Remarks by
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It's a pleasure to be with all of you today.

Through times of calm and times of crisis, the Chicago Fed has brought together the best minds in the business to explore and offer solutions to the most pressing issues of the day. This year is no exception. Much like the crisis of the late 1980s and early 1990s, many of the reforms that ultimately became part of the FDIC Improvement Act of 1991 were first debated right here, at this Conference. Once again, as the banking system is emerging from a crisis period and the clean-up is underway, reform is front and center.

Today I would like to share some of my thoughts and react to other ideas about how best to reform financial regulation. I hope my ideas will have value and get us closer to repairing our financial sector and restore it as the engine of growth for the real economy.

First, I would like to briefly identify what I believe have been key weaknesses in our system. Much has already been said about the role of securitization in skewing incentives. But related to this was over-reliance on collateral values instead of evaluating borrower or counter-party capacity to perform; over-reliance on short-term funding ... frequently to fund longer term assets (we've seen that one before); and finally, excessive leverage.

These weaknesses were central to the crisis. They facilitated the buildup of excess risk exposures in financial institutions and they severely limited regulatory-response options once those risk exposures were realized. And they can be traced, in part, to regulatory loopholes, including differences in regulatory regimes and the absence of regulation over important segments of the market.

Then I will talk about the many ideas that have been circulating for regulatory reform. As this audience has discussed many times over the years, a safety net creates incentives for risk taking. Regulation and supervision alone cannot fully guard against moral hazard. Sometimes they can contribute to it.

Government safety nets must preserve a real chance for more sophisticated market participants to experience losses and the disciplining effect that this risk of loss brings.

In my mind, creating a new regulatory regime without the ultimate backstop of market discipline through the creation of a credible resolution regime for very large and complex institutions -- will only heighten the problems already caused by too-big-to-fail.

Underwriting Standards and Collateral

The current crisis was spawned by an unfounded faith in the safety of collateral-based lending – even if the borrower could not afford the loan. "Liar" loans and 50 percent debt-service burdens only made sense to lenders and investors if they believed that the collateral backing the loan would continue to rise in value. Why assess a customer's ability to repay a loan when collateral could always cover the balance?

From the consumers' perspective, there were several factors at work. Some consumers fell prey to predatory loan practices that were allowed to permeate the mortgage market. Others lived in metropolitan areas where escalating home prices outstripped income growth and affordability pressures led borrowers to take on excessive debt or accept mortgages that their income alone could not support.

Payment shock mortgages – option ARMS and the infamous hybrid ARMS -- appealed to many consumers as long as they believed that home prices would keep rising, allowing them to refinance before the loans reset. High risk mortgages weren't the only instruments in which investors had excessive faith in the risk-mitigating benefits of collateral. The commercial paper market and leveraged loans also grew in reliance on collateral values at the expense of old-fashioned analyses of credit quality.

The OTC derivatives markets – particularly Credit Default Swaps – also suffered from a blind faith in collateral protection. And when major players in that market started experiencing difficulties last year, the rush to seize and liquidate collateral by their counterparties contributed mightily to the liquidity crisis.

The Shadow Banking Sector

Growth of the shadow financial services sector also led to a re-emergence of problems that we thought we had solved inside the banking system. Activities such as commercial paper conduits ... structured investment vehicles ... hedge funds ... private equity funds ... money market repurchase agreements ... and securities-lending became important parts of the intermediation process — all beyond the constraints placed on banks against excess leverage and funding mismatches.

By early 2007, the level of financial intermediation undertaken in the shadow banking sector exceeded the level of activity in the traditional banking sector. The combination of the huge size of the shadow banking sector ... its excess leverage and dependence on investor confidence for short-term funding ... and the industry-wide reliance on collateral ... proved to be a perilous mix.

Unlike the regulated banking industry, which has a regulatory leverage ratio ... deposit insurance ... and lender-of-last resort facilities, shadow banking had no means of mitigating the risk of uninsured creditor runs. And it couldn't get funding without risking forced asset sales or other extraordinary means. You know the rest of the story.

