
Letter from the President

LETTER FROM THE PRESIDENT

Financial Stability: Progress, but More Work to Be Done

Financial stability is central to the Federal Reserve's mission as a central bank. As the recent financial crisis demonstrated so painfully, we cannot achieve our dual mandate of full employment and price stability if financial instability disrupts the availability of credit and other financial services to households and businesses.

In the aftermath of the crisis, the New York Fed has been working with colleagues in the Federal Reserve System, as well as other agencies and regulators in the United States and around the world, to make our financial system more resilient. Our common aim is to strengthen the financial system and improve our capacity to identify, monitor, and mitigate emerging threats to financial stability.

Such threats to financial stability can either emerge from within the financial system itself or arise from external shocks. Both types of shocks can be amplified by vulnerabilities in the system. While it is impossible to predict the nature or timing of all risk events, we can make the financial system less prone to generate excesses and address structural weaknesses that magnify and propagate stress.

Because the United States—and, increasingly, countries around the globe—have a capital markets-based financial system, these efforts

have to take place both at the level of the individual firms under our supervision and at the level of market infrastructures and practices.

In this letter, I will highlight some of the significant and wide-ranging contributions our staff has made to important financial sector reform initiatives over the past year. Since our work is ongoing, I will also highlight components of the overall architecture that are still in need of construction or repair.

A special problem still in the “in need of construction or repair” category is ending what is popularly known as the “too-big-to-fail” (TBTF) problem. The underlying problem is that the potential disorderly failure of a large, complex financial firm can generate significant negative externalities for society—externalities that the firm and its suppliers of capital have no incentive to internalize in advance, unless they are forced to do so by regulators.

By creating a perception that large, complex firms will not be allowed to fail, the TBTF phenomenon risks creating a funding subsidy for such institutions. This is bad not only because it creates an un-level playing field between larger and smaller institutions, but also because it may create incentives for financial institutions to become even larger and more complex, thereby increasing the degree of systemic risk in the financial system.

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In 2012, the Federal Reserve worked with our sister agencies to strengthen . . . financial institutions. . . . As part of the Bank’s ongoing supervisory activities at firms headquartered in our District, we focused on corporate governance, risk culture, and information systems in an effort to bolster the management of these firms and hence the financial system.

TBTF cannot be ended simply by pledging in normal times never to intervene to prevent the failure of large, complex firms. Markets will view this as a “time-inconsistent” statement—one that will be reneged upon if a crisis situation emerges because the cost of a messy failure of a large, complex firm to workers, families, and businesses that had nothing to do with the firm’s own risk taking would be intolerably high.

Ending TBTF requires more than this: it requires reducing the cost to society when large, complex firms fail and eliminating any perverse incentives for firms to become bigger or more systemically important. My view is that we should seek to do this in a way that preserves to the greatest extent possible such social benefits as come with scale and scope in finance.

The New York Fed is committed to doing all that we can within our authority to end TBTF in a way consistent with the public interest and the balancing of social cost and benefit. Aspects of this effort run through much of our execution of the Federal Reserve’s financial stability agenda.

Making Firms More Resilient and More Resolvable

The Bank plays an important role in the Federal Reserve System’s efforts to make the firms under our supervision more resilient and resolvable. Large bank holding companies remain important building blocks of our financial system and are deeply integrated with our capital markets.

Governance, business models, and risk

In 2012, the Federal Reserve worked with our sister agencies to strengthen these financial institutions, thereby reducing the risk of failure. As part of the Bank’s ongoing supervisory activities at firms headquartered in our District, we

focused on corporate governance, risk culture, and information systems in an effort to bolster the management of these firms and hence the financial system.

As we deepen the reorganization of our supervisory activities begun in 2010, we continue to focus on a better understanding of the business models and risks of these firms. This includes challenging senior management and boards of directors to ensure that their risk management practices are strong enough to promote sound decision making throughout the organization—from top to bottom and side to side.

