Ben S Bernanke: Regulatory reform

Testimony of Mr Ben S Bernanke, Chairman of the Board of Governors of the US Federal Reserve System, before the Committee on Financial Services, US House of Representatives, Washington DC, 1 October 2009.

The original speech, which contains various links to the documents mentioned, can be found on the US Federal Reserve System's website.

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Chairman Frank, Ranking Member Bachus, and other members of the Committee, I appreciate the opportunity to discuss ways of improving the financial regulatory framework to better protect against systemic risks.

In my view, a broad-based agenda for reform should include at least five key elements. First, legislative change is needed to ensure that systemically important financial firms are subject to effective consolidated supervision, whether or not the firm owns a bank.

Second, an oversight council made up of the agencies involved in financial supervision and regulation should be established, with a mandate to monitor and identify emerging risks to financial stability across the entire financial system, to identify regulatory gaps, and to coordinate the agencies' responses to potential systemic risks. To further encourage a more comprehensive and holistic approach to financial oversight, *all* federal financial supervisors and regulators – not just the Federal Reserve – should be directed and empowered to take account of risks to the broader financial system as part of their normal oversight responsibilities.

Third, a new special resolution process should be created that would allow the government to wind down a failing systemically important financial institution whose disorderly collapse would pose substantial risks to the financial system and the broader economy. Importantly, this regime should allow the government to impose losses on shareholders and creditors of the firm.

Fourth, all systemically important payment, clearing, and settlement arrangements should be subject to consistent and robust oversight and prudential standards.

And fifth, policymakers should ensure that consumers are protected from unfair and deceptive practices in their financial dealings.

Taken together, these changes should significantly improve both the regulatory system's ability to constrain the buildup of systemic risks as well as the financial system's resiliency when serious adverse shocks occur.

Consolidated supervision of systemically important financial institutions

The current financial crisis has clearly demonstrated that risks to the financial system can arise not only in the banking sector, but also from the activities of other financial firms – such as investment banks or insurance companies – that traditionally have not been subject to the type of regulation and consolidated supervision applicable to bank holding companies. To close this important gap in our regulatory structure, legislative action is needed that would subject *all* systemically important financial institutions to the same framework for consolidated prudential supervision that currently applies to bank holding companies. Such action would prevent financial firms that do not own a bank, but that nonetheless pose risks to the overall financial system because of the size, risks, or interconnectedness of their financial activities, from avoiding comprehensive supervisory oversight.

Besides being supervised on a consolidated basis, systemically important financial institutions should also be subject to enhanced regulation and supervision, including capital, liquidity, and risk-management requirements that reflect those institutions' important roles in the financial sector. Enhanced requirements are needed not only to protect the stability of individual institutions and the financial system as a whole, but also to reduce the incentives for financial firms to become very large in order to be perceived as too big to fail. This perception materially weakens the incentive of creditors of the firm to restrain the firm's risk-taking, and it creates a playing field that is tilted against smaller firms not perceived as having the same degree of government support. Creation of a mechanism for the orderly resolution of systemically important nonbank financial firms, which I will discuss later, is an important additional tool for addressing the too-big-to-fail problem.

The Federal Reserve is already the consolidated supervisor of some of the largest and most complex institutions in the world. I believe that the expertise we have developed in supervising large, diversified, and interconnected banking organizations, together with our broad knowledge of the financial markets in which these organizations operate, makes the Federal Reserve well suited to serve as the consolidated supervisor for those systemically important financial institutions that may not already be subject to the Bank Holding Company Act. In addition, our involvement in supervision is critical for ensuring that we have the necessary expertise, information, and authorities to carry out our essential functions as a central bank of promoting financial stability and making effective monetary policy.

The Federal Reserve has already taken a number of important steps to improve its regulation and supervision of large financial groups, building on lessons from the current crisis. On the regulatory side, we played a key role in developing the recently announced, internationally-agreed improvements to the capital requirements for trading activities and securitization exposures, and we continue to work with other regulators to strengthen the capital requirements for other types of on- and off-balance-sheet exposures.[1] In addition, we are working with our fellow regulatory agencies toward the development of capital standards and other supervisory tools that would be calibrated to the systemic importance of the firm. Options under consideration in this area include requiring systemically important institutions to hold aggregate levels of capital above current regulatory norms or to maintain a greater share of capital in the form of common equity or instruments with similar loss-absorbing attributes, such as "contingent" capital that converts to common equity when necessary to mitigate systemic risk.

