William C Dudley: Lessons of the crisis – the implications for regulatory reform

Remarks by Mr William C Dudley, President and Chief Executive Officer of the Federal Reserve Bank of New York, at the Partnership for New York City discussion, New York, 20 January 2010.

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It is a pleasure to have the opportunity to speak here today. I will focus on the important lessons of the recent crisis and how those lessons should inform the regulatory reform effort. As always, what I have to say reflects my own views and not necessarily those of the Federal Open Market Committee or the Federal Reserve System.

In my opinion, this crisis demonstrated that a systemic risk oversight framework is needed to foster financial stability. The financial system is simply too complex for siloed regulators to see the entire field of play, to prevent the movement of financial activity to areas where there are regulatory gaps, and, when there are difficulties, to communicate and coordinate all responses in a timely and effective manner.

Effective systemic oversight requires two elements. First, the financial system needs to be evaluated in its entirety because, as we have seen, developments in one area can often have devastating consequences elsewhere. In particular, three broad areas of the financial system need to be continuously evaluated: large systemically important financial institutions, payments and settlement systems and the capital markets. The linkages between each must be understood and monitored on a real-time basis. Second, effective systemic risk oversight will require a broad range of expertise. This requires the right people, with experience operating in all the important areas of the financial system.

In this regard, I believe that the Federal Reserve has an essential role to play. The Federal Reserve has experience and expertise in all three areas – it now oversees most of the largest U.S. financial institutions; it operates a major payments system and oversees several others; and it operates in the capital markets every day in managing its own portfolio and as an agent conducting Treasury securities auctions. Also, as the central bank, it backstops the financial system in its lender-of-last-resort role.

Compared with where we were in late 2008 and early 2009, financial markets have stabilized, and the prospect of a collapse of the financial system and a second Great Depression now seems extremely remote. Even with this progress, however, credit remains tight, especially for small businesses and households. Economic growth has resumed, but unemployment has climbed to punishing levels. So while circumstances have improved, they are still very far from where we want them to be. We have no cause for celebration when the challenges facing so many businesses and households remain so daunting.

Aggressive and extraordinary official interventions were imperative to bring about this nascent stabilization of our financial markets and economic recovery. The Federal Reserve has been at the center of many of these interventions. For example, its efforts over the past two years to promote market functioning and minimize contagion were critical in preventing the strains in our financial markets from resulting in even more severe damage to the economy. These “lender of last resort” interventions on the part of the Fed, including facilities such as the Term Securities Lending Facility (TSLF) and the Primary Dealer Credit Facility (PDCF), as well as programs such as the foreign exchange reciprocal currency agreements, are examples of the rapid and responsive application of basic central bank tenants to the unique challenges we faced as this crisis evolved. Indeed, in many ways, the crisis has underscored why the Federal Reserve was created almost a century ago: to provide a backstop for a banking system prone to runs and financial panics.

Where it proved necessary and feasible to do so, the Fed also used its emergency lending authority to forestall the disorderly failure of systemically important institutions. These actions truly were *extraordinary* – well outside the scope of our normal operations, but our judgment was that not taking those actions would have risked a broader collapse of the financial system and a significantly deeper and more protracted recession. Faced with the choice between these otherwise unpalatable actions and a broader systemic collapse, the Fed, with the full support of the Treasury, invoked its emergency lending authority and prevented the collapse of certain institutions previously considered to have been outside the safety net.

The fact that the Fed needed to take those actions provides a stark illustration of the significant gaps in our regulatory structure, gaps that must be eliminated. Among those holes was the absence of effective consolidated oversight of certain large and deeply interconnected firms; the collective failure of regulators – including the Federal Reserve – to appreciate the linkages and amplification mechanisms embedded in our financial system; and the absence of a resolution process that would allow even the largest and most complex of financial institutions to fail without imperiling the flow of credit to the economy more broadly. Addressing these shortcomings will require important reforms in our country's regulatory architecture.

We entered the crisis with an obsolete regulatory system. For one, our regulatory system was not structured for a world in which an increasingly large amount of credit intermediation was occurring in nonbank financial institutions. As a result, little attention was paid to the systemic implications of the actions of a large number of increasingly important financial institutions – including securities firms, insurance conglomerates and monolines. In addition, many large financial organizations were funding themselves through market-based mechanisms such as tri-party repo. This made the system as a whole much more fragile and vulnerable to runs when confidence faltered.

