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UA36I/29 Gary Ransdell - Fed. Reserve Board - Board Report on the Case for FRS Role in Bank Supervision

St. Louis Federal Reserve Board

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Today the Federal Reserve Board published a document that Chairman Bernanke submitted to Congress explaining the benefits of maintaining a Fed role in banking supervision.

The full text is provided below and at

http://www.federalreserve.gov/BoardDocs/RptCongress/supervision/supervision_report.pdf

Also today, former Chairman Paul Volcker addressed the importance of the Fed's role in a speech before the Economic Club of New York. The full text of the speech is attached for your information.

The Public Policy Case for a Role for the Federal Reserve in Bank Supervision and Regulation

Like many other central banks around the world, the Federal Reserve participates with other agencies in supervising and regulating the banking system. The Federal Reserve's involvement in supervision and regulation confers two broad sets of benefits to the country.

First, the financial crisis has made clear that an effective framework for financial supervision and regulation must address both safety-and-soundness risks at individual institutions and macroprudential risks--that is, risks to the financial system as a whole. All individual financial institutions that are so large and interconnected that their failure could threaten the functioning of the financial system must be subject to strong consolidated supervision. Both effective consolidated supervision and addressing macroprudential risks require a deep expertise in the areas of macroeconomic forecasting, financial markets, and payments systems. As a result of its central banking responsibilities, the Federal Reserve possesses expertise in those areas that is unmatched in government and that would be difficult and costly for another agency to replicate.

Second, the Federal Reserve's participation in the oversight of the banking system significantly improves its ability to carry out its central banking functions. Most importantly, the Federal Reserve's ability to effectively address actual and potential financial crises depends critically on the information, expertise, and powers that it gains by virtue of being both a bank supervisor and a central bank. In addition, supervisory information and expertise significantly enhance the safety and soundness of the credit the Federal Reserve provides to depository institutions by allowing the Federal Reserve to independently evaluate the financial condition of institutions that want to borrow from the discount window as well as the quality and value of the collateral pledged by such institutions. Finally, its supervisory activities provide the Federal Reserve information about the current state of the economy and the financial system that, particularly during periods of financial crisis, is valuable in aiding the Federal Reserve to determine the appropriate stance of monetary policy. These benefits of the Federal Reserve's supervisory role proved particularly important during the financial crisis that emerged in 2007.

We recognize, of course, that bank supervision, including ours, needs to be more effective than in the past, and we have reviewed our performance and are making improvements at multiple levels. The Federal Reserve is working with other supervisors here and abroad to improve capital and liquidity regulation. In addition, we have begun to make changes to our oversight of large banking organizations, including the development of an enhanced quantitative surveillance program, improving data collection, strengthening financial infrastructure, and implementing a new, centralized approach to supervision that better supports identification and analysis of interconnected risks. These changes are intended to ensure that we fully employ our expertise to implement a more systemic and effective approach to our supervisory activities going forward.

The Benefits to Effective Supervision of the Federal Reserve's Unique Expertise

Two important lessons learned from the current financial crisis are that all financial firms that are so large and interconnected that their failure could threaten the functioning of the financial system must be subject to strong consolidated supervision; and that supervision of financial firms must take account of systemic, or “macroprudential” risks as well as the more traditional safety-and-soundness risks affecting individual firms.

Many of the large, complex, and interconnected financial firms whose collapse contributed importantly to the financial crisis avoided the more stringent consolidated supervision that is imposed on bank holding companies by the Federal Reserve. These firms--which included American International Group, Washington Mutual, Countrywide, Bear Stearns, and Lehman Brothers--were instead subject to consolidated supervision under statutory or regulatory schemes that were far less comprehensive than that applicable to bank holding companies. In addition, an unregulated shadow banking system (including, for example, unregulated mortgage brokers, structured investment vehicles, other asset-backed commercial paper conduits, and securities lenders) had emerged that generated mortgages for distribution, funded highly rated senior tranches of securitizations, and engaged in maturity transformation and other financial activities outside the view of any federal supervisor.

The system for regulating bank holding companies was, in important ways, inadequate as well. One issue of concern was that the Federal Reserve's consolidated supervision of such companies was, by statute, both narrowly focused on the safety and soundness of their bank subsidiaries and heavily reliant on functional supervisors of the bank and regulated nonbank subsidiaries of these companies; in turn, the functional supervisors themselves were statutorily focused only on the safety and soundness of the specific entities they regulated. None of the federal regulators had sufficient authority to focus on the systemic risk that large banking organizations posed.

While it is clear that the framework for financial supervision must address macroprudential risks, the Federal Reserve cannot and should not be responsible for oversight of the financial system as a whole; no agency has the breadth of expertise and information needed to survey the entire system. However, by virtue of the combination of experience and expertise it has developed as consolidated supervisor of bank holding companies and state member banks and as a central bank, the Federal Reserve is well suited to contribute significantly to an overall scheme of systemic regulation, particularly in the areas of consolidated supervision and macroprudential supervision.

