

Repercussions from the Financial Shock

Remarks by

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Introduction

Over the past year, many financial markets and large banking institutions have been buffeted by a severe financial shock, the effects of which persist to this day. In these remarks, I want to consider the repercussions of this shock from two distinct perspectives: first, I want to discuss their implications for regulatory, supervisory, and financial stability policies going forward; and, second, I want to examine their implications for the current and prospective economic environment.

To preview my major themes, I will suggest that the too-big-to-fail problem, with which I have long been concerned, has been exacerbated by actions taken over the past year to bolster financial stability. These actions were appropriate against the background of the risks at hand, but they also call for “systemic focused supervision” going forward to address spillovers and to reduce the likelihood of full protection of uninsured creditors of large, complex financial institutions. I will elaborate specific proposals in a few minutes. As to economic prospects, I have been convinced for some time that financial conditions in the wake of the shock are reminiscent of those prevailing during the “headwinds” episode of the early 1990s. At the least, that experience provides a useful framework for analysis of the current state of the economy and its intermediate-term prospects. And before proceeding further, let me also remind you of the usual caveat: I am speaking only for myself and not for others in the Federal Reserve System.

The Expanded Safety Net and Too-Big-To-Fail

In our Bank’s *2007 Annual Report*, I expressed concern about the recent expansion of the safety net for large financial firms and, particularly, its potential to dull the market forces that would otherwise constrain excessive risk taking. Although the *Annual Report* essay was released just a few months ago, the financial safety net has expanded since then, with the explicit increase in

government support for Fannie Mae and Freddie Mac. The too-big-to-fail (TBTF) problem has once again gotten worse.

At the same time, however, there has been progress in beginning to develop a policy framework to address TBTF and to enhance market discipline. Policymakers have begun to focus more explicitly on minimizing the fallout, or “spillovers,” from a financial firm’s impairment as they consider how to improve financial stability and to reduce the incentives for excessive risk taking inherent in TBTF.

Naturally, I view these latter developments quite positively. In our 2004 book on TBTF, Ron Feldman and I noted that “policymakers should give highest priority to reforms limiting the chance that one bank’s failure will threaten the solvency of other banks.” We came to that conclusion using the following logic:

- Policymakers provide financial support to weak but systemically important financial firms to contain spillovers;
- Reducing the fallout from financial firm failures undercuts the rationale for extraordinary government support;
- Creditor expectations of receiving government support will diminish (and market discipline will increase) when it is known that policymakers have less reason to provide such support.

Recent comments from Secretary of the Treasury Henry Paulson echo this argument (and we have seen it elsewhere as well):

In an optimal system, market discipline effectively constrains risk because the regulatory structure is strong enough that a financial institution can fail without threatening the overall system. For market discipline to constrain risk effectively, financial institutions must be allowed to fail. Under optimal financial regulatory and financial system infrastructures, such a failure would not threaten the overall system.

However, today two concerns underpin expectations of regulatory intervention to prevent a failure. They are that an institution may be too interconnected to fail or too big to fail. We must take steps to reduce the perception that this is so – and that requires that we reduce the likelihood that it is so.

Having agreement on a general policy framework is a necessary but not sufficient base for reform. Government agencies charged with addressing instability and related TBTF concerns, and private sector groups and firms critical to that effort, require specific recommendations. Those implementing reforms should have a sense for prioritization; after all, we face a world of limited resources and so must pick and choose if we aspire for effectiveness in implementation.

We have long had a list of specific reforms to address TBTF, but we have not prioritized those proposals. So of the many recommendations we made, where would we have policymakers start? We would begin the effort to manage TBTF with an approach we call systemic focused supervision (SFS).

Systemic Focused Supervision

I earlier described SFS in general as an effort to apply a focus on spillover reduction to supervision, regulation, and communication as well, but let me now detail its three pillars: they are stress testing; enhanced prompt corrective action (PCA); and stability-related communication. Combined, these efforts offer important actions in a long-term effort to limit the spillovers from the failure or impairment of a systemically important financial institution. I now describe the basics of each of the three components.

Stress Tests. In this context, this is a process to identify and respond to the material exposures between large financial institutions and between these

institutions and capital markets. By material, we mean a sufficiently significant exposure such that problems at one of these financial institutions could significantly impair other depository institutions and/or normal market functions.

This process could take many forms. Supervisors might begin by examining the performance of a small number of large financial institutions under a series of stress tests. The tests could include large losses to a given type of loan or security on the firms' balance sheets, or a significant drop in the availability of funding. The results would provide policymakers with a sense of which stresses lead to significant problems at the firms. The next step is to determine how the difficulties of one of these large institutions would affect the others. At a minimum, this would involve determining how much the failing institution owes the others at the end of the day, what form the exposure takes, how much the exposure varies over time, and so on.

The goals of the exercise I just described are (1) to give policymakers a sense of the type of events that are not likely to bring down the financial institution, thus permitting them to avoid support and (2) to identify those exposures that might bring down the firm, and thus are deserving of closer policy scrutiny and response. As part of this effort, supervisors should also consider how they will make assessments of spillover potential at the time a financial institution experiences serious difficulty. Supervisors must determine what type of information they will need in short order from financial institutions during a period of turmoil, what information they can actually get in short order, and develop a plan to address whatever gaps are identified. Closing these gaps means that policymakers can make informed judgments at the time of failure and, where possible, identify and resolve those issues that would otherwise lead them to provide extraordinary support.

