Christine M Cumming: Reform in a time of rapid change

Remarks by Ms Christine M Cumming, First Vice President of the Federal Reserve Bank of New York, at the Standard and Poor's Ratings Services Global Bank Conference, New York City, 27 March 2014.

*   *   *

It is a pleasure to speak at this program on global banks. Since your agenda covers many dimensions of transformation and adaptation of global financial institutions, I thought I'd frame my remarks around the theme of reform in a time of rapid change. Change involves both long-wave and short-wave components. Reform can be driven by both the public and the private sectors. My thesis is that the most effective reform involves both the public and private sectors and takes account of both the proximate needs for reform and the long-term trends that drive long-term transformation. The views I will express are my own and not necessarily those of the Federal Reserve Bank of New York or the Federal Reserve System.

Let me highlight two kinds of change. So much of the immediate regulatory agenda has been framed around addressing the failings in the run-up to the global financial crisis – the failings as we understand them today. The resulting lessons learned often focus on developments between 2003 and 2007: poor underwriting in the U.S. residential mortgage market, the rapid expansion of leverage in the household and the financial sectors, and the packaging and repackaging of risks from mortgages into increasingly complicated securities.

Alongside those immediate forces driving reform, I want to highlight a second kind of change – the no less major impetus for transformation in the financial services business that stems from larger macroeconomic and technological change. As we think about public sector and private sector reform, I submit that we need to address and adapt to both types of change.

What are some of those longer run forces that have been transforming the financial system? Let's start with two macroeconomic trends that reflect the result of successes in global economic policy. One is the rapid rise in wealth in much of the world and with it, new or greatly expanded institutions to concentrate and manage that wealth. The function of the banking system in the 19th and early 20th century was to intermediate scarce capital on one side and a large supply of ambitious projects on the other, projects such as the building of the transcontinental railroad. By contrast, today we live in a capital-rich world where the financial system's problem to solve is effective deployment of abundant capital, not gathering sufficient savings to meet capital needs.

Another long-run macroeconomic force has gathered substantial momentum in the last decade: the shift of income, wealth and economic energy from the so-called advanced economies of the United States, Japan and Europe to the so-called emerging economies. Ten years ago, the emerging market countries accounted for about 20 percent of world GDP – the advanced economies 80 percent. Today the proportion is 40/60, and the emerging market countries continue to grow substantially faster than the large advanced economies. Yes, China is an important component of that growth, but the trend reflects strong performance in recent years in many regions of the world outside the advanced economies.

A further long-run force, seen as the most disruptive, is technology. At one time, the financial system, perhaps until the 1970s or 1980s, played an important role in searching for savers/investors to contribute to financing those major investments. Much of the work of identifying and linking the sources and the uses of funds has been facilitated or even taken over by technology – just think of the ubiquity of trading platforms, screens, and financial news and, beyond that, the increasing automation and artificial intelligence applied to credit evaluation, financial analysis, and trading activities.

I mention these three long-run forces because the financial industry has been and still is adapting to these trends. Indeed, the major transformation in the U.S. financial industry that occurred in the course of the 1980s and 1990s – the development of over-the-counter derivatives markets, the shift toward a larger role for securities markets relative to banking markets – was just such an adaptation to the long-run forces of change. The shift reflected the growth of institutional wealth and the power of technology, ubiquitous information and expanded financial know-how.

In 1986, the derivatives markets were still nascent and securitization had just begun to spread outside the mortgage markets in the United States. At that time, a task force of central bankers, the precursor to today's Committee of the Global Financial System, which reports to the Global Economy Meeting of 31 central bank governors, published a volume titled *Recent Innovations in International Banking*.[1] The report was notable for being among the first to describe what was then a set of new financial instruments, such as over-the-counter derivatives and the expanded use of financial options. The study noted the tremendous momentum behind the 1980s wave of financial innovation, the likelihood of those forces continuing, and the changes already occurring in the financial system, especially the shift of financial activities from traditional banking markets to securities and derivatives markets.

The really noteworthy aspect of the report is the study group's effort to identify – really, anticipate – the risks and concerns that could emerge in the transforming financial system. In a section that anticipates current policy language with the cutting-edge title "Macro-prudential policy", the report enumerates these concerns:

- The risk that credit vigilance would decline in the financial system, and with it, overall credit quality.
- The potential that the transformed financial system could encourage and enable leverage.
- The risk of sudden loss of liquidity as markets come under pressure, especially because the banking system would no longer be capable of backstopping the nonbank financial sector and the broader private sector.
- Concern that instrument complexity and transaction volume could overwhelm settlement systems.