It is especially important that consolidated supervision address *both* safety-and-soundness risks at individual institutions and macroprudential risks. Addressing safety-and-soundness risks requires the traditional skills of bank supervisors, including expertise in examinations and offsite surveillance of complex banking organizations. The Federal Reserve has acquired and maintained that expertise as the primary supervisor of banks of all sizes, including community banks, regional banks, and large banks that are state-chartered member banks, as the consolidated supervisor of all U.S. bank holding companies, and as the supervisor of the U.S. operations of globally active foreign banks. With many nonbank financial firms having reorganized as bank holding companies during the crisis, the Federal Reserve already is quite familiar with the risk profiles of the vast majority of the large interconnected financial firms.

Beyond traditional bank examination expertise, however, macroprudential supervision will require economic sophistication, including knowledge of the macroeconomic environment, as well as substantial

expertise regarding money markets, capital markets, foreign exchange markets, and other financial markets. Expertise in these areas is essential for developing stress scenarios and identifying and addressing vulnerabilities to, and posed by, capital and other markets. The Federal Reserve has developed this expertise in the context of macroeconomic forecasting and monetary policymaking. Market knowledge is acquired through daily participation in financial markets to implement monetary policy and to execute financial transactions on behalf of the U.S. Treasury and foreign governments and central banks.

Macroprudential supervision also requires extensive knowledge of payment and settlement systems to understand the interconnections between financial institutions and markets. The Federal Reserve has developed this expertise through its operation of some of the world's largest payment and settlement systems (the Fedwire funds and securities transfer systems), its supervision of key providers of payment and settlement systems (the Depository Trust Company, the CLS Bank, and the government securities clearing banks), and its long-standing leadership role in the international Committee on Payment and Settlement Systems.

The Supervisory Capital Assessment Program, or SCAP, also known as the stress test, was critical to restoring confidence in the banking system and was a watershed event for modern macroprudential supervision. The Federal Reserve, which took the lead on the SCAP, drew on its macroeconomic and markets expertise to model potential credit losses and revenues at the SCAP banks. These analyses were essential to assess the amount of capital the SCAP banks would need to absorb potential losses and continue to meet the needs of creditworthy borrowers in a more adverse economic scenario. In the future, macroprudential supervision should feature both increased use of cross-firm, horizontal exams to assess common exposures and vulnerabilities as well as forward-looking stress testing based on alternative projections for the macroeconomy.

The Benefits of the Federal Reserve's Supervisory Role for Its Other Central Banking Functions

The Federal Reserve's central banking functions significantly enhance its ability to conduct its supervisory role, and offer considerable benefits for macroprudential supervision going forward. In addition, the complementarity between narrow central banking activities and supervision creates advantages in the other direction. The Federal Reserve's involvement in supervising banking institutions of a variety of sizes generates information and expertise that significantly improve the Federal Reserve's ability to effectively carry out its central-bank responsibilities and that cannot be obtained reliably through other means, such as relying on reports from other supervisors. Among the central-bank responsibilities that benefit from the Federal Reserve's supervisory role are crisis management, providing liquidity to depository institutions, and monetary policy. Especially since the start of the crisis in the summer of 2007, the information and expertise that the Federal Reserve has had as a result of its supervisory activities have been essential to its successful performance of these responsibilities.

Crisis Management

The Federal Reserve's supervisory authority has been of greatest importance to its management of financial crises. In particular, its ability to deal with diverse and hard-to-predict threats to financial stability depends critically on the information, expertise, and powers that it has by virtue of being both a bank supervisor and a central bank.*

An example of how the Federal Reserve's supervisory role contributed to its management of a crisis came in the context of the October 19, 1987, stock market crash. During that chaotic period, banks began to pull

back from lending to major securities firms. However, because of increased demand for financing from their customers and the differences in the timing of payments to and receipts from the exchanges' clearing and settlement systems, those securities firms needed access to substantial bank credit in order to make payments and settle trades. As a result, the availability of bank credit was critical to the functioning of equity and securities markets as well as futures and options exchanges. A freezing up of these critical markets would have caused a deeper and more disruptive financial crisis, likely involving further declines in asset values and, ultimately, tighter credit conditions for households and businesses. To combat those risks, the Federal Reserve announced its willingness "to serve as a source of liquidity to support the economic and financial system." Subsequently, Federal Reserve examiners on-site in major banking organizations assessed funding pressures and potential credit losses to help identify emerging problems. Armed with the resulting knowledge and with the benefit of existing supervisory relationships, senior Federal Reserve officials contacted the managements of the major banks and urged them to use liquidity from the discount window to provide loans to creditworthy securities firms. Bank credit was provided to securities firms as requested, allowing those firms in turn to make required payments to counterparties and clearing houses.

These actions allowed systemically critical stock, futures, and options exchanges to function normally, averting a more prolonged and deeper market crisis with its attendant adverse implications for the broader economy.

A similar example emerged in the case of the failure of Drexel Burnham Lambert in February 1990. Drexel's rapid collapse posed a risk of gridlock in the financial markets. Notably, because of their parent's failure, Drexel's solvent broker-dealer and government securities dealer subsidiaries experienced serious difficulties liquidating their positions. Because of its ongoing supervisory relationships with the banks that provided settlement services to Drexel's subsidiaries and its knowledge of the payment and settlement system's infrastructure, the Federal Reserve had the access, contacts, and in-depth knowledge that enabled it to obtain the information it needed to evaluate this complex problem and formulate a plan to address it. The Federal Reserve understood the potential problems of Drexel's counterparties and clearing banks and was able to work with the banks and securities firms to identify developing problems and fashion procedures that enabled an orderly winding down of Drexel without adverse effects on other market participants or further disruption to financial markets.

