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St. Louis Federal Reserve Board

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From: "Mary.H.Karr@stls.frb.org" <Mary.H.Karr@stls.frb.org>
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Subject: Fw: FedDigest, June 16, 2010: Chairman Bernanke's speech on The Squam Lake Report: Fixing the Financial System

At the Conference on the Squam Lake Report

This document is not an official transcript. The text is selectively drawn from the original and summarized. Full text: http://www.federalreserve.gov/newsevents/speech/bernanke20100616a.htm

The Squam Lake Report is a valuable contribution to the ongoing analysis of the causes of the financial crisis and the appropriate policy responses.

The key questions facing financial regulators (are): How do we strengthen the financial system and its oversight so as to minimize the risk of a replay of the recent financial crisis? And should a crisis occur, how can we limit its economic costs? The report identifies two core principles that should guide us in answering these questions. First, policymakers and supervisors must consider more than the safety and soundness of individual financial institutions, as important as that is; they should also consider factors, including interactions of institutions and markets, that can affect the stability of the financial system as a whole. Supervisors need a macroprudential as well as a microprudential perspective.

The second core principle is that the stakeholders in financial firms--including shareholders, managers, creditors, and counterparties--must bear the costs of excessive risk-taking or poor business decisions, not the public. The perception that some institutions are "too big to fail"--and its implication that, for those firms, profits are privatized but losses are socialized--must be ended.

The Federal Reserve strongly agrees with both of these principles, and both have been important in shaping our views on regulatory reform.

The Squam Lake Recommendations

The Squam Lake Report provides a substantial set of recommendations. Among these are the adoption of a more systemic approach to the supervision and regulation of financial firms and markets; enhanced capital and liquidity regulation for financial firms, particularly for systemically important institutions; improved information collection by regulators and, where possible, the public release of such information; development of a resolution regime that would allow the authorities to manage the failure of a systemically important financial firm in an orderly manner while imposing losses on shareholders and creditors; and significant strengthening of the financial infrastructure, particularly for derivatives contracts. The Federal Reserve has supported legislative changes in all of these areas, and, where possible under current law, has initiated changes along these lines within its own operations.

The Systemic Approach to Supervision

The report correctly notes that most financial regulatory systems throughout the world are designed primarily to ensure the soundness of individual institutions. While this is an important mission, we agree with the report that it is not sufficient. Regulatory agencies must supervise financial institutions and critical infrastructures with an eye toward overall financial stability as well as the safety and soundness of each individual institution and system. A too-narrow focus on the safety and soundness of individual institutions or systems can result in a failure to detect and thwart emerging threats to financial stability that cut across many firms or markets.

A critical building block of a successful macroprudential approach to supervision is a requirement that all systemically important financial firms be subject to consolidated supervision. That is, one regulator must be responsible and able to review the full range of activities of such firms. Before the recent financial crisis, many major financial firms--including Bear Stearns, Lehman Brothers and American International Group--were able to avoid robust comprehensive supervision. In the future, all firms that present systemic risks--regardless of whether they own an insured depository institution--must be subject to a common, comprehensive framework of supervision and regulation. The financial reform bills would expand and strengthen consolidated supervision of firms whose failure would pose risks to the financial system.

The report recommends that a single systemic regulator be assigned responsibility for overseeing the health of the overall financial system and, in particular, that this duty be assigned to the central bank. We agree that the central bank--in the United States, the Federal Reserve--should be extensively involved in the collective effort to promote financial stability. However, giving all macroprudential responsibilities to a single agency risks creating regulatory blind spots. Rather than concentrating all macroprudential authorities in a single agency, we prefer that all regulators be required to routinely factor macroprudential considerations into their supervision, thus helping ensure that risks to financial stability can be addressed wherever they arise.

For similar reasons, we have supported the creation of a Systemic Risk Council made up of the financial supervisors. Such a council would provide a forum for agencies with differing responsibilities and perspectives to share information and approaches, and would facilitate identification and mitigation of emerging threats to financial stability. We believe the council should not be directly involved in rule-writing and supervision. Rather, those functions should remain with the relevant supervisors, with the council in a coordinating role.

At the Federal Reserve we have already taken a number of steps to reorient and strengthen our supervision of the largest, most complex financial firms that we oversee and to broaden our field of vision to incorporate macroprudential concerns. For example, we are increasing our use of cross-firm, horizontal examinations. And we are implementing a quantitative surveillance mechanism and enhanced data collection to further strengthen our supervision of systemic firms.