Capital

In the United States and internationally, regulators have focused on raising both the quantity and quality of capital held by major banks, with the aim of making them more resilient. One effort where the Bank has made substantial contributions is the design, modeling, and analysis of the Federal Reserve System’s Comprehensive Capital Analysis and Review (CCAR).

In this year’s CCAR exercise, a substantial number of Bank staff—more than 10 percent of the Bank—contributed to System efforts to promote the development and maintenance of robust, forward-looking capital planning at bank holding companies. The exercise is aimed at ensuring that firms have sufficient capital to continue operations during periods of severe economic and financial market stress. Since firm management—or we, as supervisors—will never be able to identify every emerging risk, it is important to ensure that firms have the capacity to withstand a wide range of negative events, and the CCAR has emerged as one of the Federal Reserve’s most important tools for this resiliency.

Liquidity

In addition to our work on capital assessment, the Bank has been a leader in developing and applying methods of evaluating the liquidity of large financial institutions. Liquidity, like capital, is a bulwark against unforeseen shocks; higher liquidity serves as a buffer so that firms do not have to sell illiquid assets at the first signs of stress.

Led by staff from the Office of Financial Stability and Regulatory Policy and the Financial Institution Supervision Group (FISG), the Bank has contributed to the development of the *liquidity coverage ratio*—a measure of the amount of liquid assets that banks should hold to cover short-term stress. The Bank offered insight on the Basel liquidity reforms through participation in the Basel Committee on Banking Supervision and the Bank for International Settlements’ Committee on the Global Financial System. One of our senior leaders served as the co-chair of the Basel Committee’s Working Group on Liquidity—which was instrumental in the Committee’s establishment of global liquidity standards.

In addition, Bank staff helped direct System efforts on the design and execution of an innovative approach to horizontal liquidity analysis and review, including the evaluation of liquidity risk-management practices as well as liquidity adequacy.

Recovery and resolution planning

No matter how much capital or liquidity a financial institution has, there is always some risk that it will fail. To end TBTF, our goal is to make it so that when a firm does get in distress, the costs to society of a failure are low enough that policymakers do not feel compelled to intervene.

On this front, New York Fed staff are working with our colleagues at the Federal Deposit Insurance Corporation and across the Federal Reserve to strengthen recovery and resolution planning as a discipline for the large financial firms under our supervision. The Bank has committed substantial supervisory and legal resources to the analysis of the “living wills” generated by the largest bank holding companies—statutorily mandated plans for the orderly wind-down of failing financial firms, designed to limit potential risks to financial stability.

This effort has generated significant insights into both the complex interconnections of the largest global banking organizations and the challenges such complexity poses for orderly resolution. While the efforts of our staff have been substantial, much more work remains before the costs of a TBTF institution’s failure can be reduced to a tolerable level.

In this regard, the Bank is working with regulators around the world to determine how the official sector can manage the failure of a cross-border banking organization in a way that does not disrupt the global financial system. Our contributions have included substantial intellectual input on global financial stability work in support of the Financial Stability Board’s Resolution Steering Group.

Making Markets More Stable and Robust to Shocks

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Tri-party repo system

The tri-party repo market is a large and important market where securities dealers fund a substantial portion of firm and client assets. The crisis revealed significant fragility in the tri-party repo system. To help support financial stability in this market in 2012, a cross-bank team including contributors from FISG and the Markets, Risk, and Research groups continued their work with market participants to effect changes in settlement infrastructure. The aim is to help reduce the extension of intraday credit within the tri-party repo market and to improve dealers' liquidity risk-management practices.

To this end, the Bank intensified its direct oversight of market participants to make the infrastructure changes necessary to reduce reliance on intraday credit and worked with broker-dealers affiliated with bank holding companies and foreign banking organizations to improve risk-management practices.

