Daniel K Tarullo: In the wake of the crisis

Speech by Mr Daniel K Tarullo, Member of the Board of Governors of the US Federal Reserve System, at the Phoenix Metropolitan Area Community Leaders' Luncheon, Phoenix, Arizona, 8 October 2009.

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I am pleased to be here in Phoenix at the invitation of President Yellen. Having come across the country to speak to you today, I thought I would not confine myself to a single subject, but would instead address a number of areas about which I have been thinking. Lest you fear that means a potpourri of unrelated observations, let me assure you that there is at least some thematic unity in my remarks – namely, the challenges we face in the wake of the financial crisis. So, with your indulgence, let me strike that rather grand theme by covering the current state of the economy, the task of financial regulatory reform, and some broader comments on credit markets.[1]

The economic outlook

Turning first to the economic outlook, let me begin by stating the obvious: After a period in which there seemed to be only two plausible scenarios – very bad and even worse – financial and economic conditions have steadied. A year ago the world financial system was profoundly shaken by the failures of large financial institutions here and abroad. Significant liquidity problems that had been building since early 2007 turned into a full-blown liquidity crisis. The economy deteriorated at a pace that was both rapid and sustained. The period ending in the second quarter of this year was the first time the United States had suffered negative GDP growth in four consecutive quarters since the Great Depression.[2]

As we closed out the third quarter last week, it was apparent that economic growth was back in positive territory. Financial markets continued to stabilize and, in some respects, improved. Consumer spending was showing signs of firming. Housing-related economic indicators have turned positive. Industrial production rose significantly in the summer, and not just for the auto industry, which was effectively restarting after the disruption caused by the bankruptcies of General Motors and Chrysler. Growth in foreign markets, particularly emerging Asia, has been encouraging.

This turnaround is certainly welcome, but it should not be overstated. Although we can expect positive growth to continue beyond the third quarter, economic activity remains relatively weak. The upturns in industrial production and residential investment, for example, follow startling declines in the first half of the year. Improvement is gradual and beginning from very low levels.

The employment situation continues to be dismal. While the pace of job losses has slowed from the extraordinary levels of early 2009, the economy has recently still been losing on average about a quarter of a million jobs each month. Hopes for a steady reduction in the pace of job losses were once again confounded last Friday with release of the September employment report, which showed net job declines well above the consensus expectation of economic forecasters. The unemployment rate has risen to 9.8 percent. Decomposing this

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[1] The views expressed here are my own and do not necessarily reflect those of my colleagues on the Federal Open Market Committee.

[2] As measured in chained 2005 dollars and reported by the Bureau of Economic Analysis of the U.S. Commerce Department, the quarterly changes in GDP were -2.7 percent, -5.4 percent, -6.4 percent, and -0.7 percent in the period from the third quarter of 2008 through the second quarter of 2009.

figure, we see that the only demographic group whose unemployment rate appears less than awful is that for college graduates – at 4.9 percent. A look behind even that figure gives little reason for comfort, insofar as it has nearly doubled from the level of 2.6 percent at which it stood just a year earlier. Rates for many race or age-based demographic groups remain downright discouraging.[3]

Indicators apart from the unemployment rate underscore the weakness of labor markets. The percentage of working-age people with jobs has fallen to a point not seen in a quarter century.[4] Average hours worked have not increased through the spring and summer from what were, by historic standards, unusually low levels. The number of part-time workers who want full-time jobs jumped nearly 50 percent last fall and winter and has remained elevated since.[5] The average duration of unemployment has risen almost 10 weeks since the recession began, to more than six months.

The labor market conditions I have just described reflect the low level of resource utilization in the economy as a whole. In this context, with inflation expected to remain subdued for some time, the Federal Open Market Committee indicated after our meeting two weeks ago that exceptionally low interest rates are likely to be warranted for an extended period. Indeed, with the effects of the February stimulus package diminishing next year, bank lending that is still declining, and continued dysfunction in some parts of capital markets, there is considerable uncertainty as to how robust growth will be in 2010. At the same time, the unconventional policies pursued by the Federal Reserve in order to halt the crisis have produced levels and types of reserves that will eventually require use of the unconventional exit tools discussed on numerous occasions by Chairman Bernanke and Vice Chairman Kohn.