The financial crisis also highlighted weaknesses in liquidity risk management at major financial institutions, including an overreliance on short-term funding. To address these issues, the Federal Reserve helped lead the development of revised international principles for sound liquidity risk management, which have been incorporated into new interagency guidance now out for public comment.[2]

In the supervisory arena, the recently completed Supervisory Capital Assessment Program (SCAP), popularly known as the stress test, was quite instructive for our efforts to strengthen our prudential oversight of the largest banking organizations.[3] This unprecedented

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[1] See Bank for International Settlements (2009), "Basel II Capital Framework Enhancements Announced by the Basel Committee," press release, July 13; and Basel Committee on Banking Supervision (2009), *Enhancements to the Basel II Framework* (Basel: Basel Committee, July).

[2] See Basel Committee on Banking Supervision (2008), *Principles for Sound Liquidity Risk Management and Supervision* (Basel: Basel Committee, September). Information about the proposed guidance is available at Board of Governors of the Federal Reserve System, Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, Office of Thrift Supervision, and National Credit Union Administration (2009), "Agencies Seek Comment on Proposed Interagency Guidance on Funding and Liquidity Risk Management," joint press release, June 30.

[3] For more information about the SCAP, see Ben S. Bernanke (2009), "The Supervisory Capital Assessment Program," speech delivered at the Federal Reserve Bank of Atlanta 2009 Financial Markets Conference, held in Jekyll Island, Ga., May 11.

interagency process, which was led by the Federal Reserve, incorporated forward-looking, cross-firm, aggregate analyses of 19 of the largest bank holding companies, which together control a majority of the assets and loans within the U.S. banking system. Drawing on the SCAP experience, we have increased our emphasis on horizontal examinations, which focus on particular risks or activities across a group of banking organizations, and we have broadened the scope of the resources we bring to bear on these reviews. We also are in the process of creating an enhanced quantitative surveillance program for large, complex organizations that will use supervisory information, firm-specific data analysis, and market-based indicators to identify emerging risks to specific firms as well as to the industry as a whole. This work will be performed by a multidisciplinary group composed of our economic and market researchers, supervisors, market operations specialists, and other experts within the Federal Reserve System. Periodic scenario analysis will be used to enhance our understanding of the consequences of changes in the economic environment for both individual firms and for the broader system. Finally, to support and complement these initiatives, we are working with the other federal banking agencies to develop more comprehensive information-reporting requirements for the largest firms.

Systemic risk oversight

For purposes of both effectiveness and accountability, the consolidated supervision of an individual firm, whether or not it is systemically important, is best vested with a single agency. However, the broader task of monitoring and addressing systemic risks that might arise from the interaction of different types of financial institutions and markets – both regulated and unregulated – may exceed the capacity of any individual supervisor. Instead, we should seek to marshal the collective expertise and information of all financial supervisors to identify and respond to developments that threaten the stability of the system as a whole. This objective can be accomplished by modifying the regulatory architecture in two important ways.

First, an oversight council – composed of representatives of the agencies and departments involved in the oversight of the financial sector – should be established to monitor and identify emerging systemic risks across the full range of financial institutions and markets. Examples of such potential risks include rising and correlated risk exposures across firms and markets; significant increases in leverage that could result in systemic fragility; and gaps in regulatory coverage that arise in the course of financial change and innovation, including the development of new practices, products, and institutions. A council could also play useful roles in coordinating responses by member agencies to mitigate emerging systemic risks, in recommending actions to reduce procyclicality in regulatory and supervisory practices, and in identifying financial firms that may deserve designation as systemically important. To fulfill its responsibilities, a council would need access to a broad range of information from its member agencies regarding the institutions and markets they supervise and, when the necessary information is not available through that source, the authority to collect such information directly from financial institutions and markets.

