

Timothy F Geithner: Overview of the US financial system

Remarks by Mr Timothy F Geithner, President and Chief Executive Officer of the Federal Reserve Bank of New York, at the Bond Market Association's annual meeting, New York, 20 April 2005.

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Thanks for giving me the opportunity to join you today.

The U.S. and the world economy now confront the conjunction of several different transitions, which will have important implications for the U.S. financial system.

Among the most important of these transitions are:

- The approaching demographic pressures on fiscal resources, which will hit most major economies at a time when underlying fiscal positions are still likely to be in substantial deficit.
- The disposition of the global imbalances reflected most conspicuously in the U.S. current account deficit.
- The inevitable evolution in the exchange rate regimes of those countries that have been actively targeting their nominal exchange rate against the dollar to a system where there is more variability in their bilateral and real effective exchange rates.
- The transition from a long period of exceptionally low short-term nominal and real interest rates to levels more appropriate to the present circumstances. The slope and shape of this path toward equilibrium is necessarily subject to considerable uncertainty, and will depend on how the outlook unfolds.

These are all types of disequilibria. They can be sustained for a time, but not indefinitely. The imbalances in our fiscal and external positions could be diffused gradually and smoothly. But the transitions to a more sustainable equilibrium could also bring greater volatility in asset prices, less stability in macroeconomic outcomes, slower growth and more uncertainty.

The strength of the financial system is an important factor in assessing the probabilities associated with, and the potential impact of, the greater volatility that might be associated with these transitions. Where financial systems are strong and resilient, they provide more of a cushion against shocks and help improve the effectiveness of monetary policy in those circumstances. Where they are weaker, they can amplify the impact of shocks on macroeconomic activity and reduce the effectiveness of monetary policy in mitigating shocks.

I believe the changes in the U.S. financial system over the past two decades have produced a stronger and more stable system. The large financial institutions at the core of the system have substantial capital cushions and larger and more diversified earnings capacity. These institutions maintain capital above both the regulatory minimums and their internal economic capital measures. The technology and practice of risk management has improved dramatically. All types of risks in financial intermediation are more broadly dispersed. The financial infrastructure is stronger.

The combined effect of these changes seems likely to have made the U.S. financial system more stable across a broader range of circumstances. Although a substantial degree of uncertainty surrounds any forward looking judgment about financial resilience, the U.S. financial system seems less vulnerable to specific shocks and better able to absorb larger shocks than was true in the relatively recent past.

At the same time, however, changes in the structure of the financial system and an increase in product complexity could make a crisis more difficult to manage and perhaps more damaging.

Consolidation has produced a system in which a smaller number of financial institutions, banks and non-banks, account for a substantially larger share of financial intermediation. Therefore, while the probability of a major crisis induced by the financial failure of a major institution may be lower, the damage associated with such an event could be higher. An event large enough to threaten the solvency or liquidity of one of these core institutions could have more severe impact on the stability of the system than was the case in a less concentrated market.

The substantial increase in the role of hedge funds in our financial system also complicates the challenge of risk management. Although hedge funds help improve the efficiency of our system and

may also contribute to greater stability over time by absorbing risks that other institutions would not absorb, they may also introduce some uncertainty into market dynamics in conditions of stress.

The rapid growth in instruments for risk transfer, most recently in the credit world, has produced a large universe of exposures in complex products, whose future value is uncertain and difficult to model. The risk-reducing benefits of these innovations, for individual institutions and for the system as a whole, are substantial, but these benefits are to some extent qualified by the limits of our knowledge of how they will perform in conditions of stress.

The uncertainty and challenge posed by these developments are complicated by the confidence engendered by the stability and resilience of the U.S. economy over the past decade. Until very recently, we have seen an unusual dynamic in financial markets, in which low realized volatility in macroeconomic outcomes, low realized credit losses and low uncertainty about future inflation and interest rates have worked together to bring risk premia down across many asset prices. There is a self-reinforcing character to this pattern, with past stability seemingly increasing confidence in future stability, and this dynamic itself can magnify the risk of a more damaging reversal.

These are all good reasons to pay careful attention to the strength of the financial system today. We have a strong interest in ensuring that the largest institutions in our financial system, and the system as a whole, are able to function reasonably effectively, even in the face of a more turbulent economic and financial environment.

Capital is critical to this objective, and our current Basel I regulatory framework for capital is not up to the challenge. We have a very important global effort underway to improve the regulatory regime for capital, by tying it more closely to the actual risk profile of financial institutions. Basel II provides a much better way of determining the appropriate level of capital to hold against risk. It does a better job of capturing default risk and the true extent of risk transfer in securitization, guarantees and credit derivatives. It provides explicit recognition of operational risk, which can be larger than exposure to market risk for some complex financial institutions, not just for processing or clearing banks.

But Basel II is not the end of the process of designing a better regulatory framework for capital in financial institutions. As we move to refine and implement the Basel II framework for credit and operational risk, we need to strengthen the framework for market risk and encourage further improvements in how firms capture the possibility of extreme events.