The coincidence of a weak economy and an unusually large balance sheet at the Federal Reserve will require some judgments by the Federal Open Market Committee of a sort for which there are not many historical precedents. Still, just as with conventional monetary policy, decisions on the timing and pace for removing accommodation should and will depend on our ongoing analysis and forecasts of all relevant economic factors.

Reforming financial regulation

In one sense, the financial crisis that began in 2007 is an old and familiar tale of explosive growth in leverage built on assumptions of ever-rising asset prices. Financial crises are, as the economist Charles Kindleberger put it, a "hardy perennial."[6] Instead of tulips in the seventeenth century Dutch Republic, South Sea Company stock in eighteenth century England, or the Nikkei and real estate in late twentieth century Japan, we had subprime mortgages and securitizations. However, like most recurring stories in human history, each financial crisis has its own plot twists and themes interwoven with elements common to most crashes. To fashion an effective and sensible response, it is necessary to understand both the unique and shared features of our own experience.

The financial crisis revealed that systemic risk was very much built into our financial system. As shown by the intervention of the government when Bear Stearns and AIG were failing, and by the repercussions from the failure of Lehman Brothers, the universe of financial firms

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3 The unemployment rate is 15.4 percent for African-Americans, 12.7 percent for Hispanics, and 25.9 percent for teenagers.

4 As reported by BLS, in September the ratio of employed persons to the (adult) population stood at 58.8 percent. The last time this ratio was lower was in 1984.

5 BLS reports that in September there were about 9.2 million people working part-time for "economic reasons" – that is, because they could not find a full-time job. This compares to about 6.3 million a year previously.

6 Charles P. Kindleberger (2000), *Manias, Panics, and Crashes: A History of Financial Crises* (4th ed.) at 1.

that appeared too-big-to-fail during periods of stress included more than insured depository institutions and extended beyond the perimeter of traditional safety and soundness regulation. During the years immediately preceding the crisis, there were both private and public sector mistakes. Within many financial firms there was a massive failure of risk management. Within government there were serious shortcomings in the regulation of both firms and markets.

In truth, though, the origins of the financial crisis lay deeper. In the preceding decades our regulatory system had accommodated the growth of capital market alternatives to traditional financing by relaxing many restrictions on the type and geographic scope of bank activities and virtually all restrictions on affiliations between banks and non-bank financial firms. These changes, in turn, enabled a series of acquisitions that resulted in a number of very large, highly complex financial holding companies centered on a large commercial bank. These firms were subject to prudential supervision to be sure, but it was a kind of supervision that had not kept pace with the far-reaching changes in the industry. At the same time, there was a group of very large, much higher leveraged financial firms that were not subject to mandatory prudential regulation.

Many firms of both types relied for a considerable portion of their financing on short-term capital market sources that were often poorly matched with the maturity structure of a firm's assets. Securitization markets played a major role in these complex, tightly wound financial arrangements, which for a time seemed to promise ever-increasing credit availability. But when questions arose about the quality of the assets on which this system was based – notably poorly underwritten subprime mortgages – a classic adverse feedback loop ensued. With lenders increasingly unwilling to extend credit against these assets, liquidity-strained institutions made increasingly distressed asset sales, which placed additional downward pressure on asset prices, thereby leading to margin calls for leveraged actors and mark-to-market losses for all holders of the assets. The margin calls and booked losses would start another round in the adverse feedback loop.