In the aftermath of the September 11, 2001, terrorist attacks, supervisory information and supervisory powers to compel the provision of information allowed the Federal Reserve to understand the damage incurred by, and estimate the recovery time for, a large banking institution that played a major role in key financial markets. Following the attacks, Federal Reserve examiners were sent to the institution's contingency site. This on-site supervisory presence proved crucial in helping to obtain necessary information and clarify conflicting information in a highly confused and uncertain situation. Similarly, on-site Federal Reserve examiners at other key institutions proved to be valuable sources of information about the difficulties those institutions were facing. With this information in hand, senior Federal Reserve policymakers took the lead in assessing the damage to specific financial institutions and the implications for the government securities market and in taking remedial actions--including the provision of liquidity by the Federal Reserve--to restore financial market functioning relatively quickly. The ability of the Federal Reserve to respond promptly and effectively mitigated the adverse effects on broader financial conditions and the national economy of those tragic events.

During the current crisis, the Federal Reserve's supervisory role has not only given it timely access to

information about the banking sector, payments systems, and capital markets, but also has been essential to its understanding of the emerging strains on financial firms and their possible implications for financial markets and the broader economy. This information has been critical to the Federal Reserve's efforts to identify the difficulties facing depository institutions of all sizes and to take steps to address those problems. In particular, over the course of the crisis, the Federal Reserve has used supervisory information to monitor the liquidity needs of banking organizations in response to the disruptions in a range of short-term funding markets and mounting market pressures on firms perceived to be in a weak financial condition. This information allowed the Federal Reserve to take steps to address pressing liquidity needs with monetary policy and lending programs, thereby avoiding larger dislocations in financial markets and an even greater deterioration in economic conditions--which the Federal Reserve continues to monitor.

The Federal Reserve's supervisory information also contributed importantly to the design of a number of Federal Reserve credit programs. In particular, the development of the Primary Dealer Credit Facility was greatly aided by the understanding of the triparty repurchase agreement (repo) market and the information regarding its functioning that the Federal Reserve had as a result of its supervision of the banking organizations that handle the clearing and settlement of such transactions. In addition, its understanding of the workings of the credit markets along with its involvement in the supervision of banking institutions helped motivate the Federal Reserve's decision to implement the Term Asset-Backed Securities Loan Facility, which is a broad-based facility that provides liquidity to support auto lending, small business lending, credit card lending, student loans, and commercial real estate lending. The Federal Reserve's credit programs provided significant support to key financial institutions and markets, easing the impact of the financial crisis on the economy.

Liquidity Provision to Depository Institutions

Supervisory information and expertise also contribute to the Federal Reserve's management of the risks that it confronts in its role as liquidity provider to depository institutions, large and small--a critical central-bank function. Reserve Banks must be able to assess the financial condition of the institutions that want to borrow from the Federal Reserve and must be able to assess as well the quality and value of the collateral pledged by borrowing institutions. Active involvement in supervising financial institutions contributes significantly to such assessments because they require substantial knowledge of banking practices as well as the expertise gained from the hands-on review of loans and other assets at banking organizations. In addition, the Federal Reserve's assessment of the condition of an institution or the quality of its collateral may differ from that of other supervisory agencies.

Monetary Policy

The information that the Federal Reserve obtains in its supervisory role has been useful for the making of monetary policy, especially in periods of financial stress. For example, in the early 1990s, the Federal Reserve recognized that elevated loan losses were putting pressure on bank balance sheets, thereby contributing to very weak bank lending that was weighing on spending by households and businesses. In this context, mounting evidence of tightened lending standards and credit concerns at banks, much of it gained through the supervisory process, contributed to the Federal Reserve's decision to ease the stance of monetary policy more aggressively than it otherwise would have.

Supervisory information has played a particularly important role in monetary policymaking since the outbreak of the financial crisis in the summer of 2007. As the crisis intensified, supervisory information helped the policymaking Federal Open Market Committee (FOMC) to understand the extent of the

dislocations in credit markets and led the Federal Reserve's monetary policy response to the crisis to be more timely and decisive than it otherwise might have been. For example, Federal Reserve staff calculated estimates of potential aggregate credit losses under alternative economic scenarios and drew on supervisory information and expertise to evaluate implications for the health of the banking system. This work helped the FOMC to assess the risks to the financial system and the economy arising from worsening credit conditions and to take such risks into account in its policy decisions.

More broadly, information and expertise obtained as a result of the Federal Reserve's supervisory role have been reflected in FOMC meeting discussions of economic conditions and the outlook. Supervisory staff has attended these meetings during the crisis, and in these discussions there have been regular references to information about banking institutions gained both from examination staff and from industry contacts resulting from the Federal Reserve's supervisory role. This information has contributed to the Committee's understanding of likely loan losses, the effects of such losses and other factors on bank lending behavior, and their implications for economic activity. Moreover, given the global nature of the financial crisis, the Federal Reserve's interactions with supervisors abroad, which reflect its role as a U.S. supervisor, have provided helpful information on the health of key foreign banking firms, allowing the FOMC to judge more accurately the likely strains on U.S. financial firms and markets emanating from outside the United States.