Enhanced Prompt Corrective Action (PCA). The Federal Deposit Insurance Corporation Improvement Act of 1991 implemented PCA. Like many so-called “structured early intervention and resolution (SEIR)” regimes, PCA works by requiring supervisors to take prespecified actions against a bank as its capital falls below specified levels. A bank whose capital declines below a given level, for example, would have its ability to pay dividends constrained. In the extreme, chartering authorities will shut banks whose capital levels fall below the lowest established trigger and who cannot raise additional capital.

Closing banks while they still have positive capital, or at least a small loss, can reduce spillovers in a fairly direct way. If a bank’s failure does not impose large losses, by definition it cannot directly threaten the viability of other depository institutions that have exposure to it. Thus, the PCA regime offers an important tool to manage systemic risk.

However, many observers, including some of the most zealous advocates of using a SEIR regime in the United States, view PCA as inadequate because it relies, in great part, on the so-called book value of capital. This capital measure, particularly for bank loans, often reflects a “rear-view window” or historical assessment of the bank’s assets. Under this measure, a bank that appears to have positive capital can actually have large losses upon failure. Using PCA triggers based on more forward-looking measures of bank solvency could help address this concern.

Data from financial markets offers one source of forward-looking measures of a bank’s condition; market participants do not always get their forecast right, but they do appear to incorporate assessments of the future prospects of firms in their pricing decisions. This suggests that an enhanced PCA regime relying on both book-value capital and market measures of risk – such as subordinated debt spreads, prices of credit-default swaps, and/or equity values, among others –

would be an improvement over the current regime. In fact, the original proposals for SEIR in the U.S. used market measures of bank net worth to provoke supervisory action. In practice, this could mean that some combination of market signals and accounting measures of insolvency could lead to the closure of a bank.

In addition to being forward-looking, market measures of bank risk have an advantage in that supervisors do not determine them. In cases where supervisors might prefer to forebear (i.e., not take appropriate remedial action against a financial institution as its condition worsens), book-value measures may provide some justification. In contrast, market measures are not subject to this shortcoming.

Communication. The first two pillars of SFS seek to increase market discipline by reducing the stability-related motivations policymakers have for protecting creditors. But creditors will not know about efforts to limit spillovers, and will not change their expectations of support, absent explicit communication about spillover-reducing activities. What form might this communication take?

In general, we have suggested that this communication have three attributes. First, it should be released routinely, like the semi-annual “Humphrey-Hawkins” testimony, to facilitate the ability of interested parties to focus. Second, it should disclose information on stability-related activity at an early stage, even if it is work in progress. Such a strategy would provide creditors with a richer sense of the activity under way. Finally, we think the communication should explicitly link the activity under way to the goal of reducing spillovers, thus raising the feasibility and prudence of putting creditors at greater risk of loss.

Headwinds and the Economy

Let me now move on briefly to the second topic of these remarks, namely the implications of the past year of financial turmoil for the economy. I suggested at the outset that a useful framework for thinking about this issue was the

headwinds episode of the early 1990s. In that period, credit became expensive and, in some cases, unavailable, even for relatively high-quality borrowers. These credit conditions restrained consumer spending and business investment and, as a consequence, the recovery from the recession of 1990-91 was initially quite subdued. Eventually, of course, the economy performed very well over much of the 1990s, despite a rather rocky start.

I think that today's circumstances align well, although certainly not perfectly, with the experience of the early 1990s. There is no doubt that a variety of potential borrowers are finding funding more difficult and expensive to obtain. Moreover, while there was a significant contraction in residential construction activity in the late 1980s and early 1990s, the recent correction in this sector has been more severe, especially with the decline in housing values, and is continuing. The appreciable run-up, net, in energy and other commodity prices has taken a toll on consumer discretionary spending as well.

It is important to bear in mind, however, that many "initial conditions" prevailing prior to this financial shock were perceptibly better than in the early 1990s. Unemployment, interest rates, and inflation were all lower at the outset of the latest period of turmoil than in the previous headwinds episode. Equally important, the financial condition of both banking and nonfinancial businesses was healthier at the onset of recent problems.

Overall, while there is considerable uncertainty about the outlook and while the policy environment is challenging to say the least, my view is that the early 1990s headwinds episode remains a valuable guide at this juncture. Specifically, it would imply a continuation of only modest expansion in the economy, the likelihood of further increases in unemployment for a time, and a diminution of inflation, absent a resurgence in energy and other commodity prices.

In considering these prospects, it is worth recalling that, despite early challenges, the 1990s turned out to be an excellent decade for the U.S. economy by almost all metrics. The economy is fundamentally flexible and resilient, and these characteristics should ultimately prevail.

Conclusion

Let me quickly wrap this up, before turning to your comments and questions. I have commented this afternoon on two significant repercussions of the major financial shock which first struck the economy about one year ago. First, in view of what we have seen at some large financial institutions and in some funding markets, the need to address TBTF through a framework which reduces spillovers is critical, and we propose systemic-focused supervision as a constructive first step in this process. Second, given the headwinds associated with the financial shock, the economy appears likely to be restrained until credit conditions improve, as they inevitably will.