Massive government intervention was necessary to stabilize the system. The safety net and liquidity facilities traditionally available only to regulated depository institutions were expanded and made available to large parts of the shadow banking sector.

So where does this leave us?

Systemic Risk Regulator

Everyone is talking about the need for a systemic risk regulator. I agree. But I must point out that many of the institutions that were at the heart of the crisis were already subject to considerable regulation and oversight. Looking back, it's clear that risks were not only building up in individual institutions, but across the financial system. So why did we miss them?

Centralizing the responsibility for supervising individual institutions that are deemed systemically important would bring clarity and accountability to their oversight. The Federal Reserve seems like the perfect candidate for the job. But as we know, risks were building across the financial system—not just at individual institutions. We were slow to identify them and limited in our ability to correct. So we need to think about systemic risk regulation not just through the lens of a financial institution, but also from a system-wide perspective.

Systemic Risk Council

We could create a Systemic Risk Council as some have proposed. The Council would have a mandate to monitor developments throughout the financial system, and the authority to take action to mitigate systemic risk.

If this Systemic Risk Council had existed in 2002, what might it have been doing? Hopefully, it would have seen the risks building as a result of weak lending standards, excessive leverage, over-reliance on collateral, short-term funding and all the other risks that we've seen.

As I see it, the Council should have a more macro perspective and the authority to overrule or force actions on behalf of other regulatory entities. It should have the authority to establish consistent capital standards throughout the system to prevent excessive leverage and the painful de-leveraging that follows. In addition, to address pro-cyclicality, the capital standards should call for capital buffers that increase during expansions and are drawn down during contractions. For example, capital buffers could be hard-wired, tied to growth in credit or earnings.

The Council should also have the ability to check over-reliance on collateral, and to instill greater discipline on the underwriting process by placing limits on the use of collateral to mitigate potential loss. It could also require systemically important institutions to provide greater stability in their funding base. For instance, the council could require banks to issue: 1) commercial paper that automatically converts into a long-term unsecured liability when a distress event is realized, and to issue unsecured debt or preferred shares that convert automatically into common equity when a "distress trigger" – such as a ratings downgrade-- occurs.

In order to monitor risk in the financial system, the Systemic Risk Council should also have the authority to demand better information from financial entities and to ensure that information is shared more readily. During this crisis, as we contemplated actions necessary to preserve financial stability in the face of a possible failure, it was very difficult to get complete and timely information, particularly regarding holders of unsecured debt or credit default swap exposures. The lack of information can force a policy response that may be more blunt-edged than surgical.

Need for a Systemic Risk Resolution Regime

While a Systemic Risk Regulatory Regime would fill some of the gaps that this crisis has exposed, it does not fill them all. In fact, if regulation and supervision of systemic institutions are the sole focus of regulatory reform coming out of this crisis, the problem of moral hazard and too-big-to-fail will only grow. We need a credible resolution regime for systemically important financial firms to complement enhanced regulation.

FDIC Resolution Powers and the Current Crisis

So where does that leave us?

History has taught us that banks are special because the intermediation process facilitates the production of real goods and services. Financial intermediation is the process of channeling savings into investment and, increasingly in the past decades, into funding consumption and consumer investments like autos, houses, and college educations. When banks fail, they affect not only the shareholders and creditors of the bank, but also all the businesses and consumers who relied on the bank for their financial services.

Because of the importance of banks in this intermediation process, as well as the government benefits they receive through deposit insurance, Congress granted special resolution powers to the FDIC. These powers allow the FDIC to separate out and quickly sell the valuable parts of the failing bank, so that the intermediation process can continue uninterrupted. The FDIC's powers enable it to sell the remaining assets of the failed institution in an orderly manner over time.

The biggest positive from our process is the prompt reallocation of resources from the weak to the strong. Make no doubt about it, this can be a painful process for shareholders, creditors and bank employees. The FDIC resolution process was designed for a time when virtually all financial intermediation occurred inside of traditional banks.

Unfortunately, our laws for dealing with financial crises have not kept pace with the dramatic growth of financial services provided outside of banks. As a result, we have very different laws to resolve the different parts of a financial firm. This makes a coordinated resolution of entire financial organizations ... which may or may not include an FDIC-insured bank ... difficult and sometimes almost impossible.

