FEDERAL RESERVE BANK *of* NEW YORK

An Overview of Financial Stability

Margaret M. McConnell, Office of Financial Stability and Regulatory Policy
March 20, 2012

The views expressed in this presentation are those of the presenter and not necessarily those of the Federal Reserve Bank of New York or The Federal Reserve System

Key messages

- The secret to doing good financial stability work is in identifying and mitigating potential sources of instability *before* they manifest in a crisis

- The Federal Reserve, as well as many other central banks around the world, is working to strengthen its framework for identifying, monitoring and mitigating threats to financial stability

- The “Dodd-Frank” Act strengthens the mandate for coordination across the US regulatory system on financial stability issues

Why is the financial system important?

"Financial systems are crucial to the allocation of resources in a modern economy. They channel household savings to the corporate sector and allocate investment funds among firms; they allow intertemporal smoothing of consumption by households and expenditures by firms; and they enable households and firms to share risks. These functions are common to the financial systems of most developed economies."

- *Comparing Financial Systems*
  by Franklin Allen and Douglas Gale
  March 2001

What is a stable financial system?

A. A financial system that is not in crisis

B. A financial system that will never be in crisis

C. A financial system that is resilient to a wide range of shocks, and is not prone to unsustainable booms and costly busts

What is a stable financial system?

A. A financial system that is not in crisis

B. A financial system that will never be in crisis

C. A financial system that is resilient to a wide range of shocks, and is not prone to unsustainable booms and costly busts

How do we know if the financial system is stable?

Chairman Greenspan, 2005:

…advances in complex financial products… have significantly lowered the costs of, and expanded the opportunities for, hedging risks…The new instruments of risk dispersal have enabled the largest and most sophisticated banks, in their credit-granting role, to divest themselves of much credit risk by passing it to institutions with far less leverage… **These increasingly complex financial instruments have contributed to the development of a far more flexible, efficient, and hence resilient financial system** than the one that existed just a quarter-century ago. After the bursting of the stock market bubble in 2000, unlike previous periods following large financial shocks, no major financial institution defaulted, and **the economy held up far better than many had anticipated**.

Chairman Bernanke, 2008:

…more fundamentally, the turmoil was the product of a global credit boom, characterized by a broad under-pricing of risk, excessive leverage by financial institutions, and an **increasing reliance on complex and opaque financial instruments that have proven to be fragile under stress**. The unwinding of this boom (and the associated financial losses) has led to the withdrawal of many investors from credit markets and deleveraging by financial institutions, both of which have **acted to constrict available credit to households and businesses**.

How did we get from stability of '05 to collapse of '08?

- On the surface:

  Weak financial institutions, inadequate regulation and supervision, and lack of transparency were at the heart of the financial crises of the late 1990s as well as the recent global financial crisis.

  - IMF Factsheet on "Financial System Soundness"
  September 14th, 2011

- Beneath the surface:
  - Thousands of large and small decisions made every day by borrowers, lenders, financial firms and regulators
  - Most of these decisions probably seemed reasonable at the time, and most were based on widely-held assumptions about the economy and financial markets

How did we get from stability of ‘05 to collapse of ‘08?

- Why was it not more evident that we were headed toward a collapse?
  - In large part, because many of the vulnerabilities emerged slowly over time, through gradual structural changes in the U.S. financial system (rise of GSEs, other shadow banks, MMMFs, growth in wholesale funding), eventually outgrowing the defenses against crisis put in place in the 1930s (deposit insurance, supervision of banks, activity and geographic restrictions,...)
  - But perhaps also because there is a tendency to see a robust economic environment—a boom--as an indication of success in decision-making across all facets of the financial system…until it is not…

Overarching lessons from the recent crisis

- The underlying stability of the financial system is often difficult to ascertain until it is too late
  - The system can perform well and appear stable for long stretches of time, but apparent stability can be rapidly replaced by instability and impairment

- The degree of stability cannot be reliably inferred from current levels of spreads, values of indices or firms, or even the prevalence of a particular types of activities
  - Regulators need to evaluate not only the output of the financial system—the amount, price or type of credit being created—but also the quality and integrity of the system's underlying "production process"

What makes a financial system stable (or not)?

Would the operational and institutional infrastructure allow the system to perform its vital functions even in the face of large shocks or sustained economic stress or uncertainty?

Do financial market participants and policymakers have a good understanding of how changes in the broader environment, including macroeconomic, regulatory, technological and geopolitical factors, could be influencing the stability of the financial system over time?

Do the private incentives and regulatory oversight that govern activity in the system generally tend to foster (ex ante) accurate and timely assessments of expected return and underlying risk by borrowers, lenders and investors?

Factors contributing to the stability (or instability) of the financial system

Do market participants understand the backstops available in a crisis? The contingency plans of others?

What can hindsight teach us about risks today?

As of 2005

- How would we have answered?

As of 2008

- How would we have answered about 2005?

In 2012

- How would we answer now about 2012?

Do the private incentives and regulatory oversight that govern activity in the system generally tend to foster (ex ante) accurate and timely assessments of expected return and underlying risk by borrowers, lenders and investors?

