Timothy F Geithner: Change and challenges facing the US financial system

Remarks by Mr Timothy F Geithner, President and Chief Executive Officer of the Federal Reserve Bank of New York, before the New York Bankers Association's Annual Financial Services Forum, New York, 25 March 2004.

*   *   *

It is a pleasure to join you at the New York Bankers Association Financial Services Forum. The institutions represented in this room, together with the rest of the New York financial community, remain at the center of the U.S. and global financial systems.

Your meeting today takes place against the backdrop of a relatively favorable national and global economic outlook. The U.S. financial system is in reasonably strong shape. Financial innovation has enabled substantial improvements in the quality of risk management and in the capacity of the system to handle shocks. But the benefits of innovation have come with significant challenges to the people who run financial institutions and to those responsible for supervision and oversight. How effective we are in responding to these challenges will determine whether the U.S. financial system is as successful in the future as it has been in the past.

The consensus forecast for the U.S. economy expects solid growth this year and next, somewhat above the upper bound of the range of most estimates of U.S. potential growth. Confidence in the sustainability of the U.S. expansion, as measured by changes in these forecasts, for example, seems to be increasing. The rate of economic growth outside the United States is also looking better. Although there are pockets of weakness and potential sources of vulnerability, the overall rate of global growth has accelerated significantly and looks as if it's now running at the strongest levels in four years.

The broad measures of U.S. consumer price inflation are very low. Inflation expectations as reflected in surveys and in the Treasury inflation-protected securities, although higher than current rates, still suggest an outlook of very modest future price increases. Deflation risks worldwide appear to have diminished, and there are some signs of accelerating price increases in some economies. Overall, however, despite the sharp increases in energy and commodity prices, the inflation outlook globally appears quite benign.

At the core of the U.S. economic experience of the past decade is a significant and sustained acceleration in productivity growth. This offers the prospect of more rapid growth in income over time, both for the United States and for the rest of the world.

In the economics profession, there is a debate about whether we are in the midst of a secular trend characterized by lower GDP volatility and general price stability, which some have called the "great moderation." As important as the question of the extent of this moderation in macroeconomic volatility is the debate over its source. It's undoubtedly the result of a combination of factors, including better economic policy, innovation and globalization, plus simple good fortune in the form of smaller shocks. But, the relative contribution of these factors is uncertain.

Despite the uncertainty that exists about the sources and durability of this apparent moderation in some types of risks, financial market prices now reflect a very benign view of economic and credit fundamentals. Credit spreads generally and risk premia in many asset classes are at levels that are very low even in relation to previous periods of relative optimism.

The U.S. financial system, when judged by many conventional measures, looks reasonably healthy as well. Bank profitability is at the highest levels we have seen, depending on which measure you choose, in two to three decades. Capital positions for U.S. banks, which have been around 13 percent of assets over the past two years, are very strong, significantly above the regulatory standards required to be considered well capitalized. Asset quality also remains robust. Nonperforming loan ratios are now only 1.2 percent across the commercial banking industry. The financial markets are pricing financial institution risk at very favorable levels, with bank equity prices, subordinated debt spreads, and credit default swap spreads suggesting a high degree of investor and counterparty confidence in the financial health of the major banks and other financial institutions.

As these numbers suggest, the U.S. financial system came through the recent recession, the spate of corporate bankruptcies, the sharp adjustment in some asset prices, and the difficulties in some

emerging market economies in reasonably strong financial shape. This apparent resilience, relative to past downturns and relative to the experience of other countries, is the result of a number of factors. Some of these factors stem from developments outside the financial system, like better macroeconomic policy and better microeconomic or supply-side fundamentals. And some stem from changes in the nature of financial intermediation, the structure of the financial system, and the capacity of financial institutions to manage risk.

To start with the broader economic context, the strength and length of the expansion of the 1990s helped ensure that U.S. financial institutions entered the latest recession with strong capital positions. The fact that the recession was shallower and shorter than the average of the past helped limit the scale and scope of losses to financial institutions. The forcefulness of the monetary policy response and the large fiscal stimulus provided by the tax cuts and expenditure increases played a significant role in limiting the depth of the downturn and in helping to bring about the recovery. It is significant that the yield curve has been steeper and stayed steep longer in this latest recession than in the previous one. And, finally, the stronger microeconomic fundamentals of the U.S. economy - the shift to just-in-time inventory management, the speed of innovation in the U.S. economy, and other factors that seem to have reduced the amplitude of the business cycle and improved the flexibility and resilience of the U.S. economy in response to shocks - have also contributed to financial stability.