Enhanced Capital and Liquidity Regulation

As the report notes, minimizing the risk of future financial crises will require tougher prudential standards for financial firms, especially systemically important financial firms, as well as more intensive supervision. Stronger capital and liquidity standards and more-stringent risk-management requirements for larger and more interconnected firms are necessary to reduce the probability that a systemic firm will experience financial distress and so harm the financial system and the economy. Enhanced prudential standards for the largest firms should also reduce the incentive of firms to grow in order to become perceived as too big to fail.

At the Federal Reserve, we are already working both domestically and internationally to increase the quantity and quality of regulatory capital that banks are required to hold, to better link capital standards to the risks that banks face, and to reduce the pro-cyclicality of the regulatory capital and accounting frameworks. All of these changes will enable firms to better withstand adverse systemwide shocks. Reasonable transition periods will be necessary.

We are also working on toughening liquidity requirements. A prominent feature of the crisis was the inadequate liquidity risk-management practices of some major financial firms. Some firms, notably the independent investment banks, relied excessively on volatile, wholesale, short-term funding sources and were overly exposed when those funding markets were disrupted. To better prevent excessive levels of liquidity risk, major financial firms should be subject to explicit, internationally consistent liquidity standards.

Systemically important firms also should be subject to stronger risk-management standards. In addition, firms' incentive compensation programs should promote long-term financial performance and avoid excessive risk-taking.

An Improved Information Infrastructure

Both regulation and market discipline have important roles to play in constraining risk-taking in financial markets; the best outcomes are achieved when these two forms of oversight work effectively together. The report recommends a better system of data collection and aggregation to enhance this partnership. Better data collection would enable regulators to more accurately assess and compare risks across firms, markets, and products. A regulatory requirement to track and report timely, consistent, and fully aggregated data on risk exposures could also promote better risk management by the firms themselves. And increased public disclosure of such data would provide investors and analysts with a more complete picture of individual firms' strengths and vulnerabilities, as well as of potential risks to the system as a whole, thereby facilitating more effective market discipline.

Consistent with this recommendation, the Federal Reserve is expanding its already-extensive commitment to the collection and analysis of financial data. Importantly, attention is being paid not only to the risks to individual firms, but also to potential systemic risks arising from firms' common exposures or sensitivity to common shocks.

Resolution Regime

A recommendation in the report with which we strongly agree is that the government must not be forced to choose between the unattractive alternatives of bailing out a systemically important firm or having it fail in a disorderly and disruptive manner. The government instead must have the tools to resolve a failing firm in a manner that preserves market discipline--by ensuring that shareholders and creditors incur losses and that culpable managers are replaced--while at the same time cushioning the broader financial system from the possibly destabilizing effects of the firm's collapse. Having a method to resolve failing firms safely is necessary if commitments to allow failure are to be credible, which in turn is essential to reverse the perception that some firms are too big to fail.

The financial reform legislation would provide for such a resolution regime.

To help ensure the efficacy of this resolution authority, the financial reform legislation usefully requires each systemically important financial firm to prepare a "living will" that sets out a plan for winding down the firm's operations in an orderly manner--another recommendation in the report. The preparation and periodic review of the plans could be a valuable supervisory tool in preparing firms to withstand distress.

Financial Infrastructure

The report also addresses the importance of a strong financial market infrastructure that includes well-functioning and appropriately regulated central counterparties. Strong infrastructure helps reduce

systemic risk and guards against contagion in times of stress; by contrast, weak infrastructure can increase risk and spawn contagion.

The Federal Reserve has long supported efforts to improve the infrastructure for the clearing and settlement of derivatives and has also encouraged the development of industry warehouse utilities for the collection of trade information on derivatives.

We believe that systemic risk can be reduced in derivative markets by increasing the standardization of contracts and by requiring standardized derivatives to be cleared through well-regulated central counterparties. In addition, it is also critical that relevant financial regulators have access to detailed information on the derivatives markets--including both standardized and customized transactions--so that they can assess the extent to which derivatives trades might concentrate risk or transmit localized or regional shocks throughout the financial system.

The Federal Reserve is also working to improve the infrastructure arrangements in the triparty repo market and the stability of this key funding market.

We support the current legislative provisions that would help ensure that payment, clearing, and settlement systems--including central counterparties--are subject to robust and consistent risk-management standards and do not pose dangers to the financial system as a whole.

Status of Legislation

It appears that final legislation that addresses in some way the great majority of the recommendations in *The Squam Lake Report* could be enacted in the next few weeks.

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