With the benefit of hindsight, it is clear that the Fed and other regulators, here and abroad, did not sufficiently understand the importance of some of these changes in our financial system. We did not see some of the critical vulnerabilities these changes had created, including the large number of self-amplifying mechanisms that were embedded in the system. Nor were all the ramifications of the growth in the intermediation of credit by the nonbank or "shadow banking" system appreciated and their linkages back to regulated financial institutions understood until after the crisis began.

With hindsight, the regulatory community undoubtedly should have raised the alarm sooner and done more to address the vulnerabilities facing our banks and our entire financial system. But this was difficult because our country didn't have truly systemic oversight – oversight that would be better suited to the new world in which markets and nonbank financial institutions had become much more important in how credit was intermediated. Without a truly systemic perspective, it was unlikely that any regulator would have been able to understand how the risks were building up in our contemporary, market-based system. The problem was that both banking and nonbank organizations played an important role in credit intermediation but were subject to differing degrees of regulation and supervision by different regulatory authorities.

Although these gaps had existed for years, their consequences were not apparent until the crisis. Difficulties in one part of the system quickly exposed hidden vulnerabilities in other parts of the system, in a way that our patchwork regulatory system had not been designed to detect or readily address. In the same way, the crisis revealed the critical deficiencies in the toolkits available to the regulators to deal with nonbank institutions in duress. Emergency lending by the Fed might be enough to forestall the disorderly failure of a systemically important institution and all the wider damage such a failure might cause, but it was a blunt and messy solution, employed as a stopgap measure because better alternatives were not available. What is needed – what our country still lacks – is a large-firm resolution process that would allow for the orderly failure even of a systemically important institution.

Thus, in the fall of 2008, regulators and policymakers found themselves facing the prospect of the total collapse of a complex and interconnected *system*. It was these circumstances, and the prospect they created for an even deeper and more protracted downturn in real economic activity and employment, that required truly extraordinary actions on the part of the Federal Reserve, as well as the Treasury and many other agencies. This is a situation in which the United States must never again find itself.

For its part, the Federal Reserve is hard at work on developing and implementing new regulations and policy guidance that take on broad lessons of the recent crisis. We are working with other banking regulators in the United States and overseas to strengthen bank capital standards, both by raising the required level of capital where appropriate and improving the risk capture of our standards. We are issuing new guidelines on compensation practices so that financial sector employees are rewarded for long-term performance and discouraged from excessive risk-taking. And we are working with foreign regulators to develop more robust international standards for bank liquidity. We are working to make the tri-party repo system more robust and reducing settlement risk by facilitating the settlement of over-the-counter derivatives trades on central counterparties (CCPs). But more needs to be done and much of this requires action by Congress.

Congress is now considering several proposals for comprehensive regulatory reform, proposals that merit careful study and debate. Let me offer some general thoughts on the principles that should guide how we approach reform.

First, it's important to take a clear-eyed and comprehensive view of the financial system we have today. As I've already suggested, if there is one overriding lesson to be drawn from the events of the past 18 months, it is that the financial system is just that: a *system, and a very complex one at that.* The operational, liquidity and credit interdependencies that characterize contemporary financial markets and institutions mean that the well-being of any one segment of the system is inextricably linked to the well-being of the system as a whole. Because of this, our approach to reform must be guided by a coherent sense of the system as a whole, not merely by a focus on some of its component parts, as important as they may be.

We need a new regulatory structure that provides for comprehensive and consistent oversight of all elements of the financial system. This includes effective consolidated oversight of all our largest and interconnected financial institutions and oversight of payment and settlement systems. We must make sure that the people doing the regulation have the power and expertise to ferret out and bring to heel regulatory evasion as it occurs to prevent abuse and excess from building up in the financial system. In the end, the gaps, not the overlaps, have been the main shortcoming of our existing regulatory framework.

A second fundamental point is that regulatory reform has to ensure that the financial system will be robust and resilient even when it comes under stress so that it will not fail in its critical role in supporting economic activity. No economy can prosper without a well-functioning financial system – one that efficiently channels savings to the businesses that can make the most productive use of those savings, and to consumers that need credit to buy a home and support a family. The fact that our financial system isn't functioning well right now is part and parcel of our current economic difficulties. This critical link between the "real" and the "financial" is why we care so much about the systemic risks inherent in banking and finance.