Changes in the nature of financial intermediation have also played a role in improving the overall resilience and performance of the U.S. financial system that was evident in this latest period of economic recession and financial stress. Four different types of changes are particularly important.

- Innovation in financial technology continues to expand the opportunities for financial institutions to separate and distribute, and to manage and hedge, different types of risk.
- The increasingly greater role played by the capital markets in the financial intermediation process relative to banks - both relative to the past and compared with most other major economies - has improved the capacity of our system to handle stress. Loans and securities held by commercial banks today account for less than 20 percent of overall U.S. credit market debt, roughly two--thirds of their 1975 levels.
- The increases in the sophistication of risk management techniques and enhancements to risk management processes have delivered substantial improvements in how banks and other financial institutions actually manage risk in practice. Banks, for example, have aligned their pricing of credit products much more closely with credit risk.
- The increased scale of cross-border financial intermediation, the growing role of securitized financial instruments in those overall flows, and the growth in the size and breadth of financial institutions with global operations may also mean that, as shocks are transmitted more rapidly, they are diffused more broadly.

These are positive developments, and they are likely to be enduring. But they have come with new challenges for those of you who manage financial institutions and for those of us charged with supervision and market oversight. The overall return on these changes will depend on the skill with which we manage the challenges that come with them. Among these challenges are those that relate to the complexity of financial and operational risk management, concentration in critical markets, internal governance to manage conflicts, the quality of public disclosure, opportunities for regulatory and capital arbitrage, and trend amplifying market dynamics in times of stress.

The financial innovations that have made risk transfer and hedging possible have increased the complexity of risk management, both financial and operational. The seemingly simple structure of a loan or bond issue can now involve a complex series of additional transactions that seek to allocate risks and responsibilities along specialized lines. This increased number of transactions that need to be separately settled and tracked by themselves create new risks that must be managed.

The economies of scale inherent in certain activities have led to a significant degree of concentration in some markets. A relatively small number of dealers account for a very large share of the over-the-counter derivatives business, with higher degrees of concentration in specific markets such as interest-rate options. Two institutions dominate the government securities clearing business. The growth in the size of government-sponsored mortgage entities creates a high degree of concentration in a market with very large systemic implications. Concentration has benefits, but it necessarily increases the vulnerability of the system to an operational or financial disruption in a single institution, or the decision by a single institution to exit a particular business. Moreover, to the extent that the

same set of firms play dominant roles in multiple markets, this concentration can also give rise to linkages between markets that are not apparent in normal circumstances and that could potentially affect how the financial system functions in conditions of acute stress.

Increased opportunities for diversification offer the prospect - though not the assurance - of lower overall volatility in earnings, but they also bring much more complicated management challenges in controlling conflicts, reputational risks, and operational risks. The actual gains achieved from diversification depend on the correlation of movements in different sources of earnings and in economic growth among different regions as well as the relative volatility of the new business lines into which the institution is diversifying. To the extent that diversification achieves lower overall volatility in earnings for the major financial institutions, it is clearly good for the stability of the system. But to fully exploit these potential gains requires careful attention to the design of the control and compliance infrastructure, to monitoring and managing credit risk and concentration across diverse types of financial activities, and to managing conflicts of interest.

These are formidable challenges even for the strongest management teams. Trust and reputation are valuable competitive assets for financial institutions, and the desire to preserve those assets creates a powerful incentive for firms to manage conflicts and compliance with exceptional care. Supervision and regulation, and the enforcement response to management failures, should help strengthen the incentives for a stronger compliance infrastructure, but they cannot insulate firms from the consequences of reputational damage.

Financial innovation has made it possible for the market to assign values to a broader range of financial activities. And this, combined with improved disclosure, has increased the potential power of market discipline. But the increased complexity that comes with innovation also creates challenges for investor and counterparty risk assessment. Although the overall quality of disclosure has improved in recent years, along with accounting and auditing processes that underpin the integrity of disclosure, the complexity of public financial reporting can make it very difficult to discern the true picture of a firm's financial condition and its exposure to risk.

Financial innovation has also made it possible for risk to migrate to - and for leverage to accumulate in - parts of the financial system with less strong, or simply different, supervision, capital requirements, or disclosure norms. Risk today, on balance, seems to be allocated more effectively to those institutions better able to manage and hold it, resulting in reduced risk to banks and to the financial system as a whole. However, limitations in the extent of public disclosure over institutions that hold large amounts of risk make it hard to develop a comprehensive picture. It is obviously in the interest of institutions that transfer credit risk, interest rate risk, or other risks to understand the performance capabilities of those institutions from which they are purchasing protection. The ability to arrive at informed independent judgments about counterparty risk, however, can be hindered by the gaps that remain in the quality of disclosure.

