

Regulatory Reform: Lessons from the Front Line

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The Minsky Conference has long been known as a unique forum to discuss timely economic and financial issues, and this year is no different. The focus of this year's conference – "After the Crisis: Planning a New Financial Structure" – speaks to what we see every day in the headlines, as the U.S. Congress and governments around the world debate a wide variety of proposals to reform the world's financial regulatory structures.

Some say that major reforms can be enacted only following major crises — after conditions become "bad enough." History and human nature clearly confirm this view. What is less obvious is that hasty reactions following a crisis do not always solve the problem. In fact, they can often create new problems. If reforms are to be successful and enduring, they should reflect comprehensive assessments and analyses of the factors that contributed to the crises.

One need only look to the financial crisis that occurred at the turn of the last century in our own country for such an example. It was the market crash and panic of 1907 when things became "bad enough" for major reforms to be considered at that time. But it was also the findings and recommendations of the National Monetary Commission – which studied both the causes of the financial failures and structures adopted by other countries – that prompted the development of regulatory reforms and that ultimately established the Federal Reserve System.

I think it's absolutely true that "you cannot reform what you don't understand." Based on that truism, I will offer you some perspectives on financial regulatory reform based on the lessons I have learned, and do understand—lessons built on the front-line experiences we at the Federal Reserve Bank of Cleveland have lived through as banking supervisors.

At the Federal Reserve Bank of Cleveland, we have been engaged—as everyone else at this conference has been engaged—in studying the causes of the financial crisis and identifying opportunities for regulatory reform. In addition to our research and analysis, our proposals for reform have also been developed based on our front-line supervisory experience with the financial crisis. Through the thick of the crisis in 2008 and early 2009, our direct involvement in the supervision of banking organizations in the Fourth Federal Reserve District, and our knowledge of supervisory activities throughout the country, exposed gaps in the supervision of the financial sector that contributed to the crisis. Since then, we have been able to step back and examine the conditions that existed during those dark days and evaluate the circumstances behind them.

In my remarks today, I will first call attention to an important but sometimes overlooked aspect of regulatory reform—consolidated supervision. Second, I will describe the criteria we should use to define systemically important institutions and discuss a framework for ensuring that financial firms are effectively supervised based on the risk they pose to the financial system. Finally, I will explain why it is vitally important for the Federal Reserve to remain significantly involved in the supervision of banking firms of all sizes. Of course, these comments are my own and do not necessarily reflect the views of my colleagues in the Federal Reserve System.

The Importance of Consolidated Supervision

In the years leading up to the crisis, financial supervisors had been looking first and foremost at the risk profiles of the individual institutions that they had been responsible for supervising. This entity-based

approach to supervision, led to gaps in regulatory oversight, and the exposures within the broader financial system were underestimated as well.

As a result, many thoughtful observers have proposed that greater attention be focused on identifying a mechanism for macroprudential supervision, or what some refer to as systemic risk supervision—namely, supervision with an eye toward minimizing risk to the entire financial system. This concept has received a great deal of well-deserved attention in the regulatory reform deliberations currently taking place. I do not plan to elaborate on this concept today, other than to say I endorse it wholeheartedly.

Instead, I want to talk about another very important supervisory concept that has not received as much attention—the concept of consolidated supervision. To understand why I want to call your attention to this issue, let me first describe the banking structure in my Federal Reserve District.

In the Fourth Federal Reserve District, we are fortunate to have financial firms that vary considerably in size and structure— from small, noncomplex community banks to large, moderately complex regional firms. Of the 244 bank holding companies in our District, four are among the largest 25 domestic bank holding companies in the country. While our largest bank holding companies are not likely to be considered systemically important in their own right, their degree of complexity and risk pose considerable supervisory challenges.