One critical element of systemic risk is what is known as the "too big to fail" problem. Without sufficiently high capital and liquidity standards, and, as a backstop, a resolution mechanism that is credible, regulators are faced with a Hobson's Choice when a large, systemically important financial firm encounters difficulties. On the one hand, if authorities step in to respond to prevent failure, contagion and collapse of the broader system, that action rewards the imprudent and can create moral hazard – that is, encouraging others to act irresponsibly or recklessly in the future in the belief that they will also be rescued or "bailed out." On the other hand, if authorities do nothing and let market discipline run its course, they run the risk that the problem will spread and unleash a chain reaction of collapse, with severe and lasting damage to markets, to households and to businesses.

So what can we do about the "too big to fail" problem? It is clear that we must develop a truly robust resolution mechanism that allows for the orderly wind-down of a failing institution and that limits the contagion to the broader financial system. This will require not only legislative action domestically but intensive work internationally to address a range of legal issues involved in winding down a major global firm. Second, we need to ensure that the payments and settlement systems are robust and resilient. By strengthening financial market infrastructures, we can reduce the risk that shocks in one part of the system will spread elsewhere. Third, we need to reduce the likelihood that systemically important institutions will come close to failure in the first place. This can be done by mandating more robust capital requirements and greater liquidity buffers, as well as aligning compensation with the risks that are taken by the firm's employees. In addition, instruments such as contingent capital-debt that would automatically convert to equity in adverse environments – need to be considered. Such instruments would enable equity capital to be replenished automatically during stress environments, dampening shocks rather than exacerbating them.

I would now like to take some time to discuss some of the proposals that Congress is debating regarding regulatory reform. As Congress and the Administration consider what legislative changes are warranted, the Federal Reserve's actions before and during the crisis have been getting close inspection. Given the Federal Reserve's key role in our financial system, and the scale of the damage caused by the financial crisis, this careful scrutiny is necessary, appropriate and welcome.

Not surprisingly, there are legislative proposals that would significantly alter the Federal Reserve's powers and responsibilities, particularly with respect to supervision of bank holding companies. Again, that's entirely within Congress's purview: the Federal Reserve only has the powers and responsibilities that Congress has entrusted to us. But in drawing up new legislation, it's important not to throw the baby out with the bathwater – we should preserve what has worked and fix what hasn't. A dispassionate analysis of what is needed will almost certainly lead to better decisions and a more effective regulatory framework.

The legislative proposals concerning the Federal Reserve are not limited to the Federal Reserve's role in supervision. Consider, for example, one proposal that calls for what it terms "audits" of the Federal Reserve by the U.S. Government Accountability Office (GAO), an arm of Congress. These wouldn't be audits at all in the commonly understood sense of the term. The Federal Reserve's financial books and transactions are *already* audited by wide range of professionals internal and external to the institution. Rather, these new audits would involve ex-post review of Federal Reserve monetary policy *decisions*, a potential first step toward the politicization of a process that Congress has carefully sought to insulate from political pressures.

The notion that the Federal Reserve's financial dealings are somehow kept hidden from the public is a surprisingly widely held view – and it is simply incorrect. An independent outside audit of the Federal Reserve's books is conducted annually. You can find the results online, including a detailed accounting of the Federal Reserve's income and operating expenses in its annual report. The financial books of the regional Federal Reserve Banks also undergo independent outside audits, also available online. In addition, the GAO is empowered to review almost all Federal Reserve activities other than the conduct of monetary policy, including the Federal Reserve's financial operations, which the GAO has done so frequently. The Federal Reserve's balance sheet is posted online weekly, with considerable detail, in what's called the H.4.1 report. Finally, an additional accounting of the Federal Reserve's emergency lending programs created over the last two years is available online in a monthly report.

But my objection that GAO oversight would be broadened to include a review of monetary policy decisions is not based just on the fact that the Fed is already subject to considerable oversight. My principal concern is the damage that could potentially result to the Fed's ability to achieve its mandate of price stability and maximum sustainable employment. The effectiveness of monetary policy depends most of all on the Federal Reserve's credibility with market participants and investors. In particular, both groups need to know that the Fed will always act to keep inflation in check. That's why Fed Chairman William McChesney Martin famously joked that the Fed would sometimes need "to take the punchbowl away just as the party gets going." As you can well imagine, this may not always enhance our popularity, especially among those who were enjoying the party. But, the fact that markets know that the Federal Reserve will tighten monetary policy when needed helps keep inflation expectations in check. This, in turn, helps keep inflation low since inflation expectations affect actual inflation. The consequence is credibility with respect to the conduct of monetary policy. This gives the Fed more latitude not to tighten when inflation rises for transient reasons – say, due to a short-lived spike in oil prices – and more scope to ease credit to support the economy during economic downturns.

