Welcoming Remarks

Financial Interdependence in the World's Post-Crisis Capital Markets

Presented by GIC in partnership with the Philadelphia Council for Business Economics, the CFA Society of Philadelphia, and the Federal Reserve Bank of Philadelphia

2010 Global Conference Series (Part III)

March 3, 2010

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Federal Reserve Bank of Philadelphia

FEDERAL RESERVE BANK
OF PHILADELPHIA

The views expressed today are my own and not necessarily those of the Federal Reserve System or the FOMC.

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Opening

Good morning and welcome to the Federal Reserve Bank of Philadelphia. The Philadelphia Fed has had a long relationship with the Global Interdependence Center. For more than 30 years, we have participated in GIC meetings with policy leaders from around the globe. We have benefited from the many good ideas that have emerged from these discussions.

That is why the Philadelphia Fed is proud to host today's event — part three in this timely conference series on financial interdependence in the world's post-crisis capital markets.

As you see in the agenda, we will hear perspectives from members of Congress, investment experts, and economists. I am particularly pleased that the keynote speaker is my colleague Eric Rosengren, president of the Federal Reserve Bank of Boston.

The financial crisis of the last two years will alter the structure and performance of global capital markets in many ways. Competition and market forces will change many financial products and the way they are delivered. Financial products and innovations that failed the market test will disappear or change. And that is how it should be. We should not underestimate the power of the market and its adaptability.

Yet global financial markets will also be shaped, for better or worse, by the nature of financial regulatory reforms under consideration by lawmakers in numerous countries. For example, recent discussion in Washington has centered on which regulatory agency should have which supervisory powers and over what types of institutions. One proposal would eliminate the Fed's oversight of state-chartered member banks in favor of a focus on the largest institutions. Other proposals would transfer all bank supervision and regulation to a separate, single bank regulator. Taking away the Fed's supervisory role on Main Street or Wall Street would be unwise. As the central bank, the Fed has the depth of experience and expertise to monitor banks of all sizes. And these responsibilities support and complement the central bank's ability to meet its Congressional mandates for financial stability and monetary policy.

In 1997, the U.K. took bank regulation from the Bank of England and gave it to the Financial Services Authority. Based on its experience with a separate regulator during this crisis, the U.K. government is considering moving regulatory activity back into the central bank — just the opposite of some U.S. proposals.

Chairman Bernanke submitted a report to Congress that clearly outlines the sound reasons for retaining bank supervision in the Federal Reserve.[1] The current crisis underscores the importance of having a regulatory framework that addresses both the safety and soundness of individual institutions and the macro-prudential risks of the financial system as a whole. Given the Fed's traditional central banking roles, including having lender of last resort responsibilities, overseeing the stability of financial and payment systems, and setting monetary policy, it is uniquely situated within the government with the necessary expertise to deliver on both pieces of this regulatory mandate.

In my view, the proposals for regulatory reshuffling, at best, miss the point of what is required for meaningful reform and, at worst, weaken the current regulatory framework. The real danger is that such proposals increase the likelihood of future crises rather than fixing the problem. Instead of elaborate restructuring, I suggest we focus on three key initiatives that will truly improve our regulatory system.

First, I believe Congress should amend the bankruptcy code to include a new chapter for large nonbank financial institutions. In my view, the most important issue any reform must address is the too-big-to-fail problem. Without a credible resolution mechanism to allow the orderly failure of large and interconnected financial firms, we will be setting the stage for the next crisis.

Foremost on the agenda should be the recognition that no firm should be too big to fail.

Any resolution mechanism should address systemic risk without requiring taxpayer support. To foster market discipline and reduce moral hazard, the resolution mechanism must ensure that a failed firm's shareholders are wiped out and that creditors bear losses. Most important, the resolution mechanism must be credible. Managers, owners, and creditors must believe that firms on the verge of failure will, in

[1] See "The Public Policy Case for a Role for the Federal Reserve in Bank Supervision and Regulation," January 2010. http://www.federalreserve.gov/BoardDocs/RptCongress/supervision/supervision_report.pdf.

fact, be allowed to fail. Therefore, we must limit regulatory discretion or forbearance and the potential for political interference. The resolution regime must not become a mechanism for more bailouts. I am concerned that the current legislative proposals allow far too much discretion and could lead to more bailouts, not fewer.

Given these criteria, I believe a modified bankruptcy process would be a better mechanism than proposals to expand the bank resolution process under FDICIA to cover nonbank financial firms and bank holding companies. It seems far too easy in the heat of a crisis to deem that systemic risks are too high to let an institution fail. Yet, as we have seen, when firms expect to be protected from failure, they take greater risks at the taxpayer's expense and, in so doing, sow the seeds of other crises.

No doubt, lawmakers will need to work out the details of a new bankruptcy chapter, including who would force an institution into bankruptcy. I would favor allowing not only the regulator, but also creditors, to place a troubled financial firm into bankruptcy when it is unable to meet its financial obligations. This would enhance market discipline and lower regulatory discretion.