The causes of the crisis were thus embedded in the very nature of the financial services industry as it had evolved since the 1980s, and with the failure of the regulatory system to adapt to the new sources of financial risk. An adequate post-crisis program of regulatory reform must be equally concerned with the fundamentals of leverage and too-big-to-fail. There must be improvement in traditional, firm-centered regulation, sometimes referred to as microprudential regulation. We must also develop a macroprudential regulatory outlook – that is, an approach that considers linkages among firms and markets that could threaten the financial system as a whole, and that watches for the emergence of risks that might not be apparent solely through examination of specific financial institutions.

Both objectives will require changes by the financial regulatory agencies acting under their existing authority, as well as new legislation to ensure that there is sufficient authority and accountability for the regulatory agencies in adapting their policies. I believe that a reform program is, in fact, taking shape, though important components remain the subject of debate within Congress, the Administration, and the financial regulatory agencies. While I do not have time today to cover everything that the Federal Reserve is doing, much less the activities of other financial regulators, let me describe some of our initiatives and identify some of the more important areas in which I believe that Congressional action could be helpful.

The Federal Reserve has worked with other U.S. and foreign supervisors to strengthen capital, liquidity, and risk-management requirements for banking organizations. There is little doubt that capital levels prior to the crisis were insufficient to serve their functions as an adequate constraint on leverage and a buffer against loss. Higher capital requirements for trading activities and securitization exposures have already been agreed internationally. Efforts to improve the quality of capital have made considerable progress, with a particular emphasis on the need for higher levels of common equity, which ultimately provides the greatest protection against losses for creditors or the deposit insurance fund. We are also working with our domestic and international counterparts to deal with the procyclical tendencies that characterize important areas of financial regulation, including capital and accounting standards.

We must also adopt new regulatory mechanisms to counteract the systemic and too-big-to-fail problems that became so embedded in our financial system. One possible approach is a special charge – possibly a special capital requirement – that would be calibrated to the systemic importance of a firm. Needless to say, developing a metric for such a requirement is a new, and not altogether straightforward, exercise. Another proposal, which strikes me as having particular promise, is that large financial institutions be required to have specified forms of "contingent capital." One form of this proposal would have firms regularly issue special debt instruments that would convert to equity during times of financial stress. If well devised, such instruments would not only provide an increased capital buffer at the moment when it is most needed. They would also inject an additional element of market discipline into large financial firms, since the price of those instruments would reflect market perceptions of the stability of the firm.

In addition to changing the regulations under which banking organizations function, the Federal Reserve is adapting the methods by which we supervise those organizations. For the largest and most complex firms, we are implementing closer coordination among our on-site examiners of those firms and with Federal Reserve Board staff in Washington. We will expand our use of so-called horizontal reviews of these large firms, a process involving cross-firm analysis of key practices and circumstances that gives all supervisory participants a broader perspective on the state of the financial industry.

We are also creating a quantitative surveillance mechanism that will use supervisory information, firm-specific data analysis, and market-based indicators to identify developing strains and imbalance that may affect multiple institutions. This program will be distinct from the activities of supervisors, so as to provide an independent assessment of the conditions in major firms, as well as to provide additional information to on-site examination teams. It will also provide a good starting point for the macroprudential regulatory perspective I mentioned earlier.

There is, then, much to be done under existing supervisory authority. But there are limits. For example, under present law, our capital and other regulatory requirements apply only to firms that own a commercial bank. And yet, as became evident last year, systemic problems can arise from the activities of non-banking firms as well. Indeed, there is an incentive to shift riskier activities to such firms. For this reason, the Federal Reserve supports proposals that Congress extend the reach of the regulatory system so that every systemically important firm is subject to consolidated supervision.

A second important legislative initiative would be creation of a special resolution process for systemically important financial firms. At present we have such a process for banks, but not for the holding companies of which they are part or for other financial firms. A regime that raised the real prospect of losses for shareholders and creditors would add a third alternative to the unattractive existing options of bailout or disorderly bankruptcy. The consequent increase in market discipline before severe financial distress arises could provide another way to help contain the too-big-to-fail problem.