Post 2008, these issues sound all too familiar, of course.

Of particular note, the report stated that:

A major source of concern derives from the difficulties in pricing new instruments and the possibility that many new instruments appear to be, at least to some degree, underpriced, that is, that gross income from the transactions is insufficient, on average, to compensate fully for their inherent risks. Since it may be necessary to accumulate experience over a variety of circumstances and cyclical conditions in order for market participants fully to understand and assess all elements of risk, this problem may appear especially before the market for a new product has reached maturity.

The recent financial crisis in many ways represented the realization of many of these concerns. Some observations:

- The crisis demonstrated how the combination of poor underwriting, financial engineering, and leverage could transform what had been viewed as relatively safe markets for US residential mortgages, magnify risks in those instruments through securitization and leverage, and transmit the risks around large parts of the globe.

[1] Recent innovations in international banking (Cross Report).

- The speed at which liquidity deterioration, market dysfunction and financial institution distress set in was breathtaking – far faster than experienced in earlier crises.
- Capital and liquidity buffers in place through regulatory minimums and firms' own economic capital calculations, once viewed as robust, proved in many cases to be inadequate to absorb mounting losses during the crisis. In addition, the supervisory apparatus proved slow to recognize and address the full dimension of the problem, and when some large, systemically important firms approached failure, the public sector lacked the tools to resolve them.
- Difficulties arose in winding down large derivatives portfolios because of their size and complexity, the back office logistics and settlement risks associated with derivatives portfolios, and the lack of a sufficiently harmonized international legal framework to handle counterparty default or failure.
- At least some business models in place before the crisis proved to be unsustainable. At many large institutions, the heavy reliance on generating mortgage-related revenues, whether through flawed underwriting or creating highly complex securities, proved a vulnerability; some institutions lacked stable revenue streams robust to macroeconomic conditions; some relied heavily on funding from short-term markets such as the tri-party repo market.

Regulatory reform

The wave of regulatory reform, of course, corresponds to a considerable degree with the problems observable during the crisis. Take, for example, solving the Too Big to Fail problem. The regulatory and financial stability agenda being advanced by the Financial Stability Board and the Basel Committee on Banking Supervision is intended both to reduce the probability that large, systemically important firms could fail and to mitigate the costs of their failure, should that occur. Measures to raise both the quantity and quality of capital at the large, systemically important firms, known as G-SIFIs, such as Basel III and enhanced prudential standards, are aimed at reducing the probability of failure. The work on recovery and resolution planning, as set out in the Key Attributes for Effective Resolution Regimes, a new global standard published in 2011, aims at mitigating the cost of failure by developing the institutional arrangements and concrete plans to place a failing G-SIFI into resolution. These initiatives at the global level have been mirrored at the national level in many countries.

I'd draw special attention to stress testing in its role in reducing the probability of failure and to resolution planning in reducing failure's social cost, because both represent an important shift of focus for the supervisory community. Both processes focus attention on the far adverse tail of the probability distribution of outcomes for a firm. Technology, financial modeling, and risk management theory and practice have greatly expanded and enhanced the supervisors' ability to analyze and address those severe adverse outcomes.

Another part of the regulatory reform agenda addresses weaknesses in short-term funding markets. Efforts here include seeking to reduce the reliance on intraday credit in the tri-party repo market, to strengthen risk management in the repo and other short-term funding markets, and to make progress toward developing a collateral liquidation mechanism to prevent fire sales of collateral in distressed markets. Reforms also are being considered for money market mutual funds, where the inherent run risk in the event that a money market mutual fund "breaks the buck" continues to be a significant vulnerability.

Yet a third set of initiatives in the reform agenda seeks to strengthen the clearance and settlement infrastructure for over the counter derivatives. In addition to creating incentives to move derivative transactions into trade repositories and central counterparties, which provide the benefits of risk management mechanisms and encouragement of standardization of contract terms, the reform efforts extend to improving the international legal framework for derivatives transactions in the event of default and failure or resolution.