The Federal Reserve faces challenging decisions regarding the timing and pace of the exit from the considerable monetary accommodation put in place during the crisis. These critical policy decisions will require particularly careful assessments of developments at financial institutions and in financial markets, and their resulting implications for the real economy. For example, losses on commercial real estate loans may continue to undermine some community and regional banks and will have uneven effects across different regions of the country. At the same time, however, the improving economy may strengthen the balance sheets of other banks and conditions in many financial markets may continue to improve. Information from the supervisory process will help policymakers to assess overall credit conditions and the stability of the financial sector, and so to time appropriately the shift to reduced policy accommodation.

Could the Federal Reserve Obtain What It Needs from Another Supervisor?

A natural question is whether the Federal Reserve could obtain the supervisory information and expertise it needs for its central-bank responsibilities from other agencies. While it seems clear that this is possible to some extent--indeed, the Federal Reserve obtains information regarding the firms to which it lends from their primary supervisors--elimination of the Federal Reserve's role in supervision would severely undermine the Federal Reserve's ability to obtain in a timely way and to evaluate the information it needs to conduct its central banking functions effectively.

First, active involvement in supervision ensures that the Federal Reserve will have experts on its staff with significant knowledge of banking practices and financial instruments gained from the hands-on review of banking organizations and their operations, practices, activities and balance sheets. This expertise is critical to making effective use of information about financial firms and cannot be quickly created when needed. For example, without staff expertise in bank lending practices and evaluating bank asset quality, the Federal Reserve would be unable to assess independently and rapidly the condition of borrowing institutions and the value of the collateral they pledge at the discount window. This capability has been especially valuable since the Federal Reserve began providing credit at longer maturities during the crisis. Indeed, in some cases, it has been necessary for the Federal Reserve to deploy supervisory

experts to provide up-to-date assessments of the condition of borrowing firms and to evaluate the collateral they were providing. Owing in part to the supervisory expertise it has been able to bring to bear in its discount window operations, the Federal Reserve has maintained its record of never bearing a loss on credit it has extended to depository institutions, despite the spike in such lending to more than \$500 billion in early 2009.

Second, obtaining information from another agency would be slower and more cumbersome than obtaining it directly from financial firms. Information provided by other supervisory agencies may be stale or incomplete, particularly in a crisis, when the condition of institutions and the value of collateral can deteriorate rapidly. An independent supervisor would have its own concerns and priorities on which its supervisory staff would naturally focus, slowing the Federal Reserve's access to information in other areas. Even if the supervisory agency's staff were willing and able to provide assistance, the back-and-forth process in which the Federal Reserve must explain exactly what is needed, evaluate the information that is received, and return to the supervisor with clarifying questions and requests for additional information could slow the process appreciably.

Finally, having the legal authority to directly obtain information--through on-site examinations or otherwise--can prove critical to understanding and responding quickly to a financial crisis. While in some cases financial institutions that the Federal Reserve does not supervise may be willing to provide information to the Federal Reserve on a voluntary basis, in other cases they have not been willing, and there is no guarantee that they will be willing in future crises. For example, senior managers with relevant knowledge about the nature of the problems facing an institution or arising in financial markets may well be focused on those problems and therefore might not want to meet with, or provide information to, the Federal Reserve in a timely manner unless the Federal Reserve had the supervisory authority to require them to do so. Also, an institution may not readily recognize or acknowledge the possible adverse effects of its actions for other market participants or the financial markets and economy more generally, or it may expect the authorities to deal with such adverse effects. In such cases, it can be essential for the Federal Reserve to have the ability to compel the disrupted institution to provide timely information that would assist the Federal Reserve in addressing the crisis through its monetary policy, lending, and other policy and operational tools.

Besides the experience at the Federal Reserve, international developments suggest that a central bank role in supervision can be important. For example, many have suggested that the problems with Northern Rock in the United Kingdom were compounded by a lack of clarity regarding the distribution of powers, responsibilities, and information among the Bank of England, the U.K. Financial Services Authority, and the U.K. Treasury. In response, the Bank of England was given statutory responsibilities in the area of financial stability, its powers to collect information from banks were augmented, and many have called for it to be given increased supervisory authority. In the European Union, a new European Systemic Risk Board is being established under which national central banks and the European Central Bank will play a central role in efforts to protect the financial system from systemic risk. More broadly, in most industrial countries today the central bank has substantial bank supervisory authorities, is responsible for broad financial stability, or both.

Steps the Federal Reserve Is Taking to Strengthen its Regulatory and Supervisory Performance

Supervision by financial regulators, including the Federal Reserve, clearly had significant shortcomings in the period leading up to the financial crisis. Among other things, regulators did not insist on sufficiently strong and comprehensive risk management by private firms, and inadequate attention was

paid to the risks that could arise from the interactions of firms and markets, such as the collective dependence of many firms on similar wholesale funding sources or hedging strategies. The Federal Reserve has been and continues to be engaged in an intensive self-examination of its supervisory functions with two objectives: to address weaknesses in its supervisory function that became apparent as a result of the financial crisis, and to become a better supervisor in an environment that requires supervisors to be attentive to macroprudential as well as individual-institution safety-and-soundness risks.