A third relevant proposal for Congressional action is creation of an oversight council composed of the financial regulatory agencies. This council, which should be given access to a wide range of information from regulators and market actors, would be charged with identifying emerging risks to stability and regulatory gaps across the entire financial system, and coordinating agency responses to potential systemic risk. It could also play a useful role in identifying financial firms that may deserve designation as systemically important and thus subject to consolidated supervision, as suggested above.

These and other actions by Congress and the regulatory agencies, completed and proposed, offer a real and welcome prospect of broad reform in the financial regulatory system. Still, as the reform process proceeds and people inevitably become involved in detailed debates on the merits of particular ideas, I would suggest that there are two basic norms that should guide the outcome of this process.

First, there is some danger that reforms and restrictions on financial activity will simply be piled on one another, with insufficient attention to their cumulative or interactive effects. Reforms must reflect the social and economic desirability of ensuring access to credit on risk-sensible terms for businesses and consumers alike, even as policymakers strive to ensure that methods of credit allocation are consistent with financial stability.

Second, the reform process cannot be judged a success until it substantially reduces systemic risk and the too-big-to-fail problem. While it is unrealistic to think that these concerns can be eliminated, it is critical that they be addressed head-on. We cannot know for certain that the regulatory, supervisory, and legislative changes to which I have already alluded will be up to these tasks. Accordingly, as I have said before, all participants in the reform process must continue to explore other possibilities – including potentially quite innovative possibilities – even as we work to shape and implement the current batch of worthwhile proposals to these ends.

A "new normalcy" for credit markets

Thus far I have spoken exclusively from the perspective of a member of the Board of Governors of the Federal Reserve in thinking about the economy, monetary policy, financial supervision, and regulatory reform. Before closing, I want to make a few more general comments on changes, actual or potential, in credit markets. These remarks are prompted in part by the conversations I often have with bankers, business people, and consumers. During these discussions I have realized that just about everyone understands we will never return to the credit markets of the middle part of this decade, but very few people believe they understand what the "new normal" will look like once the crisis has fully passed and the economy is on a sustained recovery path. I suspect that this uncertainty is itself an impediment to stronger growth, since it makes financial planning more difficult.

There are some features of the pre-crisis credit world with little to be said for them, whose apparent demise we should welcome. For example, mortgage lending at high rates with little or no down payment and non-existent underwriting is not something we want to see again, for both consumer protection and financial stability reasons. Likewise, a business model for credit cards based upon low interest rates and high, frequent penalty fees seems at odds with responsible allocation and use of credit.

But what of securitization? There were undoubtedly many imprudent, even reckless, practices associated with the securitization process, particularly with respect to some exotic instruments whose risk could not be understood even by their creators. There is little to lament in their disappearance. But securitization is not in and of itself a bad thing. On the contrary, a well-functioning system for securitizing well-underwritten loans can make capital available at lower cost to businesses, homeowners, and retail consumers. The failure of many relatively straightforward securitization markets to revive without government support may be explained simply as a hangover from the excesses and still-encumbered assets of the pre-crisis period. Just as some have restarted, perhaps others will follow as markets for the underlying assets improve. But I will confess to some concern that there has not already been greater activity.

Beyond specific financial instruments, there are clearly fundamental behavioral and macroeconomic adjustments in the offing. The habit of building personal savings predominantly through appreciation of one's home is one that many Americans will have to change. Similarly, the growth models of emerging market countries dependent on unshakeable American consumption and ever-increasing borrowing will not be sustainable even as recovery becomes more established. And, needless to say, major fiscal reform here at home will very likely be the central issue of U.S. economic policy in the years following recovery from the present crisis.

Conclusion

My focus today on what follows in the wake of the crisis might itself be read as a touch of optimism, signifying that the crisis itself looks to be over. The sobering counterpoint is my argument that some rather substantial adjustments will be needed by individuals, financial firms, businesses, regulators, and nations. That there will be adjustments is not something we can choose. How deftly we adjust is the question whose answer will weigh heavily in our nation's economic performance over the next decade.