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Remarks on *The Squam Lake Report: Fixing the Financial System*

Remarks by

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at

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The Squam Lake Report--the centerpiece of this conference--is a valuable contribution to the ongoing analysis of the causes of the financial crisis and the appropriate policy responses.¹ I commend the organizers for bringing together an impressive group of scholars both to produce the report and to continue the discussion of these important policy issues at this meeting.

I think we all agree on the key questions facing financial regulators: 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 be among those that guide us in answering these questions. First, financial 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. In the jargon of economists and regulators, supervisors need a macroprudential as well as a microprudential perspective.

The second core principle put forth in the report 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.

¹ Kenneth R. French, Martin N. Baily, John Y. Campbell, John H. Cochrane, Douglas W. Diamond, Darrell Duffie, Anil K Kashyap, Frederic S. Mishkin, Raghuram G. Rajan, David S. Scharfstein, Robert J. Shiller, Hyun Song Shin, Matthew J. Slaughter, Jeremy C. Stein, and René M. Stulz (forthcoming), *The Squam Lake Report: Fixing the Financial System* (Princeton, New Jersey: Princeton University Press).

The Federal Reserve strongly agrees with both of these principles, and both have been important in shaping our views on regulatory reform. We also broadly agree with the narrative of the crisis offered in the report, which discusses, among other things, the role of subprime lending in the housing boom and bust; the structural weaknesses in the shadow banking system, including insufficient transparency and investor overreliance on rating agencies; inadequate risk management by many financial institutions; and a flawed regulatory framework that allowed some large financial firms to escape strong consolidated supervision and gave no regulator the mandate or powers needed to effectively evaluate and respond to risks to the financial system as a whole. Weaknesses in both the private sector and the public sector, in the framework for regulation, and in supervisory execution all contributed to the crisis. The crisis in turn led to a severe tightening of credit, a collapse in confidence, and a sharp global economic downturn.

The Squam Lake Recommendations

What, then, is to be done? *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. In the remainder of my remarks I will elaborate briefly on these recommendations, with particular attention to how they are currently helping shape regulatory reform and the Fed's own regulatory and supervisory activities.

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 authors of the report that it is not sufficient. The failure of large, complex, and interconnected financial firms can disrupt the broader financial system and the overall economy, and such firms should be regulated with that fact in mind. Likewise, the costs of the failure of critical financial infrastructures, such as payments and settlements systems, are likely to be much greater and more widely felt than the costs imposed directly on the owners of and participants in those systems. Regulatory agencies must thus 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. Indeed, the crisis has demonstrated that 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 systemic, or 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 investment banks like Bear Stearns and Lehman Brothers and large insurance companies like American International Group--were able to avoid robust comprehensive supervision. In the future, all firms that present systemic risks--regardless of whether they happen to own an insured depository institution--must be subject to a common, comprehensive framework of supervision and regulation. The financial reform bills that were passed in both the House and the Senate 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. The reasons for this involvement include the central bank's breadth of expertise and its traditional roles in promoting financial stability and serving as a backstop liquidity provider to the financial system. However, giving all macroprudential responsibilities to a single agency risks creating regulatory blind spots, as--in the United States, at least--the skills and experience needed to oversee the many parts of our complex financial system are distributed across a number of regulatory agencies. 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. At the same time, consistent with the report's recommendation that the lines of accountability for systemic oversight be clearly drawn, 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.

Even as the legislative process moves forward, 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, in my view a critical feature of a successful systemic approach to supervision is a multidisciplinary perspective. Our experience a year ago with the Supervisory Capital Assessment Program, or the SCAP (popularly known as the bank stress tests), demonstrated the feasibility and benefits of employing such a perspective. We are working to ensure that our supervision of large banking organizations and financial market utilities makes use of the wide range of skills of Federal Reserve staff, including those of economists, financial market specialists, payments systems experts, accountants, and others, as well as bank supervisors. The SCAP also showed how much can be learned by simultaneous evaluations and comparisons of the practices and portfolios of different firms, rather than focusing on only one firm at a time, as was the supervisory approach often taken in the past. Thus, 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 or otherwise expand their systemic footprint 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. To be sure, reasonable transition periods will be necessary to allow banks to meet these more demanding standards without unduly constricting credit or endangering the recovery.

In addition to enhanced capital standards, we are also working with domestic and international colleagues 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, supported by high-quality management information systems. In addition, supervisors should require major financial firms to structure their incentive compensation programs to 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, and in preparation for possible changes in the regulatory framework, the Federal Reserve is expanding its already-extensive commitment to the collection and analysis of financial data. For example, efforts are

under way to construct better measures of counterparty credit risk and interconnectedness among systemically critical firms. In particular, to better identify potential channels of financial contagion, supervisors are working to improve their understanding of banks' largest exposures to other banks, nonbank financial institutions, and corporate borrowers. We are also collecting data on banks' trading and securitization exposures, as well as their liquidity risks, as part of an internationally coordinated effort to improve regulatory standards in these areas. 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 clear lesson from the events of the past few years--and 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 in both the House and the Senate would provide for such a resolution regime. In both versions, the Federal Deposit Insurance Corporation would be given the authority to manage the resolution of systemically important nonbank

financial institutions in a manner broadly similar to the authority it uses for banks under current law. As noted in the report, a key challenge would be fostering the international cooperation needed to manage the cross-border aspects of such a resolution regime.

To help ensure the efficacy of this resolution authority, the financial reform legislation under consideration in the Congress 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 creation and supervisory review of these plans would require firms and their regulators to confront the difficulties posed by complex legal structures well in advance of the firm’s financial distress, and in some cases could lead firms to simplify their internal structures. While these contingency plans might not actually serve as templates for the resolution of firms that reach the brink of failure, 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. For example, the Federal Reserve Bank of New York was a leader in improving the documentation, settlement, and transparency of

credit default swaps. The Federal Reserve has also encouraged the development of industry warehouse utilities for the collection of trade information on derivatives.

Although individually customized derivatives still have an important place in the financial marketplace, 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 market for repurchase agreements, or repos, also played a prominent role in transmitting risk during the crisis. The Federal Reserve is working to improve the infrastructure arrangements in the triparty repo market and is exploring what other steps should be taken to improve the stability of this key funding market.

Given the important role played by financial market infrastructures, 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

The Congress has made significant progress in each of the substantive areas I have discussed today as well as many others. Indeed, 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. Like you, we will be following legislative developments closely as we continue to plan for and implement reform.

Once again, I appreciate the valuable contribution this group has made to articulating an intellectual framework for transforming the lessons of the recent financial crisis into practical recommendations. I look forward to discussing these issues with many of you in the future.