Timothy F Geithner: Principles to guide the future evolution of financial supervision and regulation

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 2006, New York, 19 May 2006.

* * *

Thanks for inviting me to speak to you today.

You are meeting at a time of significant confidence in the strength of the global economy and in the overall health of the financial system. On the available evidence, the core of the U.S. financial system is stronger than it has been in some time. Capital levels are higher and earnings stronger and more diversified.

This strength is the result of many factors. It is the result of the length and strength of the economic expansion in the United States and the associated improvements in credit fundamentals. It reflects increases in the scale and scope of the operations of the largest institutions. It is the result of the dramatic innovations in the technology of finance and in the opportunities that has created for managing risk more effectively. And it reflects the increased integration of national financial institutions and the resulting competitive pressure and opportunities for diversification.

We have seen substantial improvements in risk management practice and in internal controls over the past decade. These improvements are the product of large investments in people and technology, as well as changes to the internal architecture around control and compliance. These investments were, of course, driven by a series of important changes in law and regulation, but they also reflect a rational response by the institutions themselves to the financial and reputational damage associated with some of the earlier weaknesses.

The progress achieved in internal control regimes has of course come with some costs. Many of these costs can be measured in dollars, but others, such as management attention and the uncertainty induced by greater vulnerability to enforcement action and litigation, are more difficult to measure. Despite the difficulty of adding up all these costs, it is hard to challenge the widespread view that they have been quite substantial. But the relevant metric is not merely their magnitude, but how they compare to the magnitude of the resulting gains.

There is no straightforward way to make this assessment, but today I want to offer some perspectives on our continued efforts to balance critical financial stability objectives with the need to foster and encourage the innovation and dynamism that is such a central part of the U.S. financial system.

I'll begin with the observation that profitability measures suggest that the business of financial intermediation is reasonably healthy, despite the costs induced by changes in the regulatory environment. Part of this reflects the reduction in credit costs and increased macroeconomic stability of the past several years. The financial performance of the well-run U.S. financial institutions seems to compare favorably to that of their peers in other markets.

The pace of innovation in U.S. financial markets has continued to be robust. The explosive growth in the volume and type of credit derivatives is only one example of the overall creativity and dynamism of U.S. financial markets in recent years. This suggests that the incentives and opportunities for innovation in our markets remain powerful despite concerns about the impact of changes in the overall regulatory environment.

And confidence in the integrity of U.S. financial markets seems to be strong today - integrity in the sense of reduced vulnerability to illicit activity and improvements in the reliability of public disclosure. We can see evidence of this confidence in the apparent willingness of the world's savers to invest in the United States and in the scale of capital formation in our markets.

The apparent robustness of market activity and innovation in the face of fairly substantial changes in the legal, supervisory and enforcement environment is encouraging. But the cumulate effects may take years to manifest themselves fully. Therefore, the official community has to be very attentive to the risk that we have the balance wrong.

I thought I might outline some broad principles that should guide the official community as we apply the existing body of regulation and supervisory guidance, as we refine current proposals, and as we design future changes.

It is imperative that we get it right. The efficiency, dynamism and resilience of the financial system are strategic assets for U.S. economy. The relatively favorable performance of the U.S. financial system is the result both of the wisdom of past choices made to foster a very open and competitive financial system, but also is the result of good fortune and some of the special advantages that have come from the unique role of the United States and the dollar in the world economy and financial system.

Some of these relative advantages are likely to decline over time with the maturation and deregulation of other financial markets around the world. And this healthy evolution prompts us to be even more attentive to the potential risk that the costs we impose on financial institutions in our markets and on companies that want to raise capital in our markets become prohibitively high.

Here are a few considerations or principles that I believe should guide us in the official community as we strive to improve the regulatory framework going forward. I want to emphasize that these principles, as in the case of many principles, are easier to state than to achieve.

Let me start by acknowledging there are aspects of the exacting standards we have sought to impose on our financial system that have turned out to be expensive in relation to the return against our public policy objective. And provisions that seem optimally designed at any given time are likely to need to evolve as conditions change. That this should occur is a natural aspect of a dynamic financial environment. There are areas where we are likely to have erred in being too prescriptive and others where we left too much room for discretion and judgment. It would be good if we could find a way to build into the initial design of guidance and regulation the capacity for quicker and continuous evolution as we learn more.

Second, we need to continue to adapt our approach to the imperatives of a much more integrated global financial system. Global integration, of course, gives us all a greater stake in the quality of supervision outside our borders. This pragmatic interest will lead us to spend progressively more resources and attention on the international dimension of our work. This recognition informed the efforts that led to the Basel Capital Accord, the Lamfalussy Standards for payment and settlement systems and many other international cooperative efforts. But the imperative is much stronger today because of the much greater extent of financial integration, and it is only likely to grow.

It is also important that the design of regulatory initiatives in the United States be informed by a careful assessment of their relative impact on U.S. institutions and markets. Effective solutions to many of the concerns we face in our national financial systems will require multilateral approaches. Rather than starting with a presumption that we will act in the United States and then hope to induce the world to follow, there are some areas where the more effective approach will be to start with the borderless solution by which I mean one designed to apply to a class of institutions and financial instruments, independent of geography and currency. Where this does not prove possible on terms or in a time frame we like, we of course preserve the option to move alone.