The current regulatory treatment of market risk does a good job of capturing directional risk from movements in interest rates, exchange rates and equity and commodity prices. It is less effective, however, in capturing the full range of risks associated with some newer products and trading strategies, where values can react sharply and discontinuously. In particular, the risks of trading strategies based on changes in the correlation between asset returns are not always captured under the current regulatory capital regime, nor are some of the risks associated with traded credit products. And given the relatively short history of some of these products, the current regulatory treatment of market risk may not capture the risks of these products going forward. While a clear consensus on the best way to capture these risks has yet to fully emerge, these are very active areas of risk modeling at banks, and this is clearly a frontier area in both the regulatory and consensus economic capital regimes.

In this regard, an important question to ask is how well the current capital frameworks capture the possibility of extreme events, those far in the "tail" of the distribution. Stress testing can play an important role in addressing these concerns. Stress tests should allow institutions to assess likely losses under extreme market events, those that happen too rarely to be captured under traditional value-at-risk measures, but that could cause very significant losses to the institution should they occur. Institutions have long engaged in this kind of analysis for internal management purposes. Now, however, those at the forefront of risk management are assessing the adequacy of their value-at-risk results against stress losses and finding ways of integrating the results of stress testing into their capital frameworks. Indeed, an important aspect of our supervisory process includes critically assessing stress-testing regimes.

More rigorous and comprehensive stress testing of large shocks across multiple markets, geographic regions and business lines is vital, particularly for systemically important institutions. In this context, we need to see more attention paid to risks to market liquidity, and the effects on market liquidity that could result from the exit of a major dealer. Stress regimes need to capture market risk and credit risk across the firm, incorporating exposures in priced credit products, such as credit default swaps and structured credit products, and the strong linkages between these priced credits and traditional credit

instruments such as bank loans. Stress regimes need to take into account the effects of a firm's own actions and trading strategies on market prices during times of stress, and the constraints on their room for maneuver imposed by size.

Banks hold a special place in our financial system, and most of our focus on improving the regulatory framework for capital will always be on banks. Getting to a greater degree of comfort about the adequacy of the capital cushion for banks is a necessary but not sufficient condition for achieving a higher level of comfort about the resilience of our financial system. This point applies equally well to non-bank financial firms that play critical roles in our financial system. These institutions, too, need to have internal controls and risk management systems and capital levels commensurate with their critical role in the financial system.

The SEC's initiative to implement internal-models-based regulatory capital requirements for securities firms as part of the Consolidated Supervised Entity (CSE) framework will help bring more consistency and more sophistication across banks and securities firms in the capital treatment of traded positions.

Among the major non-bank financial institutions, the most important part of the financial system today where we need a stronger capital regime relates to the GSEs. Even with the improvements in risk management at these institutions over the last few years, we are some distance from the point where their regulatory capital requirements appropriately reflect their risk.

While critically important, capital alone does not define an institution's strength. It is vitally important for firms to continue to invest in strong internal controls and to make sure that advances in the operational infrastructure keep pace with rapid growth, particularly in complex transactions.

Strong operational controls can help ensure smooth market functioning in times of stress, and when they are weak they can exacerbate adverse market dynamics. An important element of a sound operational control environment is timely and accurate information for senior managers, especially when it is most critical for them to have a clear picture of the firm's exposure. As such, strong operational controls can help reduce some dimensions of uncertainty and therefore help markets function better in conditions of stress.

The challenge of ensuring that operational controls keep up with front office advances in the complexity and volume of transactions is particularly evident today in the area of credit derivatives. The rapid growth in the trading of credit default swaps and structured credit products has resulted in considerable back-office backlogs (unsigned confirmations and master agreements, delays in trade capture into risk management systems, delayed notification of assignments of positions) that create significant operational risk for market participants.

These types of operational problems have arisen more broadly in the OTC derivatives market over time and they have gotten worse with the rapid growth in activity by hedge funds. Efforts underway to automate matching and confirmation of credit default swap transactions should help address these concerns. But we need to see a stronger collective commitment by the principal dealers in these markets to reduce the outstanding backlog of confirms, shorten confirm times and move larger share of transactions in the more standardized instruments to automated platforms. And we'll act to reinforce that commitment.

These considerations are particularly important for the systemically significant financial institutions that stand at the core of the U.S. financial system. These institutions need to have exceptionally high standards in terms of internal controls, capital and risk management and governance. The greater complexity of their risk profile puts more exacting demands on the risk management architecture and requires a higher margin of capital than would be necessary for a business profile with less volatility and more predictability in returns. And the central role these firms occupy in our financial system and the consequences to other firms and to the stability of the financial system should one of them face significant financial or operational difficulties requires that they hold a higher margin of capital above economic capital than would be appropriate for smaller institutions with a similar risk profile.

These arguments are compelling on their own, and they are made more compelling by the challenges ahead facing the U.S and the world economy.

The increased stability in macroeconomic outcomes that has characterized the last two decades, the relative ease with which the U.S. financial system weathered the stress of the equity market shock and September 11, the increased mobility of the world's savings and the optimism produced by the acceleration in productivity growth, have all worked to lower expected future volatility and risk premia.

The reduction in credit losses and in realized volatility has created room for institutions to take greater risk without showing deteriorating risk-based capital measures.

But the macroeconomic environment may not prove to be as benign in the future as it has in the recent past. And it is important that the major financial institutions in particular sustain a strong capital cushion at levels that will enable them individually and the U.S. financial system as a whole to manage safely in a more uncertain and perhaps more volatile world.

Thank you.