Welcoming Remarks to the Symposium on Asian Banking and Finance
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By John C. Williams, President and CEO, Federal Reserve Bank of San Francisco
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Risk Management and Macroprudential Supervisory Policies

Welcome to the San Francisco Fed and our beautiful city by the Bay. I want to extend a special greeting to those of you who have come all the way from Asia to join us. I'm sorry that other commitments kept me from joining you yesterday. I'm sure though that Mohamed El-Erian's keynote address set a strong tone for this conference, which is convening at a time of heightened financial uncertainty around the world.

This is the San Francisco Fed's fifth Asian Banking Conference & Symposium. These events are designed to encourage conversation and dialog. Our aim is to provide a forum for a wide range of opinions and to promote the cross-fertilization of ideas by taking advantage of the diversity represented here. Conference participants include financial professionals, financial institution supervisors, consultants, and academics from the United States and Asia. The varied views represented here are particularly helpful to those of us in the Federal Reserve System as we weigh supervisory and monetary policy decisions. Taking part in the debates and discussion at these conferences sharpens our own sense of the issues and helps us make better policy decisions.

These events are also valuable because they provide opportunities for regulators and banking industry leaders to talk in a neutral setting outside the supervisory framework. In that way, the conference can foster the kind of give-and-take on vital financial and policy issues that can't be duplicated within the supervisory relationship itself. The global financial system is

experiencing great stress as it adapts to the new, post-crisis rules of the game. Those new rules are both explicit and implicit. They call for more capital, reduced leverage, lower risk appetites, more thorough supervision, and stronger regulation, at both the systemic and individual institution levels. In this environment, open dialog is all the more important as we collectively reach a common understanding of how the new rules should work in practice.

This year's symposium focuses on risk management in a financial and regulatory landscape transformed by crisis. All of us have been busy digesting the lessons of the crisis of 2007–09. The challenge we now face is to make sure the global financial system is strong enough to weather periods of extreme stress and volatility. On both the public and private-sector side, we have much work to do to restore confidence in the financial system and reassure the public that financial crises can be contained.

Let me take a few minutes to outline some key supervisory policy challenges related to today's more robust enhanced prudential supervision standards. Yesterday you discussed the evolution of regulation in Asia. Of course, Asia is one of the world's most rapidly growing financial markets. Like the United States, it needs regulatory policies that keep up with rapid changes in bank practices and financial markets.

Globally, one of the more contentious areas of regulation concerns new proposed capital requirements aimed at containing systemic financial risk. The key rules in this area apply to systemically important financial institutions—SIFIs— whose failure could harm the broader economy. For these institutions, we must set capital requirements high enough to ensure that failure is extremely unlikely while still allowing enough leverage for banks to provide reasonable returns to shareholders. Another reason for this "SIFI surcharge" is to eliminate the advantage

such institutions enjoy in their funding costs by being perceived as too big to fail. The surcharge makes the playing field between SIFIs and smaller organizations more even. And it provides disincentives for firms to become extremely large, increasing their systemic footprint. Nonetheless, setting an appropriate surcharge is a tough balancing act and these standards are sure to provoke pointed discussion on the part of bankers and supervisors alike.

Let's look at this issue more deeply. How will SIFI managements adjust their business models in the face of higher capital requirements? Either expectations will shift regarding appropriate levels of risk and reward, or business practices will change in ways that accommodate the additional capital charge. For their part, supervisors will have to judge whether such changes are consistent with microprudential standards of safety and soundness for individual institutions and macroprudential standards for containing systemic risk.

Related to these matters is the question of the economic effects of heightened risk management standards and higher capital and liquidity requirements. Although we have thousands of banking organizations in the United States, the U.S. banking sector is highly concentrated in a small group of large and complex financial institutions. As a central banker, I am keenly interested in the potential economic impact of regulatory policy and supervisory actions. Will lower risk tolerance and higher capital and liquidity requirements for SIFIs slow economic growth? How do we balance any such lost growth against the economic damage of a financial crisis? We know economic activity is hurt when credit is hard to get. To what extent will the new rules of the game make credit less available, especially from SIFIs? Will any possible declines in SIFI lending be offset by financing from other sources? The Basel Committee on Banking Supervision has concluded that the expected long-term economic impact of stronger capital and liquidity requirements will be relatively small due to the lengthy phase-in

period and the continuation of current return-on-equity expectations.[1] Still, many variables could potentially alter this outcome, and further analysis is needed to sort out the economic crosscurrents stemming from the forthcoming stricter risk management standards.

Managing systemic financial risk is a challenge of the first order for regulators. By their very nature, the decisions we make as macroprudential supervisors will be hard to get right. I have a great deal of confidence in the experience, judgment, and talent of our supervisors. Nonetheless, systemic supervision is a new endeavor that requires new ways of thinking, new forms of analysis, and new supervisory practices. We will have to make judgments and take action to head off systemic events that are very difficult to see in advance. Bank regulators and economists around the world are working hard on this problem and some promising analytical tools are being developed. For example, regulators are looking at how to determine at what point excess credit flows and relaxed underwriting standards become dangerous. Still, decisions resulting from this macroprudential supervisory framework will be based in part on preventing future events that are inherently uncertain. These decisions will probably be met with criticism not only from the industry, but also from political, business, investor, and consumer quarters. And this process will have effects that won't be fenced off in a single country. With today's interconnected global markets, macroprudential supervisory action in the United States will have repercussions in financial markets around the world.

I'm convinced that timely communication about these policies and practices is critical if we are to get things right. We must explain to the financial sector and the public in clear language when we believe an unsafe situation is developing and how it could potentially lead to a crisis. This implies speaking plainly about the economic costs and benefits of macroprudential

[1] See Bank for International Settlements (2010).

supervision. We now know the extraordinary cost of allowing residential real estate underwriting standards to get too loose during the housing boom years. But the steps taken to tighten lending standards also have a cost. Some borrowers can't qualify for loans, which is one of the factors reducing demand for housing and holding down house prices. It's important to talk about both sides of the coin—the threat represented by a buildup of systemic risk and the cost of policies and practices that contain that risk. The challenge is to design a regime of macroprudential supervision that maintains financial stability and maximizes long-term economic growth.

The Federal Reserve is committed to working with other financial supervisory agencies in the new Financial Stability Oversight Council and with the financial industry to make the macroprudential regime successful. Discussions and dialog at symposiums such as this are part of the process of building a new supervisory approach. This is a new endeavor and we need you to be actively engaged in thinking, talking, and writing about the issues raised by our efforts to stabilize the financial system. So, as you take part in the discussions here, know that you are contributing to the development of a better system of supervision. I am sure that the expertise and talent in this room will contribute to that effort. I hope you that you find your time here to be informative and stimulating, and I hope that it helps you advance risk management disciplines at your institutions. Thank you very much.

Reference

Bank for International Settlements. 2010. "An Assessment of the Long-Term Economic Impact of Stronger Capital and Liquidity Requirements." Basel Committee on Banking Supervision, August. http://www.bis.org/publ/bcbs173.pdf