Regulatory reform can create guardrails for the financial system, but in my view, those reforms are far more effective if accompanied by similar reform efforts in the private sector. Private sector reform can take the form of enhancing internal governance, re-evaluating strategy and business models, and strengthening risk management and internal controls within individual firms. It can also take the form of industry collective action to improve market structure and practice, to invest in financial infrastructure and to recommend best practices. In the U.S., the combination of public sector – and private sector – driven reform has historically played an important role in our financial system and should play a role today.

I experienced the interplay of public and private sector efforts in the early 1990s, in the wake of the commercial real estate and leveraged buyout downturn in the US Northeast. In the public sector, the supervisors pursued an aggressive program of remediation for troubled banks with three major elements. Because the problems at that time were simpler, the remediation program imposed by supervisors was easy to understand and it was effective. The three principal actions were: a troubled bank had to raise additional capital and strengthen its liquidity; it needed to fully identify its problem assets and exposures, isolate them and place them in workout; and it needed to develop a new business plan.

At the same time, Congress passed the Federal Deposit Insurance Corporation Improvement Act, otherwise known as FDICIA in 1992; for its time, it contained a large number of provisions to guide supervisory and market practice. Its lasting contributions were the prompt corrective action framework escalating the intensity of supervision as capital levels fall in a bank culminating in the ability to close banks before capital is fully depleted and a management attestation about the quality of internal controls that foreshadowed Sarbanes-Oxley. Today, however, much of FDICIA has been forgotten.

The reason? At many financial firms, bankers struck the theme of “never again”. That conviction spurred them to identify lessons learned and institute stronger controls on commercial real estate lending and buyout lending and maintain them. One sign that the effort mattered appeared as the commercial real estate market heated up later in the 1990s and lending terms started to loosen. Deal flow came to a near-standstill as the controls established in the early 1990s kicked in. The market only resumed when underwriting standards retraced their way back to higher ground.

So, as we benchmark progress in the recovery of financial institutions from the recent financial crisis, one area stands out. The early 1990s supervisory program comprised strengthening capital and liquidity, identifying problem exposures and placing them in workout, and developing a new business plan – there is one area where more progress will need to be made. The international community of supervisors has done a great deal to address the need for more and better quality capital through new capital standards. The identification and workout of troubled assets has made significant progress, which we can observe in the recovery of markets for some troubled assets. But global financial firms are still working on the new business plan. From the financial press, it’s clear that many large financial companies have been rethinking their strategies, often along the lines of increasing the focus on nonfinancial businesses and households and reducing the focus on expanding capital markets businesses. But I believe we are more at the beginning than toward the end of that process of reconsideration.

In my personal view, the reconsideration of business plans needs to incorporate the long-term macroeconomic and technology trends even as they incorporate the lessons learned from the financial crisis. Those business plans need to look ahead five years or more to position the financial firms and, with them, the financial system for the opportunities and risks that lie ahead. We will need to meet the long-term challenges of changes in the global macroeconomy, the distribution of growth opportunities and the distribution of wealth, and the speed and power of technological change.

Since so much opportunity has developed elsewhere in the world, how will the public sector reform agenda impact the global banking activities of financial institutions? We do not know yet how the reform agenda will affect the international activities of G-SIFIs, although we can see some early indications. Higher capital requirements and more stringent prudential standards are causing some firms to re-examine their correspondent and business relationships and make new cost-benefit assessments. The greater focus on stress testing and resolution planning may lead to more discussion of firm structure, including the number of subsidiaries, the alignment of the corporate structure with the firm's business activities, the management of intragroup exposures, the use of parent guarantees, and the correlation of the firm's capital and liquidity structure with the firm's business and legal entity structure.

In my personal view, discussion will no doubt lead to action, in the best scenario, by the large, systemically important financial firms themselves. The issues reflect areas where the true costs of managing a large, complex, internationally active firm have not yet been fully internalized by the firms. Said differently, the cost of international financial activity has probably been too low, and as it rises, some readjustment of those activities will be necessary.

The forces of change continue strong, as strong as they were in the peak years of innovation more than 25 years ago. Now, as then, financial institutions will need to adapt and transform themselves. This time, however, we have the sobering experiences of the financial crisis to guide us. We all have an interest in moving forward, given the pace of change in the world and in technology.

Thank you for your attention.