Another issue involves how to handle qualified financial contracts, including swaps, repos, and derivatives of those firms in bankruptcy. Current law exempts these contracts from various provisions of the bankruptcy code, including the automatic stay provisions. In other words, the contracts are permitted to close out even though the firm is in bankruptcy. Some argue that these exemptions prevent systemic risk. Yet others argue that these exemptions actually raised the systemic risks surrounding Bear Stearns, AIG, and Lehman.[2]

The international nature of these large financial firms means that we must work to ensure international coordination of a bankruptcy process. Yet it is not uncommon or impossible to fail international firms. We also need to ensure a timely bankruptcy process, so the bankruptcy proceedings do not drag out for years. I do not think that either of these challenges is insurmountable.

I am not arguing to replace the current process of resolving small and medium-sized bank failures outside of bankruptcy — the FDIC has demonstrated its ability to resolve these institutions quickly (usually over a weekend) and at relatively low cost to the taxpayer. However, the handling of the largest financial institutions during this crisis has persuaded me that the system cannot easily expand to encompass large firms without biasing the outcomes toward bailouts rather than resolution. Thus, I favor a bankruptcy mechanism as a more credible solution to the too-big-to-fail problem.

[2] See Thomas H. Jackson and David A. Skeel, Jr., "Bankruptcy, Banks, and Non-Bank Financial Institutions," manuscript prepared for the Wharton Financial Institutions Center Workshop "Cross-Border Issues in Resolving Systemically Important Financial Institutions," February 12, 2010.

My second recommended action is to clarify the Federal Reserve's umbrella supervision role for financial holding companies. Under current legislation, the Federal Reserve supervises bank holding companies and serves as umbrella supervisor of financial holding companies, while the appropriate functional regulators supervise the subsidiaries. For example, the SEC supervises an investment-banking subsidiary, while a state insurance commission supervises an insurance subsidiary, and the designated federal or state bank supervisor watches over the commercial banking subsidiary.

To reduce regulatory burdens, the Gramm-Leach-Bliley Act limits the Federal Reserve's power to examine subsidiaries that have a functional regulator. So the Fed has relied on the functional regulator for information about holding company subsidiaries. I believe Congress should clarify that the Fed has umbrella supervisory powers and the responsibility to exercise them, including collecting supervisory information on the holding company and all of its subsidiaries on a routine basis. These changes would not broaden the supervisory powers of the Fed – or any other agency. Indeed, under Gramm-Leach-Bliley, the Fed has been given authority to examine and take action against any subsidiary that may pose a material risk to the financial safety and soundness of an insured depository affiliate, or the domestic or international payment systems. Clarifying the Fed's umbrella supervisory role would encourage regulators to work together to take a comprehensive look at the systemic risks of consolidated financial organizations. This thorough review of each firm would help the Fed in its macro-prudential mission to help ensure financial stability and the integrity of the payments system.

Further, I believe Congress should also clarify the Fed's financial oversight responsibilities by requiring a semi-annual *Financial Stability Report* for Congress and the public, much as it requires the Fed to submit its *Monetary Policy Report*. This report would also improve the transparency and accountability of the Fed's financial oversight responsibilities, which would help ensure public trust and credibility.

My third recommended action is to integrate market discipline into our regulatory structure rather than relying solely on more regulations. Consider regulations governing financial institution capital. One of the lessons of the financial crisis is the speed with which capital ratios can decline. A firm can move from "well-capitalized" to "undercapitalized" almost overnight, and then face enormous difficulties in raising capital during a crisis. This argues in favor of raising regulatory capital ratios for financial institutions.

Yet, rather than simply raising capital requirements, regulators should marshal market forces by requiring financial firms to hold contingent capital in the form of convertible debt that would convert into equity in periods of financial stress. Contingent capital would be less costly than simply raising capital requirements, since it is triggered only under bad economic conditions, when capital is most costly to obtain. Thus, it reduces the incentives for financial firms to seek ways to evade dramatically higher capital requirements. The ready contingent capital also avoids the need for fire sales of assets to raise capital, which can exacerbate an economic downturn. And perhaps most important, it can reduce the necessity of government rescues and bailouts.

Contingent capital would enhance both regulatory supervision and market discipline. The market price of such debt would provide regulators with a valuable signal about the financial health of the firm and about the market's perception of systemic risk. In addition, the threat of the debt's conversion to equity would mobilize creditor discipline. We should also consider requiring higher levels of capital for banks that pose greater systemic risks. This might be done by basing capital requirements not only on credit risk but also on liquidity risk and asset growth. These steps would strengthen market discipline and improve financial stability. And regulators can add these capital requirements without additional legislation.

I believe these three actions would go a long way toward improving financial stability. Enacting a credible bankruptcy process to solve the too-big-to-fail problem, clarifying the Fed's umbrella supervision and financial stability roles, and enhancing market discipline are steps we must take to lower the probability of a future crisis. We could simplify the entire financial regulatory legislative initiative by focusing on these three key elements. We do not need huge new bureaucracies, or a complete restructuring of our regulatory agencies.

These are a few of my own thoughts on post-crisis reform. Today, we'll have the opportunity to hear many more and consider how to progress toward a sound solution that will safeguard the integrity of our market mechanisms. I look forward to the presentations and discussion.