Applying the lessons of the crisis to central banking

- *The (relatively) easy part:*
  - Identifying, with hindsight, what we got wrong in 2005
- *The slightly harder part:*
  - Identifying what, if anything, we could have done differently in 2005 to have helped avoid or lessen the severity of the crisis that hit in 2007-2008
- *The really hard part:*
  - Envisioning ourselves in 2015 or 2016, looking back on 2012, and imagining what important things we could realize we were wrong about
  - Identifying what steps, however small, we could take *now* to make the financial system more resilient to those potential mistakes

How do central banks do financial stability work?

- Some of the work is quantitative analysis, including devising better ways to measure and depict the degree of "systemic risk"

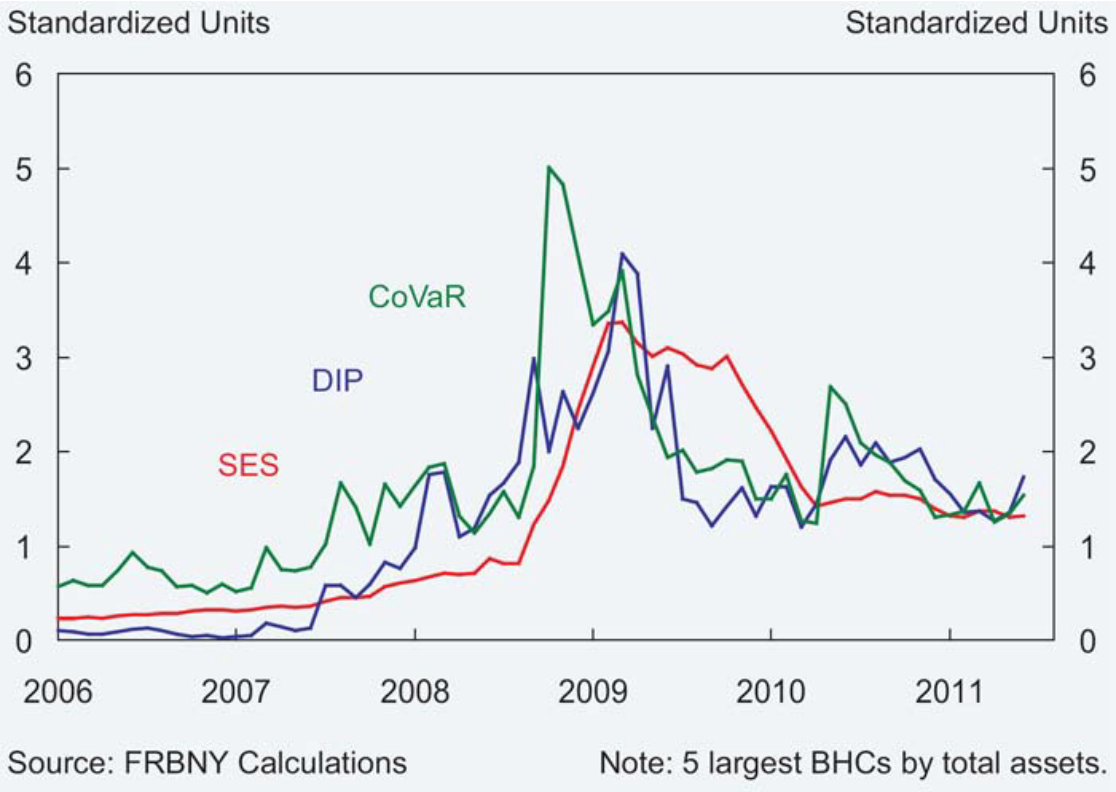

Chart J.1 from the 2011 FSOC Annual Report
Average Risk Measures Across the 5 Largest BHCs

How do central banks do financial stability work?

- Some of the work is quantitative analysis, including devising better ways to measure and depict the degree of “systemic risk”

> *Directly measuring systemic risk is challenging, and no consensus exists on the best measure of the level of systemic risk in the financial system*
>
> *- from 2011 FSOC Annual Report*

How do central banks do financial stability work?

- Some of the work is of a more qualitative nature:
  - **Improving the risk identification process:** asking ourselves where our diagnosis of a situation might be materially off, either because we assume something is true that may not be true, or because we are not seeing all the important parts of the picture
    - We need to get better at “connecting the dots” between insights from the supervisory process (or other regular engagement with market participants) and the more quantitative analysis we produce to depict systemic risk
    - Humility is also a crucial to effective risk identification:

      "The most difficult subjects can be explained to the most slow-witted man if he has not formed any idea of them already; but the simplest thing cannot be made clear to the most intelligent man if he is firmly persuaded that he knows already, without a shadow of doubt, what is laid before him.” — Leo Tolstoy

How do central banks do financial stability work?

- Some of the work is of a more qualitative nature:
  - **Improving the risk mitigation process:** asking ourselves what steps we could take *now* to make the system more robust or resilient to us being wrong about:
    - How we are reading the world (what we do not measure well)
    - To events we aren't even contemplating (what we do not measure at all)

How do central banks do financial stability work?