The lack of an effective resolution mechanism for large financial organizations is driving many of our policy choices. It has contributed to unprecedented government intervention into private companies. It has fed the "too big to fail" presumption, that has eroded market discipline for those who invest in and lend to very large institutions.

Investors and creditors have lacked strong incentives to perform due diligence because of the perception that these institutions are so large and complex that the government would have to bail them out. They were absolutely right. And this intervention, in turn, has given rise to public cynicism about the system and anger directed at the government and financial market participants.

We need a new resolution regime that minimizes the economic impact of the failure of a large complex financial institution. This new regime must also do a better job of imposing losses on investors and creditors, instead of leaving those losses in the hands of government and in the laps of taxpayers.

Let me be clear about this. A resolution regime for systemically important institutions is NOT a new bailout system. It's NOT a blanket guarantee of all of the firm's liabilities. It is a regime that brings discipline by imposing losses on appropriate parties, and is industry funded. It should work much the same way as the FDIC now resolves a failed bank.

Why a systemic risk resolution regime is necessary

Bankruptcy doesn't really work for systemically important financial firms. For instance, one of the many advantages of the FDIC process is the ability to set up a "bridge" bank so that critical operations and services can continue without interruption, and the valuable parts of the franchise keep their value. This process facilitates the creation of a "good bank" -- "bad bank" model, which has a number of appealing features.

Under this scenario, you'd take over the troubled firm, requiring any losses to be absorbed first by stockholders and unsecured creditors. Viable portions of the firm would be placed into the "good bank" using a structure similar to the FDIC's bridge bank. The nonviable or troubled portions of the firm would remain behind in a "bad bank," that would be unwound or sold over time as markets allow.

Financial firms are highly interconnected and are central to the provision of credit and liquidity. When a systemically important financial firm is in trouble, we need a resolution process that imposes losses on appropriate parties and keeps markets functioning while providing for an orderly transfer or unwinding of the firms' positions. This cannot be accomplished in a court-based bankruptcy proceeding. The lack of a resolution mechanism has required the government to improvise for each individual situation, making it very difficult to address systemic problems in a coordinated manner.

Special expertise is needed to provide continuity in markets and protect the taxpayer from undue losses. For instance, in the case of insured depository institutions, the FDIC has exercised its special resolution authority to prevent immediate close-out netting and settlement of an insured depository's financial contracts. We have 24 hours after appointment as receiver to decide whether to transfer the contracts to another bank or to an FDIC-operated bridge bank ... or to cancel the contracts. This remedial authority prevents instability and contagion, which is what you can get from a bankruptcy.

On top of that, there is the matter of fairness. Government should not be in the business of arbitrarily picking winners and losers. And smaller banks shouldn't be subject to one regime, while larger institutions and non-banks are subject to another.

Conclusion

Creating a workable resolution mechanism for large, systemic financial organizations would be a brave new world. In the short term, it could increase the cost of capital for large institutions. Investors and creditors would come to understand their own responsibility (and the wisdom) of conducting due diligence of the strengths and weaknesses of bank managers and balance sheets. In turn, investors and creditors could charge a premium for the newly recognized risk, that indeed, these institutions could fail.

This is as it should be. Everybody should have the freedom to fail in a market economy. Without that freedom, capitalism doesn't work.

In the longer term, a legal mechanism to resolve systemically important firms would result in a more efficient alignment of capital with better managed institutions. Ultimately, this would benefit those better managed institutions.

Let me conclude by saying again that we cannot effectively solve the problems caused by the "too big to fail" notion unless we overhaul how we regulate and supervise big institutions, and how we resolve them when they implode. Closing down a big name company is never pleasant. It's a painful business but a necessary one in a market economy.

To move forward, we can't let ourselves be prisoners of out-dated authorities, trapped in a resolution regime which pre-dated the evolution of the "shadow banking sector"... crafted in a prior era when insured banks overwhelmingly dominated financial services.

The sooner we modernize our resolution structure, the sooner we can end too big to fail, and clear the way for a stronger, brighter and more stable economic future.

Thank you very much.

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