Money market funds

In 2012, the Bank continued to support reform in the money market fund business. The crisis made clear that the monies provided to the money market mutual funds by their own investors are inherently unstable and susceptible to runs in times of panic. Investors in money market funds with a fixed net asset value can take money out on a daily basis at par value,

with no redemption penalty. This can occur even if the money market fund does not have sufficient cash or liquid assets to meet all potential redemptions. This creates an incentive for investors to be the first to get out whenever there is any uncertainty about the underlying value of the assets in the fund. The size of the money market fund sector and its interconnectivity with the rest of the financial system make reform of these vulnerabilities crucial.

While the primary responsibility for implementing money market fund reform lies with the U.S. Securities and Exchange Commission, the Bank provided substantial analysis to policymakers on reform alternatives, with leadership from staff in the Research Group and the Office of Financial Stability and Regulatory Policy. In early 2013, I personally joined with the presidents of the other eleven Reserve Banks to offer our public support for reform in this market.

OTC derivatives

The Bank continues its work in support of stability in the OTC derivatives markets. As the supervisor of the financial institutions most active in the OTC derivatives markets, the Bank understands that resilient and well-functioning OTC derivatives markets are an important component of the financial markets and the broader global economy. In 2012, Bank staff, led by FISG, contributed to efforts to ensure that the derivatives clearance and settlement activities at supervised firms (currently being transitioned to the new regulatory regime under the Dodd-Frank Wall Street Reform and Consumer Protection Act) are being conducted in a safe and sound manner.

Further, the Bank helped advance the Group of Twenty's OTC derivatives reform agenda and collaborated with domestic and international

authorities on a variety of initiatives to support implementation of OTC derivatives reform. Internationally, the Bank co-chaired the Financial Stability Board's OTC Derivatives Working Group, which monitors progress in implementing the Group of Twenty's commitments on central clearing, reporting to trade repositories, and trading on organized platforms. In addition, Bank staff, and particularly Risk and FISG staff, contributed to the Working Group on Margining Requirements of the Basel Committee on Banking Supervision and the International Organization of Securities Commissions, which will soon finalize a policy framework that establishes minimum standards for margin requirements for non-centrally cleared derivatives.

Resiliency in the foreign exchange market

The Bank has special responsibilities for supporting stability and resiliency in the foreign exchange market. This market is the most liquid sector of global financial markets, and the one that generates the largest amount of daily cross-border payments. The Bank led a working group, sponsored by the Basel Committee on Banking Supervision and the Bank for International Settlements' Committee on Payment and Settlement Systems, that revised supervisory guidance on risks linked to the settlement of foreign exchange transactions. The updated guidance expands on and replaces a version published in 2000, covers a broader range of risks, and reflects the significant changes in the foreign exchange market during the past decade.¹ The

guidance serves as a basis for the Bank to facilitate further discussions on sound practices with other regulators and the industry, and will be integrated with the Bank's supervisory program.

Financial market infrastructure

Another area where the Bank provided leadership this year was the strengthening of the financial market utilities, multilateral systems that link financial institutions through the transfer, clearing, or settling of payments, securities, or other financial transactions. Regulators and supervisors are working together to ensure that the utilities have appropriate governance, risk-management practices, and resources. In addition, the Bank is collaborating with regulators to develop an enhanced ability to look at utilities across the Second District in a consistent way and aims to use this "lens" to identify and address sources of systemic risk.²

Again, this aspect of the Bank's work has international dimensions. For example, I served as chairman of the Committee on Payment and Settlement Systems of the Bank for International Settlements through the spring of last year and, together with other Bank staff, worked with central bankers and practitioners around the globe to finalize new principles for financial market infrastructures. These international principles for financial market infrastructures are aimed at substantially raising the bar for resiliency. This effort and other global engagements will help ensure that we are moving toward a more resilient financial system.

We have made significant progress in increasing the stability of the world's financial system, but the task of reforming the system remains incomplete. . . . Much more must be done to ensure that the financial system is robust enough to absorb shocks and still provide the credit needed for economic growth and job creation.

¹ *Supervisory Guidance for Managing Risks Associated with the Settlement of Foreign Exchange Transactions*, published by the Basel Committee and the Committee on Payment and Settlement Systems in February 2013 (available at <https://www.bis.org/publ/bcbs241.htm>).