- Central banks around the world, including the Federal Reserve, are working to develop stronger frameworks for identifying and mitigating risks to financial stability
  - Improving lender of last resort and crisis management tools, in keeping with new restrictions under Dodd-Frank
  - Developing new tools to prevent the buildup of systemic risk (e.g., *Instruments of Macroprudential Policy*, Bank of England, Dec 2011)
  - Understanding how existing central bank tools can be used to better achieve financial stability objectives, including how to make supervision more preemptive

How the objectives are achieved in a pre-emptive manner	High-level objectives of a central bank			
		Price stability and maximum sustainable employment	**Financial system safety and soundness**	
			Supervised firms	Rest of the system
	Setting of concrete standards/targets consistent with objectives	Implicit or explicit inflation target and definition of full employment (or similar concept)	Standards for the condition of an individual firm as articulated in regulation, supervisory guidance or otherwise	Standards for the condition of the system as articulated in regulation, guidance or otherwise
	Measuring/monitoring performance relative to standards; assessing whether deviations from standards constitute a material threat to achievement of objectives	Metrics to assess inflation performance (e.g., Inflation forecast, inflation expectations) and judge whether metrics deviate materially enough from target to warrant action Metrics to assess output performance (e.g., output gap forecast) and judge whether metrics deviate materially enough from target to warrant action	Metrics to assess condition of individual firm relative to standards and judge whether condition of firm deviates materially enough from standards to warrant supervisory action	Metrics to assess condition of system relative to standards and judge whether conditions deviate materially enough from standards to warrant action.
	Actions to remediate deviations in performance metrics from standards or to otherwise mitigate risks to objectives	Changes to interest rate or other policy instruments, potentially including public communication about risks or policy actions/tools	Organizational restrictions, activity restrictions, changes to risk management or controls, changes to capital or liquidity	**Imposed on supervised firm(s):** Organizational restrictions, activity restrictions, changes to risk management or controls, changes to capital or liquidity **Imposed on other aspects of system:** LTV and DTI ratios, changes to interest rate or other policy instruments, potentially including public communication about risks or policy actions/tools

Financial stability work across regulatory agencies

- Prior to crisis of 2008, US financial regulatory community suffered from “mandate myopia”
  - Individual regulators did engage in risk identification and mitigation, but engagement was diffuse and often myopic
  - Financial stability concerns often limited to what a particular regulator could see and did not sufficiently incorporate a role for the linkages across markets, products and institutions
  - Certain critically important areas (such as housing policy, reform of vulnerabilities in short-term funding markets) were not fully owned by any one agency and hence slipped through the cracks

Select items of "Dodd-Frank*" Act

*Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010

- Created the Financial Stability Oversight Council (FSOC), an interagency council to detect and deter emerging threats to the financial system
- Created the Office of Financial Research within the Treasury to support the Council

- Also:
  - Strengthened consolidated supervision of systemically important financial institutions;
  - Gave the government a new tool to safely wind down failing financial firms;
  - Requires large complex companies to periodically submit "living wills" for event of financial distress to regulators

FSOC membership

Voting Members

- Secretary of the Treasury (Chair)
- Chairman of Federal Reserve
- Director of the Bureau of Consumer Financial Protection
- Comptroller of the Currency
- Chairman of the SEC
- Chairperson of the FDIC
- Chairperson of the CFTC
- Director of the Federal Housing Finance Agency
- Chairman of the National Credit Union Administration Board
- Independent member having insurance expertise

Non-voting Members

- Director of the Office of Financial Research
- Director of the Federal Insurance Office
- State Banking Commissioner
- State Securities Commissioner
- State Insurance Commissioner

Guests/observers

How the FSOC Works in Practice

- Meetings of the FSOC
  - The FSOC is required to meet at least on a quarterly basis; thus far, meetings have occurred every seven to eight weeks
  - Meetings consist of a closed session and open session with topics divided between the two sessions
    - Open sessions are open to the press and public via live web stream with minutes released after each meeting
    - Meeting minutes are available on the Department of Treasury's FSOC Website

- FSOC Annual Report
  - Purpose is to describe significant financial market and regulatory developments, analyze potential emerging threats, and make recommendations

Recommendations from the 2011 FSOC Annual Report

…pertaining to financial institutions

- Construct robust capital, liquidity, and resolution plans; bolster resilience to unexpected interest rate shifts; maintain discipline in credit underwriting standards; employ appropriate due diligence for emerging financial products; keep pace with competitive, technological, and regulatory market structure developments

…pertaining to financial regulatory reform

- Continue with coordinated implementation of regulatory reform to enhance the integrity, efficiency, competitiveness, and stability of U.S. financial markets; promote market discipline; and maintain investor confidence by closing regulatory gaps that contributed to the crisis and previous market dislocations

…pertaining to structural vulnerabilities

- Eliminate most intraday credit exposure and reform collateral practices in tri-party repo market; implement structural reforms to mitigate run risk in money market funds; improve overall quality of mortgage servicing by establishing national mortgage servicing standards and servicer compensation reform

…pertaining to housing finance

- Continue to strengthen housing finance system, including developing a framework for return of private capital to system