Second, the Congress should support a reorientation of individual agency mandates to include not only the responsibility to oversee the individual firms or markets within each agency's scope of authority, but also the responsibility to try to identify and respond to the risks those entities may pose, either individually or through their interactions with other firms or markets, to the financial system more broadly. These actions could be taken by financial supervisors on their own initiative or based on a request or recommendation of the oversight council. Importantly, each supervisor's participation in the oversight council would greatly strengthen that supervisor's ability to see and understand emerging risks to financial stability. At the same time, this type of approach would vest the agency that has responsibility and accountability for the relevant firms or markets with the authority for developing and implementing effective and tailored responses to systemic threats arising within their purview. To maximize effectiveness, the oversight council could help coordinate responses when risks cross regulatory boundaries, which often will be the case.

The Federal Reserve already has begun to incorporate a systemically focused approach into our supervision of large, interconnected firms. Doing so requires that we go beyond considering each institution in isolation and pay careful attention to interlinkages and interdependencies among firms and markets that could threaten the financial system in a crisis. For example, the failure of one firm may lead to runs by wholesale funders of other firms that are seen by investors as similarly situated or that have exposures to the failing firm. These efforts are reflected, for example, in the expansion of horizontal reviews and the quantitative surveillance program I discussed earlier.

Improved resolution process

Another critical element of the systemic risk agenda is the creation of a new regime that would allow the orderly resolution of failing, systemically important financial firms. In most cases, the federal bankruptcy laws provide an appropriate framework for the resolution of nonbank financial institutions. However, the bankruptcy code does not sufficiently protect the public's strong interest in ensuring the orderly resolution of a nonbank financial firm whose failure would pose substantial risks to the financial system and to the economy. Indeed, after the Lehman Brothers and AIG experiences, there is little doubt that we need a third option between the choices of bankruptcy and bailout for such firms.

A new resolution regime for nonbanks, analogous to the regime currently used by the Federal Deposit Insurance Corporation for banks, would provide the government the tools to restructure or wind down a failing systemically important firm in a way that mitigates the risks to financial stability and the economy and thus protects the public interest. It also would provide the government a mechanism for imposing losses on the shareholders and creditors of the firm. Establishing credible processes for imposing such losses is essential to restoring a meaningful degree of market discipline and addressing the too-big-to-fail problem. The availability of a workable resolution regime also would replace the need for the Federal Reserve to use its emergency lending authority under section 13(3) of the Federal Reserve Act to prevent the failure of specific institutions.

Payment, clearing, and settlement arrangements

Payment, clearing, and settlement arrangements are the foundation of the nation's financial infrastructure. These arrangements include centralized market utilities for clearing and settling payments, securities, and derivatives transactions, as well as the decentralized activities through which financial institutions clear and settle such transactions bilaterally. While these arrangements can create significant efficiencies and promote transparency in the financial markets, they also may concentrate substantial credit, liquidity, and operational risks, and, absent strong risk controls, may themselves be a source of contagion in times of stress.

Unfortunately, the current regulatory and supervisory framework for systemically important payment, clearing, and settlement arrangements is fragmented, creating the potential for inconsistent standards to be adopted or applied. Under the current system, no single regulator is able to develop a comprehensive understanding of the interdependencies, risks, and risk-management approaches across the full range of arrangements serving the financial markets today. In light of the increasing integration of global financial markets, it is important that systemically critical payment, clearing, and settlement arrangements be viewed from a systemwide perspective and that they be subject to strong and consistent prudential standards and supervisory oversight. We believe that additional authorities are needed to achieve these goals.

Consumer protection

As the Congress considers financial reform, it is vitally important that consumers be protected from unfair and deceptive practices in their financial dealings. Strong consumer protection helps preserve households' savings, promotes confidence in financial institutions and markets, and adds materially to the strength of the financial system. We have seen in this crisis that flawed or inappropriate financial instruments can lead to bad results for families and for the stability of the financial sector. In addition, the playing field is uneven regarding examination and enforcement of consumer protection laws among banks and nonbank affiliates of bank holding companies on the one hand, and firms not affiliated with banks on the other hand. Addressing this discrepancy is critical both for protecting consumers and for ensuring fair competition in the market for consumer financial products.

Conclusion

Thank you again for the opportunity to testify on these important matters. The Federal Reserve looks forward to working with the Congress and the Administration to enact meaningful regulatory reform that will strengthen the financial system and reduce both the probability and severity of future crises.