The Federal Reserve is seriously engaged in measures to strengthen its regulatory and supervisory performance. For example, working through the Basel Committee on Bank Supervision and the Financial Stability Board, the Federal Reserve has played a key part in efforts to ensure that systemically critical financial institutions hold more and higher-quality capital and employ more robust liquidity management. The Federal Reserve also played a key role in international work to ensure that banks use compensation structures that provide appropriate performance and risk-taking incentives. Domestically, it has taken the lead in addressing flawed compensation practices, issuing proposed guidance that would require banking organizations to review their compensation practices to ensure that they do not encourage excessive risk-taking, are subject to effective controls and risk management, and are supported by strong corporate governance, including oversight by their boards of directors.

In the fall of 2008, the Federal Reserve updated its guidance on consolidated supervision, reaffirming the importance of such supervision, particularly for large complex firms, and emphasizing the importance of bringing a macroprudential perspective as well as an individual institution safety-and-soundness perspective to consolidated supervision. Of considerable importance, the Federal Reserve has taken steps to ensure that, when risk-management shortcomings are identified, its supervisors hold managers accountable and make sure that weaknesses receive proper attention at senior levels and are resolved promptly. This requires routinely and promptly communicating important supervisory concerns to the highest levels of bank management, including through more frequent involvement of senior bank managers and boards of directors and senior Federal Reserve officials. This approach proved especially effective during the SCAP and in other circumstances when clear expectations for prompt remediation were forcefully communicated to large banking organizations.

The Federal Reserve has also begun to make fundamental changes to its supervision and regulation of large bank holding companies to include a macroprudential, as well as an individual-institution safety-and-soundness, perspective to supervision. For example, the Federal Reserve is developing a program of enhanced quantitative surveillance of large bank holding companies. Enhanced quantitative surveillance combines aggregate economic data, firm-level market-based indicators, and supervisory information to provide a fuller picture of the financial condition of firms, the risks they face, and their potential effects on the broader system. Examples of this approach are the indicative systemwide loss and pre-provision net revenue estimates that were developed for the SCAP and used in the subsequent analysis of Troubled Asset Relief Program redemption requests, and the firm-specific loss and revenue estimates that were developed by combining these systemwide estimates with supervisory information. The Federal Reserve is working with other domestic and international regulators and market participants to overcome the collective action problems that often plague efforts to strengthen market infrastructure. Since 2005, the Federal Reserve has been leading efforts by market participants and domestic and international regulators to strengthen the infrastructure of the credit derivatives and other over-the-counter derivatives markets. While further progress is needed, without the progress that was achieved since 2005, the failures of major dealers and defaults by some of the very largest names traded in the credit derivatives markets

surely would have been far more disruptive than they were. Likewise, this year the Federal Reserve took the lead in organizing a private-sector group that is developing recommendations for cooperative measures to strengthen margin and settlement practices in the triparty repo markets.

The Federal Reserve is also making changes designed to fully employ its expertise to effectively supervise large banking firms. The new supervisory framework will better accommodate a macroprudential orientation that goes beyond the traditional focus on individual institutions and better supports the identification and analysis of interconnected risks and sources of financial contagion. The new approach will implement a more centralized approach to the supervision of large, complex banks that are potentially systemically important.

In particular, strategic and policy direction for the supervision of large, complex financial institutions will be coordinated through a newly formed multidisciplinary committee led by senior officers representing various functions at the Board and Reserve Banks. Supervisors, economists, and market specialists, combined with officials responsible for quantitative surveillance activities, will define supervisory priorities and examination plans for large, complex banking organizations. Supervisory teams will be constructed around portfolios of firms with similar business lines and risks, and cross-firm examinations will consider interconnected risks, such as spillover and feedback effects.

As in the SCAP, representatives of primary and functional supervisors will be fully integrated in the process, participating in the planning and execution of horizontal exams and consolidated supervisory activities. As was evident in the recent crisis, interconnected risks can span several operating entities. Subprime mortgage exposures, for example, were dispersed across mortgage banks, broker-dealers, and off-balance-sheet vehicles, as well as insured depositories. Effective supervision of complex holding company structures must involve greater coordination among consolidated and functional supervisors and an integrated assessment of risks across the holding company, including bank and nonbank subsidiaries.

While supervisory authorities here and abroad are still developing the tools and instruments needed to fully implement a macroprudential approach to supervision, recent experience has shown that such an approach is critical to avoiding financial imbalances that can result in severe financial and economic dislocations. The Federal Reserve will continue to strengthen its supervisory efforts and to learn from events as they unfold, with the goal of doing all in its power to identify and address risks that may imperil the financial system.

