Donald L Kohn: Restoring financial intermediation by banks – the role of regulators

Speech by Mr Donald L Kohn, Vice Chairman of the Board of Governors of the US Federal Reserve System, at the Office of Thrift Supervision National Housing Forum, Washington DC, 8 December 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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I thought I might use these brief introductory remarks to put some of our challenges as regulators in the broad context of the tremendous shifts in the pattern of financial flows that we are witnessing. Traditionally, funds have been channeled from savers to borrowers in two ways: through financial markets and through financial intermediaries, such as banks and savings institutions. The turmoil in the U.S. financial system during the past 16 months has put both channels of financial intermediation under great strain and, in doing so, has produced a significant financial crisis. Large losses taken by financial institutions and investors, mostly from mortgage-related assets, have increased uncertainty and undermined confidence; these events have caused lenders to greatly tighten credit conditions for households and businesses, which, in turn, have contributed to a downturn in the economy that has reinforced the strains in the financial system.[1]

One consequence of the distress in financial markets is that banks are being pushed to take a greater role in financial intermediation, which reverses, in part, a long-term trend away from bank-based financial intermediation and toward market-based intermediation. And, indeed, bank lending surged earlier in the fall following a lull over the summer. However, the degree to which the pickup represented deliberate choices by banks is unclear, as many households and businesses reportedly drew on previously committed lines of credit, and selling of loans in securitization markets was hampered by further deterioration in those markets. In recent weeks, bank lending appears to have dropped back, consistent with the significant tightening of terms and standards reported by bank loan officers in recent quarters as well as the weakening of economic activity.

The need for greater bank intermediation has occurred at a time when banks are managing losses and are worried about meeting their funding needs. Concerns about banks' creditworthiness have made it costly for them to issue long-term debt. Growth in bank deposits has been fairly strong this year, and the recognition that deposits can be a reliable source of funds protected by the federal safety net has perhaps helped to draw investment banks to convert to bank holding companies. But the competition for deposits has raised their relative cost, and deposits cannot be expected to make up fully for reduced funding from other sources.

The challenge for regulators and other authorities is to create an environment that supports greater bank intermediation, which should help to restore the health of the financial system and the economy. We want banks to be willing to deploy capital and liquidity, but they must do so in a responsible way that avoids past mistakes and does not create new ones.

Banks need access to funds to make loans – especially with securitzation markets impaired – and the authorities have taken several steps to enhance the supply of funds to banks. The Treasury, working with the regulators, has used its authority under the Emergency Economic

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[1] The views expressed are my own and not necessarily those of my colleagues on the Federal Reserve Board and the Federal Open Market Committee. Karen Dynan, J. Nellie Liang, and Sabeth Siddique of the Board staff contributed to these remarks.

Stabilization Act, or EESA, to inject capital into banks so they will be stronger and more stable. The Federal Deposit Insurance Corporation has expanded its guarantee on deposits and is insuring new senior debt obligations of banking firms. The Federal Reserve has reduced the cost of borrowing at the discount window and created a new facility to provide term credit to banks.

The Federal Reserve and the other federal banking agencies have also issued regulatory guidance to promote greater lending by banks. This guidance encouraged banks to meet the needs of creditworthy borrowers in a manner consistent with safety and soundness – specifically, by taking a balanced approach in assessing borrowers' ability to repay and making realistic assessments of collateral valuations.[2] Additional capital, liquidity backstops, and regulatory encouragement should all reinforce financial stability and set the stage for increased bank lending.

As it is neither realistic nor desirable for banks to meet all financial intermediation needs, the Federal Reserve and other authorities are also making efforts to stabilize financial markets more broadly. In this regard, the Federal Reserve has created facilities to lend to primary dealers, to purchase highly rated commercial paper at a term of three months, and to provide backup liquidity for money market mutual funds. We are also creating a facility to support the issuance of asset-backed securities collateralized by student loans, auto loans, credit card loans, and loans guaranteed by the Small Business Administration.

In related actions, policymakers are taking steps to address the problems in housing and mortgage markets. The Federal Reserve supported placing Fannie Mae and Freddie Mac into conservatorship to help stabilize an important source of housing finance. More recently, the Federal Reserve has announced that it will purchase $600billion in debt issued by the housing-related government-sponsored enterprises and in mortgage-backed securities backed by Fannie Mae, Freddie Mac, and Ginnie Mae, which could reduce funding costs for mortgages. It also is supporting foreclosure prevention and neighborhood stabilization efforts, which help reduce unnecessary foreclosures and their costs on communities. Limiting foreclosures will also help reduce the risk that house prices will sink significantly below the level justified by fundamentals.

The events of the past year and a half have highlighted the need for changes in our financial system. Presumably, such changes may include a different balance between bank-based and market-based financial intermediation. As regulators of banks and thrifts, our job is not to determine what this balance should be. Rather, our job is, and has been, to create an environment in which, in the short run, banks can step up to fill as much of the gap as possible that has been left by still-dysfunctional markets, consistent with a strong, stable banking system. Over time, of course, we will need to work with the Congress and the new Administration to construct a system of oversight over both markets and institutions that better protects the stability of the financial system and the U.S. economy.

2 See Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, and Office of Thrift Supervision (2008), "Interagency Statement on Meeting the Needs of Creditworthy Borrowers", joint press release, November 12.