These supervisory challenges became quite apparent during the crisis. Despite their smaller size compared with those firms typically considered systemically important, these regional firms were engaged in complex activities that resulted in a higher level of risk both to themselves and to the broader financial system. These regional bank holding companies and their affiliates were supervised by multiple federal and state agencies. All of these functional regulators were focused on supervising the individual entities for which they were responsible – and rightfully so. However, this entity-based approach to supervision created gaps in the oversight of the consolidated enterprise. As the various supervisors focused on the risks originated and faced by the particular part of the company for which they were responsible, it was sometimes difficult for bank holding company supervisors to identify the aggregate risk in the enterprise, and to do so in a timely way. For example, think about the liquidity required for a particular entity in a holding company versus the liquidity needs of the overall enterprise. A liquidity level that may appear adequate for the needs of a specific entity – the bank subsidiary, let’s say – may not meet the needs of the consolidated organization. Within the corporate structure, both bank and nonbank entities require funding to remain active. Consolidated supervision would provide for the ability to identify the aggregate liquidity requirements and to develop a comprehensive supervisory plan that addresses the risks to the entire organization.

The Federal Reserve has already taken steps to sharpen our focus on enterprise-wide risk supervision, but I support legislation that would remove some of the constraints we currently face to obtain information from, and address unsafe and unsound practices in, the subsidiaries of bank holding companies. In other words, we should move toward consolidated supervision to ensure that the aggregate risks of the entire firm are identified in a timely way and that appropriate supervisory action can be taken, regardless of where that risk originates in the organization. Without consolidated supervisory authority, oversight gaps will continue, making it difficult to identify cross-entity risks within a bank holding company and to take appropriate action to mitigate those risks.

Identifying Systemically Important Institutions

In addition to learning firsthand the value of clear, consolidated supervisory authority, experience has also sharpened my thinking about the identification of systemically important firms. Let me be clear here about the goal—to put an end to the “too big to fail” problem. To achieve this goal, banking supervisors must be able to identify which firms are systemically important, and why. While the size of a specific financial firm is an important factor, it is only one of several factors that should be considered. Other important factors that need to be considered are contagion, correlation, concentration, and context – what we at the Federal Reserve Bank of Cleveland refer to as “The Four C’s.”

Contagion can be thought of as the “too interconnected to fail” problem. If an institution is connected to many other institutions and firms – through loans, deposits, and insurance contracts, for example – all of those firms may collapse if the first firm fails.

Correlation can be thought of as the “too many to let fail” problem. Institutions may engage in the same risky behavior as many other institutions, and the failure of one institution may result in the closure of all those institutions engaged in that same practice.

Concentration can be thought of as the “too dominant to fail” problem. In these situations, an institution has a market concentration sufficiently large that its failure could materially disrupt or lock up the market.

Context can be thought of as the “too much attention to fail” problem. Because of market conditions and other conditions that exist at the time, the closure of a particular institution may cause panic and result in the impairment of other firms.

Thinking about systemic importance in the context of these four factors results in a more reliable and comprehensive identification of firms that, in and of themselves, may be considered systemically important for reasons beyond just their size. Size is a necessary, but not sufficient, criterion upon which we should determine systemic importance. These Four C’s - contagion, correlation, concentration, and context - must also be considered.

Establishing a Framework of Tiered Parity

When people discuss the composition of our financial industry, they often refer to just two categories—the large, highly complex firms generally referred to as “systemically important institutions” and “all others.” But once we’ve identified those firms that are systemically important – based on their size and the Four C’s – we are left with an “all others” category that I find to be too simplistic and that requires further refinement. Let me explain why.

My experience suggests that there is a middle tier of financial firms that poses a greater risk to the financial system than community banks and thus requires a higher degree of supervisory attention. So I believe that a multi-tier approach to thinking about our financial industry is very useful, and I have proposed a three-tiered framework called tiered parity that would have categories labeled “systemically important,” “moderately complex,” and “noncomplex.”

The fundamental principle behind this framework is that the regulations and the approach to supervision for each tier would correspond to the degree of risk posed to the financial system by the firms within each tier. While we currently make some distinctions between firms of different sizes and complexity in terms of how we supervise, one objective of my approach is to draw even sharper distinctions than we do today. In the new framework, differences in treatment between the tiers would be based on differences in risk and complexity. Another objective of this framework is to ensure that institutions within each tier would receive the same regulatory treatment and supervisory oversight, so my approach incorporates parity of treatment within each tier.