** In addition to the examples discussed here, the Federal Reserve has taken steps to address strains at financial institutions and in financial markets on a number of other occasions in recent decades, including following the bankruptcy of the Penn Central Railroad in 1970, the collapse of a speculative boom in the silver market in 1980, the failure of Continental Illinois in 1985, and the global financial strains that followed the Russian default and the collapse of Long-Term Capital Management in 1998. See Andrew F. Brimmer (1989), "Distinguished Lecture on Economics in Government: Central Banking and Systemic Risks in Capital Markets," *Journal of Economic Perspectives*, vol. 3 (Spring), pp. 3-16; and Ben S. Bernanke (2007), "Central Banking and Bank Supervision in the United States," speech delivered at the Allied Social Science Association Annual Meeting, Chicago, Ill., January 5, <http://www.federalreserve.gov/newsevents/speech/bernanke20070105a.htm>*

Attachment: Speech by Chairman Volcker

REMARKS BY PAUL A VOLCKER
AT A LUNCHEON OF
THE ECONOMIC CLUB OF NEW YORK
NEW YORK, JANUARY 14, 2010

THE ROLE OF THE FEDERAL RESERVE
IN A NEW FINANCIAL ORDER

Twenty months have passed since I last addressed the Economic Club of New York. The sudden demise of Bear Stearns had happened only a few days before. That event, and the market turbulence that accompanied it, had already justified labeling what had seemed a containable sub-prime mortgage crisis as the "mother of all crises".

The events of the Fall of 2008 drove the point home. For a few weeks the whole financial world seemed to be tottering on the edge of a nervous breakdown. Only aggressive intervention by the Treasury and the Federal Reserve in this country, and similar initiatives in the U.K. and in other parts of Europe, restored even a precarious sense of stability. Those actions by the national authorities went far beyond the established role of central banks as lenders of last resort. Several trillion dollars, in substantial part budgetary funds, were spent in the United States to support markets and financial institutions, bank and non-bank. In effect, institutions and markets that had been proud and profitable exemplars of modern finance became wards of the state, de facto if not de jure. In sum, the world of finance was turned upside down.

By now, there are signs of return to more normal conditions. The economy seems to be slowly growing. Large banks, emerging from Government support and benefitting from the flood of liquidity are reporting large operating profits. Real progress is being made in restoring capital ratios even as loan losses continue. Risk premia seem more normal. Funds are flowing, if not yet in all markets at needed volume.

In the circumstances, some market participants, possibly some in this room, seem to be suggesting that the events of the past couple of years were like a bad dream - a truly unsettling bad dream, but nonetheless something that in the cold light of day need not require a really substantial change in the structure of markets or corporate life style. Better board oversight, a tightening of institutional risk management practices, more adequate capital and liquidity standards, better informed and abler regulators, a review of credit rating practices, certainly more sensible and uniform accounting

practices - the sort of thing I characterize as "reform light" should be adequate to do the job.

But surely the need is more fundamental. This latest crisis has been cited as a once in a century - or maybe once in a generation - affair. But do not forget it is only the latest in a string of crises over the past 30 years that seemed to be growing in both frequency and intensity. Even more significant, the forceful official responses necessarily were undertaken in the white heat of crisis, without the luxury of time or the benefit of established emergency procedures and financial resources. We are left with a residue of really fundamental questions about the appropriate role of government in rescuing failing institutions and markets. The old questions colloquially described as "too big to fail" loom larger than ever.

I don't think in the light of all that has happened that we can escape dealing more clearly with the question of moral hazard. That is the elephant in the room - or perhaps I should say in the halls of Congress. It is not going to go away. Unless we can develop a reasonable, well understood approach, then all these other reforms - all those potentially useful efforts to improve financial housekeeping - won't provide the reassurance we need.

My sense is that the Administration, the Congress and other national authorities, have a common interest in achieving an intellectually satisfying and workable consensus. Given the inherent complexity and different national and private interests at stake, as well as the competing Congressional priorities, the fact that the process has taken time is understandable. It is important that we get it done, and get it done right. All the interests refusing to recognize the need for real change must not hold sway.

Illustrative of the resistance is the push back against the Administration's efforts to work toward fail-safe procedures for the clearing and settlement of derivatives and to insist on greater responsibility in sponsoring collective debt instruments.

I have not been restrained in recent weeks and months in setting out my own view on what I perceive to be one key element in strengthening the financial structure. My starting point is that for all the innovations in the market, commercial banking organizations are still the indispensable backbone of the financial system. Today they comprise almost all the institutions of truly systemic importance. In recognition of that fact, I do not think the United States or other countries should or will eliminate the basic "safety net" for commercial banks - deposit insurance and access to a lender

of last resort balanced by appropriate regulation and close supervision. But I also believe we ought to recognize that some areas of finance, as well as ownership ties with commercial firms, are inappropriate for banking.

I have cited, in particular, hedge funds, private equity funds, and proprietary trading in that respect. The point is that they present added risk and virtually unmanageable conflicts of interest with more essential customer relationships. Those market oriented activities are appropriate for our broader capital markets, but should not, implicitly or explicitly, be provided safety net support. I also believe that very few of the institutions engaged in those activities are systemically important.

Instead of bringing these activities and the capital market institutions within the safety net, a special new "resolution authority" should be created, a point the Administration has consistently advocated. That authority should be empowered to take control of financial institutions that are approaching failure, arranging as appropriate either an orderly liquidation or merger. In no case should that amount to a "rescue" in the sense of protecting either management or stockholders; some creditors would be at risk as well if assets in fact ultimately prove to fall short of liabilities.

