

Ben S Bernanke: Regulatory restructuring

Testimony of Mr Ben S Bernanke, Chairman of the Board of Governors of the US Federal Reserve System, before the Committee on Financial Services, US House of Representatives, Washington DC, 10 July 2008.

The original speech, which contains various links to the documents mentioned, can be found on the US Federal Reserve System's website.

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Chairman Frank, Ranking Member Bachus, and other members of the Committee, I am pleased to be here today to discuss financial regulation and financial stability.

The financial turmoil that began last summer has impeded the ability of the financial system to perform its normal functions and adversely affected the broader economy. This experience indicates a clear need for careful attention to financial regulation and financial stability by the Congress and other policymakers.

Regulatory authorities have been actively considering the implications of the turmoil for regulatory policy and for private-sector practices. In March, the President's Working Group on Financial Markets (PWG) issued a report and recommendations for addressing the weaknesses revealed by recent events.¹ At the international level, the Financial Stability Forum has also issued a report and recommendations.² Between them, the two reports focused on a number of specific problem areas, including mortgage lending practices and their oversight, risk measurement and management at large financial institutions, the performance of credit rating agencies, accounting and valuation issues, and issues relating to the clearing and settlement of financial transactions. Many of the recommendations of these reports were directed at regulators and the private sector and are already being implemented. These reports complement the blueprint for regulatory reform issued by the Treasury in March, which focused on broader questions of regulatory architecture.³

Work is also ongoing to strengthen the framework for prudential oversight of financial institutions. Notably, recent events have led the Basel Committee on Banking Supervision to consider higher capital charges for such items as certain complex structured credit products, assets in banks' trading books, and liquidity guarantees provided to off-balance sheet vehicles. New guidelines for banks' liquidity management are also being issued. Regarding implementation, the recent reports have stressed the need for supervisors to insist on strong risk-measurement and risk-management practices that allow managers to assess the risks they face on a firmwide basis.

In the remainder of my remarks I will comment briefly on three issues: the supervisory oversight of primary dealers, including the major investment banks; the need to strengthen the financial infrastructure; and the possible need for new tools for facilitating the orderly liquidation of a systemically important securities firm.⁴

¹ President's Working Group on Financial Markets (2008), "Policy Statement on Financial Market Developments", March 13.

² The membership of the Financial Stability Forum consists of central bankers, regulators, and finance ministers from many countries, including the United States. Their report is available at: Financial Stability Forum (2008), "Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience", April 7.

³ The Treasury blueprint is available at: U.S. Department of the Treasury (2008), "Blueprint for a Modernized Financial Regulatory Structure", March 31.

⁴ Primary dealers are banks and securities broker-dealers that trade in U.S. government securities with the Federal Reserve Bank of New York. On behalf of the Federal Reserve System, the New York Fed's Open Market Desk engages in the trades to implement monetary policy.

Prudential supervision of investment banks

Since the near-collapse of The Bear Stearns Companies, Inc., in March, the Federal Reserve has been working closely with the Securities and Exchange Commission (SEC), which is the functional supervisor of each of the primary dealers and the consolidated supervisor of the four large investment banks, to help ensure that those firms have the financial strength needed to withstand conditions of extreme market stress. To formalize our effective working relationship, the SEC and the Federal Reserve this week agreed to a memorandum of understanding.⁵

Cooperation between the Fed and the SEC is taking place within the existing statutory framework with the objective of addressing the near-term situation. In the longer term, however, legislation may be needed to provide a more robust framework for the prudential supervision of investment banks and other large securities dealers. In particular, under current arrangements, the SEC's oversight of the holding companies of the major investment banks is based on a voluntary agreement between the SEC and those firms. Strong holding company oversight is essential, and thus, in my view, the Congress should consider requiring consolidated supervision of those firms and providing the regulator the authority to set standards for capital, liquidity holdings, and risk management.⁶ At the same time, reforms in the oversight of these firms must recognize the distinctive features of investment banking and take care neither to unduly inhibit innovation nor to induce a migration of risk-taking activities to less-regulated or offshore institutions.