Recognizing these benefits, Congress wisely acted many years ago to exempt monetary policy decisions from the GAO's wide powers to review Federal Reserve activities. Congress' decision to bolster the Fed's monetary policy independence has been followed by similar actions around the world – substantial independence for the central bank in the conduct of monetary policy is now widely regarded as international best practice. Policy independence does not absolve the Federal Reserve from accountability for its monetary policy decisions and the need to clearly explain why they were taken. But it avoids the politicization of monetary policy decision-making. And this is good because politicized central banks generally do not have enviable records with regard to inflation, economic growth or currency stability. Risk premia on financial assets are typically much higher in countries with politicized central banks.

Of course, a reversal of Congress's earlier decision would not amount to legislative control over monetary policy decisions. That's not the issue. The issue is that a reversal of Congress' earlier decision could create the appearance that the legislature seeks to *influence* monetary policy decisions by establishing a mechanism to publicly second guess those decisions. Such a move would blur what has been a careful separation of monetary policy from politics. Market confidence here and abroad in the Federal Reserve would be undermined. Asset prices could quickly build in an added risk premium, which might lead to tighter credit conditions. These unintended consequences would undermine the legislation's intent.

I'm also concerned about those proposals under consideration that would move the regulatory and supervisory functions now held by the Federal Reserve to other agencies, new or existing. At present, the Federal Reserve is the consolidated supervisor for bank holding companies, a group that has expanded recently as investment banks and other companies formerly outside the Federal Reserve's purview have been brought under Federal Reserve oversight. In my view, further *disaggregation or fragmentation* of regulatory oversight responsibility is not the appropriate response to our increasingly interconnected, interdependent financial system. Funneling information streams into diverse institutional silos leads to communication breakdowns and too often to failure to "connect the dots."

In addition, there are clear synergies between the supervisory process and the Federal Reserve's monetary policy and financial stability missions. The information we collect as part of the supervisory process gives us a front-line, real-time view of the state of the financial industry and broader economy. Monetary policy is more informed as a result. Only with this knowledge can a central bank understand how the monetary policy impulse will be propagated through the financial system and affect the real economy.

Similarly, involvement in the supervisory process gives us critical information in fulfilling our lender-of-last-resort responsibilities. Information sharing with other agencies is simply not as good as the intimate knowledge and understanding of markets and institutions that is gathered from first-hand supervision. Indeed, many institutions at the center of the crisis and arguably the most troubled – Bear Stearns, Lehman Brothers, Merrill Lynch, AIG and the GSEs – were not supervised by the Federal Reserve. Consequently, when those institutions came under stress, the Federal Reserve had poorer quality and far less timely information about the condition of these institutions than would have been the case if we had had the benefit of direct supervisory oversight.

In fact, some of the hardest choices the Federal Reserve had to make during the most chaotic weeks of the crisis concerned systemically important firms we did *not* regulate. It is not surprising that, in the wake of the crisis, some countries that had separated bank supervision from the central bank monetary policy role are now reconsidering that division of labor. That is mainly because coordination problems created difficulties in responding quickly and effectively in the crisis. Separation made it more difficult to communicate in a timely way and to understand the broader implications of what was transpiring. It is critical that we not introduce new inefficiencies and impediments. No matter what steps are taken to improve our regulatory system and strengthen market discipline, history tells us that there will inevitably be circumstances in which an informed and effective lender of last resort will play a critical role in preventing shocks and strains in financial markets and institutions from generating a broader collapse of the financial system.

Of course, there are legitimate questions as to how broad the Federal Reserve's regulatory and supervisory responsibilities should be. That question is up to Congress, and should be decided on the merits. What is fundamentally at issue here is ***not*** "turf", but rather how we as a nation can best ensure that we never again re-live the events of the past few years – that the legitimate public interests associated with a safe, efficient and impartial banking and financial system are well served.

In the end, it is critical that financial reform be decided on the basis of the merits. If objective and careful policymaking prevails, we will all be the better off for it. In contrast, if we fail in this endeavor, that would truly be tragic. We must act informed by the important lessons that we have learned from this crisis.

Thank you for your kind attention.