This afternoon, I rather want to spend my time on a closely related area of reform that is of critical importance but, surprisingly to me, has become highly controversial. What has been particularly disturbing is the position of some that the Federal Reserve should be largely, even completely, shorn of its regulatory and supervisory responsibilities.

You will not be surprised to hear me say that I reject that view. What seems to me beyond dispute, given recent events, is that monetary policy and the structure and condition of the banking and financial system are irretrievably intertwined. Those reciprocal influences and the interdependence make a compelling case that central banks should have a strong voice and authority in regulatory and supervisory matters.

"I do not want to deny that there are other legitimate public interests in regulatory policy, not least of the finance ministry. Ways and means can be found to bring a variety of points of view to bear. But I would insist that neither monetary policy nor the financial system will be well served if a central bank loses interest in, or influence over, the structure and performance of the financial system.

"The clear challenge for central banks and their colleagues in the regulatory process over the next few years will have to reinforce confidence in the banking system while weaning it away from excessive reliance on official support".

These two paragraphs in my text were the easiest for me to put on paper. In fact, they were lifted word for word from a lecture I gave 20 years ago.

What I want to do is place those old words into today's context.

Only 10 days or so ago, Chairman Bernanke made the relevant point. If we are concerned about identifying and dealing with financial bubbles - and I think we should be - we need both the ability to identify the danger points and have the instruments to deal with them. We might debate the extent to which the blunt instrument of monetary policy can and should be brought to bear. But to be timely, to be effective, to act with anything approaching surgical skill, supervisory and regulatory tools are relevant. As appropriate, those tools will need to be coordinated with decisions with respect to monetary policy.

The practical fact is that the Federal Reserve in executing open market operations and acting as Treasury agent is in the financial markets day by day. It is inescapably dependent upon the efficient functioning of those markets. In acting as lender to banks it must know its counterparties, and know them well. At times of crisis, those relationships will be intensified, and we have just been witness to extreme examples of that. A related point is that the Federal Reserve both oversees and participates in the basic payments system; large value payments, domestic and international, routinely pass through its own books.

What other official institution has the knowledge, the expertise, the experience to identify and evaluate market conditions, to judge the risks, protect its own position and act on short notice, overnight if necessary?

The basic structure of the Federal Reserve System is also relevant. It is an elaborate, in some ways cumbersome, organization, deliberately so. It is designed to protect its independence within government, to assure an element of regional participation, and to

maintain contact with financial, commercial and agricultural interests. The fact that it has remained pretty much intact for close to a century itself suggests the genius of its founders.

These days, bestselling books remind us that challenges to that structure, and particularly to the Fed's insulation from political pressure, arise from time to time. The sense of anger about the amounts of funds required to "bail out" both institutions and markets is palpable. But that truly exceptional response to financial crisis - drawing on long dormant emergency powers - was a properly coordinated decision with the Administration, not a misuse of independent authority.

A more limited critique is that authorities responsible for maintaining the safety and soundness of particular banks and financial institutions should not be "distracted" (if that is the right word) by potentially competing objectives of monetary policy. Or conversely, the Federal Reserve, preoccupied with monetary policy will, consciously or unconsciously, not give enough attention to supervision responsibilities. I believe neither point can be sustained. There are times when supervisory and monetary policies must work in harmony.

It simply doesn't make sense, as then Fed chairman Mariner Eccles complained during the Great Depression, that the efforts of the Federal Reserve to ease money be to some degree frustrated by overzealous banking regulators determined to restore bank capital and assure strong lending standards. Nor would it help if banking regulators are reluctant to tighten capital or other supervisory standards of particular institutions at a time of incipient excesses in banking and financial markets more generally.

None of this, to my mind, is an argument for exclusive regulatory and supervisory authority to lie in the Federal Reserve. To the contrary, there is merit to some division of responsibilities. The FDIC, for instance, brings to the table a far flung examiner staff with an immense amount of experience in dealing with troubled banks. Clearly we do not want competition in laxity among a number of regulators closely aligned with particular constituencies. But equally there is a danger that a single regulator may be excessively rigid and insensitive.

There is more than one suitable model for the United States or for other countries. I do insist, however, that whatever the particular model that emerges from the present revision, the central bank should maintain a robust presence with real authority in

regulatory and supervisory matters, a point of view strongly supported by the present Administration.

Recall that the original Federal Reserve Act almost 100 years ago set out in its preamble as one of the main purposes of the new institution "a more effective supervision of banking". In those days, commercial banks, for all practical purposes, were the financial system, and when bank holding companies became significant, Federal Reserve responsibility was extended to bank affiliates.

In practice, those responsibilities have been shared with the Comptroller of the Currency, the FDIC, state agencies, the SEC and some more specialized organizations. Plainly, some consolidation is called for. In considering that needed reorganization, I would remind you that it is the Federal Reserve to which the Congress, successive Administrations, the general public, and not least financial institutions themselves have looked to in times of trouble.