Third, we live in a financial system in which nonbank financial institutions play a much larger role than they did in the past, a system in which the differences between the activities of the bank-centered financial institutions and nonbanks has diminished, and in which the largest commercial banks and investment banks compete with each other and with other nonbank institutions in both the United States and abroad.

These changes in market structure have many positive implications for financial efficiency and stability, but they also mean that differences in the size and nature of the incentives faced by institutions with different supervisory and regulatory regimes can have larger competitive effects. The resulting opportunities for regulatory arbitrage have the potential to reduce the impact of provisions that apply only to regulated or supervised institutions. The risk that regulating the core of the system simply pushes financial activity to the periphery can raise the risk that distress among nonbanks can cause greater damage to the financial system. This means that we have to look for ways to cooperate more closely with other supervisors across the functional lines of supervision in our system in such as way as to impact the incentives of a broader range of market participants.

Fourth, we need to find ways to accelerate the pace at which the regulatory framework evolves to meet new challenges. The increase in the pace of change in financial innovation and in market structure requires greater agility among supervisors and regulators. Without this agility we risk lagging too far behind changes in the frontier of risk. This does not mean that each innovation needs to be met with a regulatory response. That would be an unfortunate and surely counterproductive impulse to encourage in regulation. But when a problem in the existing framework has significant implications for financial stability or efficiency, we need the flexibility and expertise required to act more quickly than we have been able to in some areas in the past.

Fifth, we need to be creative in identifying areas where market-led initiatives, rather than new laws, regulations or formal supervisory guidance, are likely to be successful and possibly more efficient in achieving certain policy objectives. Where collective action problems limit the incentive or the ability of individual institutions to make the necessary investments in infrastructure, the official sector can facilitate or motivate cooperative effort among market participants to solve the problem. At times, we may be more effective by helping to convene a group of market participants to reach consensus on best practices or a common solution than we would be defining or imposing a solution ourselves. Of course, not all problems are amenable to a solution by public support of private initiative, but we should be open to these types of approaches when they are likely to be successful in achieving our objectives.

And sixth, we have to be careful that the necessary and constructive attention that has been devoted over the past several years to meeting control and compliance challenges does not detract from the classic safety and soundness requirements of risk management. These should not be competing priorities. The financial costs and reputational damage associated with compliance and control failure can be very large. And the investments in the internal control infrastructure—in audit and corporate governance changes and in controls over financial reporting—are crucial parts of the foundation for a credible risk management framework. But we need to make sure that the demanding and ever evolving challenges of managing credit and market risk receive a degree of attention by senior management and boards that is commensurate with the risks. And this balance needs to be reflected in where we focus our supervisory efforts, as well. These classic prudential issues, those that make a critical difference in reducing the vulnerability of markets to systemic risk, need to be a principal focus of supervisory attention.

This is a time where I believe it is important to encourage more care and conservatism in the discipline of risk management. There are three areas at the top of our hierarchy of concerns.

First, it is very important that the major dealers make the investments necessary to improve the operational infrastructure that underpins the credit derivatives and broader over-the-counter (OTC) derivatives market. Operational risk and infrastructure failures have played a prominent role in past financial crises, and the infrastructure weaknesses that have characterized the credit derivatives markets since their inception are another credible source of concern.

The major market participants, both the dealers and the traditional and nontraditional investors, are in the process of improving the infrastructure that supports these markets. The changes underway to clean up the backlog of unconfirmed trades, to automate the entire post-trade-processing environment, and to improve the settlement process in events of default will help reduce operational risk in the derivatives market and reduce some sources of uncertainty that could exacerbate a market shock. We are encouraged by the progress made to date and will continue to encourage further improvements.

Second, we believe that the major dealers, as well as the large commercial and investment banks, should take a cold, hard look at financing conditions and margin practice, particularly with respect to hedge fund counterparties and in OTC derivatives. The reports issued by the Counterparty Risk Management Policy Groups I and II both make the important observation that the financial system is likely to be more resilient under conditions of stress when counterparties set initial margins at levels that are likely to be sustainable in less benign conditions. When margin levels are set more conservatively, firms are likely to have more flexibility in responding to stress and are less likely to take action that might amplify the market shock and exacerbate the reduction in liquidity. When competitive pressure drives margins down, markets may be less resilient.

Third, we believe the major financial institutions need to continue to improve their capacity to measure their exposure to risk in a less benign market and economic environment than we have experienced in recent years. The discipline of stress testing and scenario analysis that is designed to measure tail risk is at the frontier of this challenge. Senior management and the boards of directors need to understand the limitations of the tools we use to assess these risks, to try to better understand the potential scale of losses the firm may face, and to carefully examine how well risk exposures reflect the overall risk appetite of the firm, and the size of the capital and liquidity cushion maintained in relation to those exposures.

I want to conclude with the observation that the requirements of effective risk management and control regimes are likely to become more rather than less demanding over time. Those charged with managing the major financial institutions need to continue to make the investments necessary to stay abreast of change and to get as close to the frontier as possible. This reality makes it even more important that we in the supervisory community continue to look for ways to address aspects of the existing supervisory regime that impose unnecessary costs and burdens or that pull resources and attention away from potential sources of risk to the financial system.

Thank you.