Strengthening the financial infrastructure

The potential vulnerability of the financial system to the collapse of Bear Stearns was exacerbated by weaknesses in the infrastructure of financial markets, notably in the markets for over-the-counter (OTC) derivatives and in short-term funding markets.

The Federal Reserve, together with other regulators and the private sector, is engaged in a broad effort to strengthen the financial infrastructure. For example, since September 2005, the Federal Reserve Bank of New York has been leading a major joint initiative by both the public and private sectors to improve arrangements for clearing and settling credit default swaps and other OTC derivatives. The Federal Reserve and other authorities also are focusing on enhancing the resilience of the markets for tri-party repurchase agreements, in which the primary dealers and other large banks and broker-dealers obtain very large amounts of secured financing from money funds and other short-term, risk-averse investors. In these efforts, we aim not only to make the financial system better able to withstand future shocks but also to mitigate moral hazard and the problem of "too big to fail," by reducing the range of circumstances in which systemic stability concerns might prompt government intervention.

More generally, the stability of the broader financial system requires key payment and settlement systems to operate smoothly under stress and to effectively manage counterparty risk. Currently, the Federal Reserve relies on a patchwork of authorities, largely derived from

⁵ Under the memorandum of understanding, the SEC and the Fed will freely share information and analyses pertaining to the financial conditions of primary dealers. The two agencies have also agreed to work jointly with the firms to support their continued efforts to strengthen their balance sheets, their liquidity, and their risk-management practices. See: Board of Governors of the Federal Reserve System and Securities and Exchange Commission (2008), "Federal Reserve and SEC Issue Memorandum of Understanding to Deepen Information Sharing and Cooperation", press release, July 7.

⁶ Bank-affiliated primary dealers are already subject to mandatory consolidated supervision, but the focus of that supervision has been on limiting risks to the banks and other insured depository institutions within the holding company. Existing provisions may need to be modified to provide regulatory authority to assess and limit risks to all functionally regulated entities, including securities subsidiaries.

our role as a banking supervisor, as well as on moral suasion to help ensure that the various payment and settlement systems have the necessary procedures and controls in place to manage the risks they face. By contrast, many major central banks around the world have an explicit statutory basis for their oversight of payment and settlement systems. Because robust payment and settlement systems are vital for financial stability, the Congress should consider granting the Federal Reserve explicit oversight authority for systemically important payment and settlement systems.

Preventing or mitigating future crises

The financial turmoil is ongoing, and our efforts today are concentrated on helping the financial system return to more normal functioning. It is not too soon, however, to think about steps that might be taken to reduce the incidence and severity of future crises.

In particular, in light of the Bear Stearns episode, the Congress may wish to consider whether new tools are needed for ensuring an orderly liquidation of a systemically important securities firm that is on the verge of bankruptcy, together with a more formal process for deciding when to use those tools. Because the resolution of a failing securities firm might have fiscal implications, it would be appropriate for the Treasury to take a leading role in any such process, in consultation with the firm's regulator and other authorities.

The details of any such tools and of the associated decisionmaking process require more study. One possible model is the process currently in place under the Federal Deposit Insurance Corporation Improvement Act (FDICIA) for dealing with insolvent commercial banks. The FDICIA procedures give the Federal Deposit Insurance Corporation the authority to act as a receiver for an insolvent bank and to set up a bridge bank to facilitate an orderly liquidation of the firm. The FDICIA law also requires that failing banks be resolved in a way that imposes the least cost to the government, except when the authorities, through a well-defined procedure, determine that following the least-cost route would entail significant systemic risk. To be sure, securities firms differ significantly from commercial banks in their financing, business models, and in other ways, so the FDICIA rules are not directly applicable to these firms. Although designing a resolution regime appropriate for securities firms would be a complex undertaking, I believe it would be worth the effort. In particular, by setting a high bar for such actions, the adverse effects on market discipline could be minimized.

Thank you. I would be pleased to take your questions.