

Repercussions from the Financial Shock

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Introduction

Over the past 14 months, many financial markets and large financial institutions have been buffeted by a severe financial shock, a shock unprecedented in my tenure as a Reserve Bank president. The disruptions intensified over the summer and persist to this day, despite considerable injections of liquidity on our part and other actions intended to ameliorate the situation. While I will not comment on specific proposals or their implementation, it is clear to me that a comprehensive program to unlock the credit markets is required.

Making progress against the turmoil at hand is certainly the top priority at this stage. But soon enough policymakers will want to identify fundamental reforms that reduce the likelihood that we will face another period of financial instability. In this spirit, in my comments this morning I want to consider the repercussions of these events 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 consider 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 fully appropriate against the background of the risks at hand, and it is essential that they succeed, but going forward they will require policies 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, but let me emphasize one point: it is critical that we address TBTF because, if left unchecked, it could well be a major source of future instability.

As to economic prospects, I have been convinced for some time that financial conditions in the wake of the shock are reminiscent of, although certainly not identical to, 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 credit markets, the economy, and 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 expansion of the safety net for large financial firms and, particularly, its potential to dull the market forces that would otherwise serve to constrain excessive risk taking. Although the annual report essay was released just a few months ago, the financial safety net has expanded appreciably since then. The dimensions of the too-big-to-fail (TBTF) problem have increased once again.

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 positively. In 2004 I co-authored, with Ron Feldman, a book entitled *Too Big to Fail, the Hazards of Bank Bailouts*. In that work, we emphasized 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 undermines the principal rationale for extraordinary government support;
- Creditor expectations of receiving government support will diminish (and market discipline will increase) as policymakers have less reason to provide such support.

This reasoning can contribute to agreement on a general policy framework to address TBTF, but such a framework is not a 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. We have long had a list of specific reforms to address TBTF, but heretofore 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

In general, SFS attempts to focus supervision and regulation efforts on spillover reduction, and it consists of three pillars: early identification, enhanced prompt corrective action (PCA), and stability-related communication. In particular, SFS uses the information-gathering and analytical skills of supervisors to better understand how one firm's impairment might spread to other firms or markets; it relies on the enforcement capabilities of regulation (combined with market information) to close firms before they incur losses that could bring down their peers; and it extends central bank communication techniques to financial-stability-related efforts.

This program builds on the strength and current direction of supervision and regulation to focus across firms and the interconnections in the banking and financial system as a whole, rather than concentrating on supervisory assessment of single firms. Combined, these efforts constitute important actions in a long-term effort to limit the spillovers from the failure or impairment of a systemically important financial institution. I'll now describe what I see as the basics of the three components.

Early Identification. This is a process to identify and to respond, where appropriate, to the material exposures between large financial institutions and between these institutions and capital markets. By material, we mean a sufficient exposure such that problems at one of these financial institutions could significantly impair other depository institutions and/or normal market functions.

Early identification could take many forms. Supervisors might begin by examining the performance of a number of large financial institutions subject to a series of shocks. The shocks could include large losses to a given type of loan or security on the firms' balance sheet, or a significant drop in the availability of funding. The results of this examination would provide policymakers with a sense of which stresses lead to significant problems at the firms. A second step is to determine how the material 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 business day, what form the exposure takes, how much the exposure varies over time, and so on.

The goals of the exercise I just described (1) to give policymakers a sense of the type of events that are not likely to cause severe impairment, 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 an essential part of this effort, supervisors should 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, and develop a plan to address gaps that 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 to provision of extraordinary support.

Enhanced Prompt Corrective Action. 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 certain 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 close 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 most 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 DIs that have exposure to it. Thus, PCA is 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 “rearview mirror” or historical assessment of the bank’s assets. Such assessments may, at times, prove excessively generous. Using PCA triggers based on more forward-looking measures of bank solvency could help address this shortcoming.

Data from financial markets offer 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 enhance 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 timely closure of a bank.

Incorporating market signals into PCA certainly has potential downsides. Like other reforms that increase market discipline, enhanced PCA may force firms into resolution, and potentially into the sale of troubled assets, precisely when the financial system seems most vulnerable. This observation suggests the need to average market measures over time to smooth out short-run volatility, or to rely on peer comparisons, for example, so as to avoid overreaction. I would also note that enhanced PCA assumes a bank-like resolution regime, something that does not yet exist outside of the banking venue.

Communication. The first two pillars of SFS seek to increase market discipline by reducing the motivation of policymakers to protect uninsured creditors. But creditors will not know about efforts to limit spillovers, and will not change their expectations of support, absent explicit communication by policymakers about these activities. What form might that communication take?

In general, we have suggested that this communication possess several attributes. First, it should be released routinely, like the semi-annual Humphrey-Hawkins testimony, so that interested parties can rely on it. 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 changes underway. Finally, we think the communication should explicitly link the activity underway to the goal of reducing spillovers, thus raising the feasibility and prudence of putting creditors at greater risk of loss.

If we take a step back and reflect on these proposals, at the end of the day SFS is all about preparation – preparation from two distinct, but closely-related, perspectives. The underlying idea is, before severe problems arise, to identify potential vulnerabilities and

spillovers, and to select market signals to enhance PCA. And, secondly, specific, regular communication is necessary to prepare creditors for the change in regime and to encourage changes in their expectations and behavior.

The general cross-institution focus of SFS has similarities to what is often called macro prudential supervision. But just as I view SFS as building on current trends in safety and soundness supervision, effective SFS must have a strong foundation in the supervision of an individual financial institution, what some call “micro prudential supervision.” Implementation of SFS requires supervisory staff to maintain a strong grasp of the operational activities and the inherent risk profile of the financial institutions they supervise as well as the risk management systems these firms employ. Put another way, I think SFS has the best chance of meeting objectives if it becomes part and parcel of core supervisory operations; I have some concern about the value of SFS if it becomes an appendage to “routine” supervision carried out by macro prudential specialists.

Carrying out early identification, for example, requires a detailed understanding of how large financial institutions conduct their business, strong grasp on the financial reporting/MIS of the financial institutions under review, clear and routine communication with their management, and sufficient supervisory experience to evaluate the data/information provided by the financial institution. Enhanced PCA will maintain a supervisory capital measure. This requires supervisory evaluation of a financial institution’s capital position which necessitates reviews of asset quality and the allowance for loan losses, among other items. Even robust communication will benefit from integration with institution specific supervision.

Headwinds and the Economy

Let me now move onto the second topic, namely the implications of the past year of financial turmoil for the economy. I suggested at the onset 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.

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 most banking and nonfinancial businesses was relatively healthier at the onset of recent problems.

In my judgment, the 1990s headwinds episode continues to provide a valuable reference point for thinking about economic prospects. For the near-term, I think that this framework suggests further declines in employment and likely softness in consumer spending, with a diminution of inflation, absent a resurgence in energy and other commodity prices.

It is worth recalling that the recession of 1990-91 was brief but not especially mild. Depending on how one reads the data, headwinds restrained the pace of the ensuing expansion of the early 1990s for from 12 to 36 months. Something similar is certainly conceivable today. However, in considering these prospects, we should note that, despite early challenges, the 1990s turned out to be an excellent decade for the U.S. economy by almost all metrics. The underlying flexibility and resilience of the economy is intact, and these characteristics should ultimately prevail.

Conclusion

Let me quickly wrap this up, before turning to your comments and questions. I have commented this morning on two significant repercussions of the major financial shock which first struck the economy about 14 months 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 these conditions improve, and that will take some time.