As my predecessors and successors have been well aware, when the crisis breaks, it is their telephone that rings and the ensuing conversations have a great sense of urgency. That has been true whether the emergency was the collapse of the silver market or the Latin American debt crisis early in the 1980's, major bank and thrift institution failures later in that decade, the Asian crisis and an overleveraged hedge fund in the 1990's, more recently troubled investment banks and a foundering mortgage market.

That is not a matter of narrowly defined responsibilities closely defined by law. Rather, it reflects a certain confidence in the central bank as both independent and professionally qualified. It implicitly recognizes the reciprocal influences and interdependencies among institutions and between monetary policy and regulatory concerns that I emphasized earlier.

Of course, there is a further and very tangible consideration: it is the central bank that has financial resources immediately available; if more money is needed, well, that can be created.

What the current crisis has brought to our attention is that concerns about financial stability cannot be confined to a crisis in being. The Administration's proposals for regulatory reform, the recent remarks of Chairman Bernanke, and of many foreign authorities, the G-30 Report a year ago, and many other private analysts have called for arrangements to provide broad oversight of financial markets and institutions - what I term a "systemic overseer".

The point is that there is a functional distinction between broad oversight of the system and enforcing regulatory and supervisory authority over particular institutions. It is concern about the interdependence of those institutions, about trends in leverage and risk management generally, about the framework of markets and the significance of new institutions and innovations for containing (or perhaps amplifying) risks.

The Administration appropriately and strongly has set forth that rationale. While affording a strong regulatory role for the Fed, it contemplates the further oversight role be centered in the Treasury, chairing and staffing a rather large "council of regulators". The alternative, as I see it, is to lodge that responsibility explicitly in the Federal Reserve. That approach would be consistent with the broad responsibilities of the central bank. Operationally it would build upon its experience, its existing professional staff, its strong regional presence, and its tradition of broad consultation with banks and other financial institutions, with the business community and the public at large.

Whatever the particulars, a close relationship among regulatory authorities, encouraged by an advisory council or otherwise, would be essential. The new "overseer" would clearly need adequate authority to collect information. Consideration needs to be given to what elements of regulatory authority beyond the implicitly powerful tool of moral suasion would be needed.

The present crisis has exposed weaknesses in existing approaches of all the regulatory agencies. I am acutely aware that is particularly true of the Federal Reserve itself which, as I see it, carries the broadest responsibilities and has access to the greatest resources. The appropriate response, for all the reasons I have set out, must not be to denude the Federal Reserve of supervisory and regulatory responsibilities. Rather, there must be legislation and reforms to clarify those responsibilities. We need assurance that the regulatory responsibilities will be consistently respected at the top of the institution, by the Board of Governors and by the managements of the regional banks.

Designation of the Federal Reserve as the systemic overseer would itself carry a strong message as to its responsibilities. Within the organization, I do believe there is a clear need for a stronger administrative focus. In that respect, I can only repeat and reinforce the suggestion I made in speaking here more than a year ago that one Board member be designated as Vice Chairman for Supervision with direct responsibility for managing the effort of the entire Fed

System. The position would be subject to Senate confirmation, with a requirement for reporting at intervals to the relevant Congressional committees on the "State of the Financial System". Consistent with the new framework, emphasis on the oversight and supervisory responsibilities of the Reserve Bank presidents should be emphasized.

Looking to the composition of the Reserve Board and the Open Market Committee, I do not believe those bodies should be viewed as a kind of academic conclave to which professional economists have a special entry ticket. Economic training can, indeed, provide a strong analytic focus and an important sense of discipline for central banking. Understanding the significance and limitations of data as they become available, and awareness of inter-connections between market behavior and policies is important. But a profession that has become more and more abstract, abstruse and mathematical, also has limitations in providing insight into human and institutional behavior. The Board will always benefit by some members drawn from business (large and small), from finance generally or banking in particular, and from those with experience in public life. Surely, the regulatory and supervisory staff must attract some of the nation's best talent - certainly professional economists, but also financial engineers, auditors, and risk management experts, ready and eager to accept the challenge of participating in public service.

I will conclude by placing the role of the Fed in a broader setting.

The United States is still the world's largest economy. It has been the exemplar of the benefits of a market system. One hallmark of leadership has been innovative financial markets. The United States is the home of large and active financial institutions internationally. Our influence has been pervasive right around the world.

Now it is clear that leadership can no longer be taken for granted as a kind of birthright carried over from the 20th century. In relative terms, neither our economy nor our financial system has unquestioned dominance. We are plainly overextended in budgetary terms and in our dependence on foreign capital; we resort to the "kindness of strangers" to meet our deficits. The great recession and the collapse of some of our largest and proudest financial institutions have carried an ominous message of vulnerability.

I am confident we can make our way back to a healthy economy and to a strong and stable financial system privately owned and operated. But it is also evident that the simple and essential quality of trust is in short supply whether within our country or abroad.

We must not shrink away from change but accept the need for basic financial reform. In undertaking that job, let us also recognize that this is no time to weaken the role of the one economic institution - our central bank - that has long commanded a sense of respect and confidence not only among Americans but right around the world. Political leaders and market participants alike have looked to the Federal Reserve as guardian of stability of the financial system in general and the dollar in particular.

I do too.

We simply cannot afford inadvertently to undermine that sense of trust.

If you agree I urge you to make your voices heard.