The same developments in financial technology that have improved the sophistication of risk management and the ability to transfer risk can create positive feedback mechanisms that, for at least short periods of time, amplify large moves in asset prices. There have been substantial increases over the past decade in the capacity of the market, meaning the principal dealers, to handle very large increases in hedging-related flows. This dimension of the financial infrastructure is critical to the capacity of our markets to absorb and respond to large shocks. Dynamic hedging of options and other similar strategies, however, depend on the availability of sufficient liquidity to work effectively. Stressful periods, of course, are marked precisely by a material reduction in market liquidity.

These changes in the nature of finance have several important implications for the supervisors and those responsible for market oversight. Financial innovation will, in some ways, always move ahead of the evolution in risk management techniques. As supervisors, our challenge is to work to ensure that the sophistication of the supervisory process evolves to keep abreast of the pace of change in financial innovation. This is a formidable challenge, and we need to continue to work hard at it. The revisions to the Basel Capital Accord, which aim to align supervisory assessments of capital adequacy more closely with the frontier of risk management techniques, are a good example of these efforts.

The changes in the structure of finance and the nature of the financial intermediation process reinforce the importance of cooperation between supervisory authorities. The sources of potential risk to financial stability are not confined to banks. Financial institutions increasingly operate across the legal parameters that define the responsibilities of the individual supervisory authorities. The economic characteristics of many of the financial credit instruments provided by banks and other financial institutions have converged. Our supervisory system is a complex framework in terms of the number of

responsible supervisory institutions, differences in approaches, overlaps, and gaps. This complexity makes it even more important that we collectively work to ensure a comprehensive look at sources of systemic risk and that we raise the bar on the quality of supervision and market oversight where it is necessary.

Bank supervisors have made significant progress in improving how we share and divide responsibilities for supervision of banks and bank holding companies, reduce overlap, and raise the overall contribution of the examination process. With the passage of the Gramm-Leach-Bliley Act in 1999, and the increased scope of activities it has allowed financial institutions to engage in across the financial services industry, we have worked to strengthen cooperation with other regulatory bodies. This will be increasingly important to the effectiveness of the overall supervisory process, as the SEC moves toward providing a form of consolidated supervision for the largest securities firms.

At the international level, we have made considerable progress in developing a network for cooperation and information sharing among national authorities that better matches the increased integration of national financial systems. We have worked to clarify the division of labor among supervisors of institutions with supra-national reach, and to cover gaps in the supervisory overlay. We have also worked to identify and promote the adoption of best practices and standards for many dimensions of the institutional framework that underpins well-functioning financial markets. Strengthening home-host supervisory cooperation and avoiding duplication of supervisory efforts will continue to be top priorities for the international supervisory community, especially as we adopt newer supervisory approaches, such as Basel II.

Finally, we need to continue to promote investments in strengthening resilience in critical infrastructure in payments and settlement systems and those institutions that play an important role in market clearance systems. This is a critical part of the supervisory and market oversight process we perform, and there is an active public-private effort underway to bring about further improvements in back-up facilities and overall resilience.

The innovations that have transformed finance over the past decade have substantially improved the overall stability and resilience of the U.S. financial system. But these improvements are unlikely to have brought an end to what Charles Kindleberger called “manias and panics” in financial markets. They cannot fully insulate the financial system from the effects of large macroeconomic shocks. And they will not by themselves preclude the possibility of failure in a major financial institution or a critical piece of market infrastructure. For these reasons, it is important that those of you who run financial institutions build in a sufficient cushion against adversity.

Of course, the overall performance of the financial system and the degree of financial stability depends on more than just the skill of risk managers and supervisors. The unique strengths of the U.S. financial system in allocating capital to where long run returns are highest depend on the overall confidence investors have in the fairness and integrity of our financial markets. These strengths depend on our openness to competition and the opportunities and rewards to innovation that the regulatory environment provides.

The stability of the financial system also depends significantly on the quality of macroeconomic policy, not only in terms of the credibility of monetary policy, but also in the degree of confidence investors have in U.S. fiscal management. The current deterioration in the U.S. fiscal position and the acute decline in the net national savings rate represent risks to the financial system and the economy as a whole. These risks are magnified by the size of the U.S. external imbalance and the unprecedented scale of financing requirements it reflects.

Although the present economic environment looks quite favorable, these broader macroeconomic policy challenges make it even more important that we build on the substantial progress we have already made in strengthening risk management and the resilience of critical market infrastructure. Our success in meeting these challenges will help ensure that our financial system proves as resilient in the future as it has in the recent past.

Thank you.