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Remarks by

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Chair

Board of Governors of the Federal Reserve System

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Good morning. I'm delighted to have this opportunity to speak to you today, even though I am unable to be with you in person. I'd like to share a few thoughts about the important issues that the Financial Markets Conference (FMC) is addressing this year. Many of these issues, of course, are ones the FMC has grappled with every year since the crisis, an event which elevated the importance of this gathering and of the vital contributions made by the research and the policy discussion the FMC fosters.

One of those issues is liquidity. Maturity transformation is a central part of the economic function of banks and many other types of financial intermediaries. But as we saw in the crisis, maturity transformation also exposes intermediaries to liquidity risk, particularly when intermediaries are heavily reliant on short-term wholesale funding. In 2007 and 2008, short-term creditors ran from firms such as Northern Rock, Bear Stearns, and Lehman Brothers, and from money market mutual funds and asset-backed commercial paper programs. Together, these runs were the primary engine of a financial crisis from which the United States and the global economy have yet to fully recover.

In response to the crisis, the Basel Committee on Banking Supervision's first task was to strengthen bank capital requirements through the adoption of the Basel III capital accord and, last summer, our domestic rule implementing the Basel III capital requirements in the United States. Strong bank capital rules remain the foundation of bank regulation. But capital requirements as currently constructed are generally based on credit and market risks from the asset side of the balance sheet and from off-balance-sheet transactions. They do not directly address liquidity risk.

Thus, the Basel Committee's second task was to develop new liquidity standards for global banking firms: the Liquidity Coverage Ratio (LCR) and the Net Stable

Funding Ratio (NSFR). The LCR is designed to improve a bank's ability to withstand severe short-term liquidity stress events by requiring banking firms to hold a buffer of highly liquid assets to cover net cash outflows in a 30-day stress scenario. The NSFR is meant to promote resilience over a one-year horizon by requiring banks that hold less liquid assets to fund their activities with more stable sources of funding.

As others have observed, the new Basel liquidity standards address financial stability risks associated with excessive maturity transformation through at least two channels.

First, the new standards insulate banks from liquidity shocks. In the case of the LCR, requiring firms to hold a buffer of highly liquid assets will help to ensure that they have a means of generating liquidity in the event of creditor runs. In the case of the NSFR, requiring firms to use higher levels of stable funding for less liquid assets reduces the vulnerabilities of a firm to structural maturity mismatches. Banking firms that self-insure against liquidity risk in these ways are less likely to need government liquidity support in times of stress.

Second, the new standards provide an incentive for firms to move to more stable funding structures. Under the LCR and NSFR, firms that engage in unstable forms of maturity transformation will be required to maintain buffers of highly liquid assets and use stable funding, both of which will impose costs for the firms. Reducing the amount of maturity transformation they engage in will help firms minimize these costs.

While the LCR and NSFR are important steps forward, they do not fully address the financial stability concerns associated with short-term wholesale funding. These standards tend to focus on the liquidity positions of firms taken in isolation, rather than

on the financial system as a whole. They only apply to internationally active banks, and not directly to shadow banks, despite the fact that liquidity shocks within the shadow banking system played a major role in the crisis. Furthermore, the current versions of the LCR and NSFR do not address financial stability risks associated with so-called matched books of securities financing transactions.

Federal Reserve staff are actively considering additional measures that could address these and other residual risks in the short-term wholesale funding markets. Some of these measures--such as requiring firms to hold larger amounts of capital, stable funding, or highly liquid assets based on use of short-term wholesale funding--would likely apply only to the largest, most complex banking organizations. Other measures--such as minimum margin requirements for repurchase agreements and other securities financing transactions--could, at least in principle, apply on a marketwide basis. In designing such measures, we are carefully thinking through questions about the tradeoffs associated with tighter liquidity regulation that will be discussed at this conference.

While these cost-benefit questions are difficult to answer with either certainty or precision, let me highlight one data point that suggests that there may be net social gains from introducing further reforms to address short-term wholesale funding risks. In 2010, the Basel Committee assessed the long-term economic impact of stronger capital and liquidity requirements for global banks. Factoring in the Basel III capital requirements and the NSFR, the Basel study suggested that tightening risk-based capital and liquidity requirements would, on net, provide economic benefits, and that benefits would continue to accrue at even higher levels of risk-based capital than are part of Basel III.

While it would be a mistake to give undue weight to any one study, this study provides some support for the view that there might be room for stronger capital and liquidity standards for large banks than have been adopted so far.

As the Board continues to weigh such steps to further strengthen the financial system, I expect that conferences like the FMC will continue to be a vital part of the process, providing the ideas, analysis, and debate that will help us make the best possible judgments. Thank you for listening and for this opportunity to be a part of this important conference.