment has important implications for policymakers and market participants alike. Let me comment on just a few:
    - On the negative side, crises are more complex and unfold much more quickly and with surprising dimensions. Variable and often highly interdependent cross-market developments are often critical in the evolution of a given case and its implications for others. Indeed, many of the more recent crises were triggered by problems in domestic banking, currency, and debt markets that then spread to the capital account. Also, in today's environment, the fear of an event often is the event itself, because of the inherent tendency of markets to anticipate developments and overreact.

- But on the positive side, financial recoveries can proceed more rapidly in today's environment, particularly with the right policy responses from borrowers. In part, this reflects the fact that today's market participants generally have the capacity - - and many have little choice, under mark-to-market accounting - - to digest losses and move on. The broader sourcing of capital today also gives more scope to the possibility that, while some investors may withdraw, others may take their place. The caveat here is that the well not be poisoned through unnecessarily broad or heavy-handed approaches, a point I will return to later.

- What is the right way to deal with this changed and changing environment? In my view, 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.**

- Being successful in today's environment requires adapting to the particularities of the case at hand, as well as the global financial and economic context, and requires seeking, as far as possible, to work with the grain of a given situation. 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, because financial recoveries can proceed more rapidly than in the past.

  - To be more specific, in my view, although much has been made of the difficulties in achieving debtor workouts, the truly thorny issues associated with emerging market financial crises usually relate to the following:

    - containing the fallout to domestic financial systems and to local consumer and investor confidence,

    - minimizing contagion and spillovers to other cases and markets,

    - maintaining or restoring market access, particularly for private sector borrowers, and,

    - most importantly, encouraging policy reform so that a given crisis falls as closely as possible to the liquidity, rather than the solvency, end of the spectrum.

  - Working with the grain means recognizing the realities and limitations inherent in the current market structure and its functioning, and tailoring approaches to the specifics of individual cases. This involves acknowledging that attempts to impose solutions from outside 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.

    - 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 we at the New York Fed in numerous instances, spanning several decades, have worked to help borrowers and creditors find mutually beneficial solutions that involved some degree of concerted or coordinated financing.

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

- The linchpin of a market-based, minimalist approach has to be a strong policy response on the part of the country in crisis. Markets may not always be reasonable, but they usually have reasons for reacting adversely. Those reasons most often relate to policy or institutional shortcomings. Across all of the episodes of market distress in the emerging world over the past two decades, an essential element of heading off or minimizing damage from a crisis has been policymakers showing that they "get the message" about the need for reform, and are prepared to take appropriate measures.

  - In this regard, the comparative advantage of the international public sector is in guiding economic and financial policy, and fostering the conditions that will facilitate the restoration or maintenance of voluntary credit and investment flows. 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.

  - This role is particularly important in unfolding crisis situations, because borrowing country authorities too often are slow to recognize the full dimensions of the policy challenges confronting them, and the private sector is ill-equipped to deal with this.

- A case-by-case approach by definition is supremely tactical, but it also needs to be **strategic** in orientation if it is to be successful in the longer run. I would like to highlight several ways in which the case-by-case approach needs to be strategic.

  - First off, strategy needs to be informed by a long-run view about the case at hand. The emphasis should not be merely on "working out" the problems at hand, but on "working through" them. The latter orientation focuses attention beyond the current circumstances to the restoration of growth, access to capital, and normal market functioning, recognizing that *workouts are but one of several means to that end, not an end in themselves.*

    - We should not forget that a crisis is not over when capital outflows have been halted and prices stop falling. Emerging market economies depend on sustained and predictable 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.

  - Secondly, 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, foreign exchange, and credit 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 deal more effectively with cases when private sector borrowers and lenders 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 bank 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 levels - - longer maturities, and greater reserve coverage and back-up financing - - will create margins to ride out financial shocks. And more effective insolvency regimes would make decentralized workouts more feasible, particularly in cases where systemic stress is better contained.

- 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.
  - The various experiences since the late 80s with buybacks, partial guarantees, and debt exchanges provide some hints for how targeted deployment of public moneys can spur tendencies in a direction consistent with public policy goals. Such creativity is essential if we are to get beyond stark and unpalatable choices entailing either massive bailouts or sweeping defaults.
- 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 broad, 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.
- There are, of course, other points of view. In particular, it has been suggested that an early recourse to broad 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 preemptively override market processes would do the opposite. Let me share a few thoughts with you on this point.
  - The desire for certainty and control which seems to underlie such proposals is understandable, as it appears to offer 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 the international community 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 a preemptive 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 bailouts risk encouraging too much risk taking, efforts to orchestrate preemptive bail-ins may encourage too little.

- 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.

Thank you.