² As outlined in *Risk Management Supervision of Designated Clearing Entities*, prepared by the Commodity Futures Trading Commission, the Securities and Exchange Commission, and the Board of Governors of the Federal Reserve System (available at <http://www.sec.gov/news/studies/2011/813study.pdf>).

Improved financial stability will also require more collaboration at home and internationally. After the crisis, it became evident that the regulatory and supervisory framework had not kept up with the changes in size, complexity, interconnectedness, and globalization that created growing systemic risk externalities.

Unfinished Business

We have made significant progress in increasing the stability of the world's financial system, but the task of reforming the system remains incomplete and uneven. Much more must be done to ensure that the financial system is robust enough to absorb shocks and still provide the credit needed for economic growth and job creation.

While we must be alert for unintended consequences and open to learning as we go, we must also recognize that changes to the scale and profitability of activities that were artificially inflated by flaws in the system pre-crisis are not unintended—they are necessary and intended consequences of reform.

Living wills and resolution

We have much work still to do to reduce the cost to society of the failure of large, complex financial institutions. This is the key to resolving the TBTF problem. Changes to corporate organization and market practices, along with deep collaboration between regulators in different jurisdictions, will likely be needed to make the orderly resolution of internationally active firms truly credible.

Wholesale funding, market structures, and OTC derivatives reform

While much has been done over the past few years to mitigate the structural flaws that make wholesale funding a point of weakness in the global financial system, some important issues and vulnerabilities remain. Tri-party repo reform still has considerable work to do, including completion of infrastructure reform and better contingency planning by market participants—particularly in the dimension of addressing the nexus of run risk, fire-sale risk, and resulting financial instability.

Going forward, we need to look at the larger issue of the appropriate role of wholesale funding in the financial system. We need to evaluate how comfortable we should be with a system in which critical financial activities continue to be financed with short-term wholesale funding beyond the scope of the type of lender-of-last-resort facility that reduces the risk of runs and asset fire sales that can threaten the stability of the entire financial system.

We also need to press ahead on OTC derivatives reform. The goal is fewer bespoke trades and more standardized trades. If regulators, financial market infrastructures, and market participants make the effort, the financial system will be safer, more resilient, and more transparent. The reforms under way, if properly executed, should over time significantly reduce the shortcomings in the OTC derivatives market that exacerbated the financial crisis.

Collaboration at home and internationally

Improved financial stability will also require more collaboration at home and internationally. After the crisis, it became evident that the regulatory and supervisory framework had not kept up with the changes in size, complexity, interconnectedness, and globalization that created growing systemic risk externalities and widened the wedge between private and social costs in the event of stress.

In a globally integrated financial system, it is essential that we have effective coordination between regulators within and between countries. Such coordination allows us to better respond to crises and to avoid pernicious regulatory arbitrage that can foster excessive risk taking. We can do better through international cooperation and coordination, both

on macroeconomic policy and on regulation and supervision, than by trying to “go it alone.”

In the United States, the creation of the Financial Stability Oversight Council and the implementation of the Dodd-Frank Act strengthen the mandate for coordination across the U.S. regulatory system on financial stability issues. My Bank colleagues and I are also involved in international efforts to secure financial stability. These global efforts align with our efforts at home to strengthen both market infrastructures and the largest financial institutions.

The way forward

The task of securing financial stability will never be truly complete. A dynamic financial system,

in intermediating between savers and borrowers and in allowing for efficient capital formation, will always have the potential to tip toward instability. As central bankers and regulators, we will need to continue the work of watching for symptoms of instability and intervening to correct when things threaten to go awry.

That said, the recent financial crisis carried stiff costs for society and hard lessons for the central banking community. We are on the path to learning from this episode and to addressing our shortcomings—in understanding the vulnerabilities of wholesale funding and in grappling with the complexities and costs of too-big-to-fail institutions. We are not where we need to be yet, but we are determined to get there.

William C. Dudley

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