Any institution that is identified as systemically important would be subject to stricter supervisory requirements, such as capital and liquidity standards, as well as close supervision of its risk taking, risk management, and financial condition. In addition, firms in this tier would be required to develop what some have called a “living will” that would provide for planned and orderly unwinding if necessary. The goal would be not only to limit the amount of risk these companies could pose to the financial system overall, but also to discourage the combination of size, complexity, and nature of operations that enabled them to become a systemic threat in the first place. All of these steps should help us to eliminate the specter of “too big to fail.”

Firms in the first tier are systemically important by their very nature. Firms in the second tier – the moderately complex firms – can pose risk to the financial system under certain circumstances. In particular, a group of Tier 2 firms may exhibit common systemic risk characteristics, such as exposure to

a specific type of risky asset that results in correlation among these firms, or together the firms may have a concentration in a particular activity.

Our supervisory approach to this group of moderately complex financial firms would be revised and customized to consider the risks they collectively pose to the financial system. Supervisors would conduct focused reviews of all the firms in this group at the same time to determine the degree of risk they pose and to ensure the consistent application of supervisory action, where warranted.

Last year's Supervisory Capital Assessment Program, or what some have referred to as the large-bank stress tests, is an example of the successful application of this supervisory approach. In this process, firms with a common degree of risk were subjected to a unique supervisory approach that was considered appropriate for the degree of risk perceived at the time. What mattered most was not whether a firm was among the largest and most complex financial institutions, but whether it posed systemic risk under the circumstances. The review of incentive compensation practices currently being conducted on selected financial firms is another example of a practical application of this framework. Both of these examples illustrate that our supervisory approach has already been changing in response to identified risks.

The advantage of formally establishing the tiered parity framework is to identify the degrees of risk in financial firms before problems arise, and then to fashion regulations and supervisory approaches according to the risks posed by the institutions in each of the three tiers. Of course, the approach to supervision at any given time will need to be adapted to changes that occur in the economic and financial environment. The result will be a more refined, proactive, and effective approach to regulating and supervising our nation's financial firms.

The Ongoing Role of the Federal Reserve

I would now like to explain how my experiences during the crisis reinforce my view that the Federal Reserve should continue to supervise banking organizations of all sizes and should take on an expanded role in supervising systemically important financial institutions. Retaining our role in the supervision of banks of all sizes is vital.

Our nation's banks serve an extremely diverse range of customers, industries, and geographies. Their health is critically important to the communities and regions they serve. During the peak periods of strains in financial markets, these institutions looked to their Federal Reserve Banks for liquidity. As banking supervisors, we had a firsthand understanding of the safety and soundness issues facing banking companies. This information was critical to us in our role as lender of last resort, as we understood the particular liquidity circumstances they faced. And as the central bank, we recognized the risks to the economy of credit markets seizing up. Our experience enabled us to respond quickly. We adapted our regular discount lending programs to create an auction facility, and we provided for longer lending terms and more collateral flexibility—not just for the largest and most complex banking organizations, but for all banking organizations.

In my Reserve Bank, the economists worked closely with banking supervisors and discount window lenders to pool information, assess situations, and make decisions. And I can tell you that the knowledge, expertise, and direct access to information that come from our supervision and lending responsibilities contributed to our effectiveness in monetary policy. During the darkest moments of the crisis, this knowledge, expertise, and direct access to information were critical and could not have been developed at a moment's notice. Even today, the intelligence I gather from my banking supervisors is extraordinarily useful to me as a monetary policymaker in helping to identify factors that may pose risks to my economic outlook.

In turn, I also find that the knowledge that the Federal Reserve has about the economy and financial markets enhances our effectiveness as a financial supervisor. This wide range of expertise also makes the Federal Reserve uniquely suited to supervise large, complex financial organizations and to address risks to the stability of the financial system. No other agency has, or could easily develop, the degree and nature of expertise that the Federal Reserve brings to the supervision of banking organizations of all sizes and the identification and analysis of systemic risks.

Conclusion

Financial reform is not a new idea—we have seen examples of it following crises, and we have seen reform proposals during periods of relative calm. This financial crisis has unfortunately provided us with compelling reasons to press on with the regulatory reform agenda. As we do so, let's act on our best understanding of economic theory and the results of solid research. But let's also act on the basis of what we have learned directly from our firsthand experiences.