Presentation to the California Bankers Association, 121st Annual Convention
Dana Point, CA
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For delivery on May 4, 2012

Bank Regulation in the Post-Crisis World[1]

Good morning. It's a great pleasure to be with you at the 121st annual convention of the California Bankers Association. This is my first opportunity as president of the San Francisco Federal Reserve Bank to meet with the CBA. I look forward to continuing the productive relationship we've built between our two organizations over the years. The Fed has been under quite a lot of scrutiny in recent years. One of my goals here is to help improve understanding of what we are doing, both as regulators and monetary policymakers.

During the past 120 years, the banking industry has transformed dramatically. But one thing hasn't changed. Banks rooted in local communities continue to play an essential role in the American economy. Community bankers have detailed knowledge of the people and businesses in their towns, cities, and regions that can't be duplicated by computer algorithms. That makes community banks uniquely suited to serve customers who might otherwise fall through the cracks in the financial system.

The theme of my talk is how the recent housing boom and bust, and the financial crisis and severe recession that followed, continue to affect us. These events have shaped the economic recovery and transformed the regulation of the financial system. I'll start by looking at the role the financial sector played in the crisis. I'll then consider the regulatory response, which

[1] I want to thank Cynthia Course, John Fernald, Maureen O'Byrne, Mark Spiegel, and Sam Zuckerman for their help in preparing these remarks.

is aimed at avoiding another near-breakdown of the financial system. I'll note some of the steps the Fed has taken to help community banks navigate a shifting regulatory landscape. The crisis has also shaped the monetary policy environment. So I'll close by offering my outlook for the economy and my perspective on monetary policy. As always, my remarks represent my own views and not those of others in the Federal Reserve System.

I am highlighting the financial crisis because it remains the backdrop for the way we at the Fed do our job today. Not all recessions start with a financial crisis. But this one emphatically did. Its origins lay in the largest and most dangerous financial bubble of the post-World War II era. From subprime lenders, to Main Street mortgage bankers, to global investment banks, financial institutions got swept up in the euphoria of a housing market in which prices seemed to be on a nonstop ride upward. Many community banks got too deeply involved in construction and land development lending. Suffice it to say, the story ended badly.[2]

Out of this debacle came an all-important lesson: Excesses in the financial system brought us perilously close to economic catastrophe. It is no exaggeration to say that we were on the brink of another Great Depression. Though we avoided the worst, the effects on the economy were severe. Millions of people lost jobs or homes. Many thousands of businesses failed. For the Fed, working the way we did before the crisis is simply not an option. To avoid another disaster, more effective regulation of our financial system is essential.

At the Fed, the fundamental rethinking of bank regulation and supervision began while the storm was still blowing at full strength. The crisis revealed a number of flaws in our system of financial regulation. Some were at the microprudential level—the oversight of individual institutions. But the most critical shortcomings were at the macroprudential level. We didn't pay sufficient attention to the stability of the financial system as a whole. Nor did we fully

[2] For more on the financial crisis and the economy, see Williams (2012).

comprehend the degree to which turmoil in the financial system could wreak havoc on the economy.

We faced the crisis with a regulatory framework left over from the Great Depression, built on a foundation of deposit insurance and Federal Reserve lender-of-last-resort protection. The goal was to indemnify depositors and prevent runs. With this safety net in place, the key role of supervision and regulation was microprudential, that is, to ensure the soundness of banks. The idea was that the stability brought by the safety net and effective microprudential supervision of each institution would protect the financial system as a whole.

Unfortunately our concentration on the safety and soundness of individual depository institutions was wholly inadequate in an age of global interdependency, and when transactions handled by nonbanks dwarfed those in the highly regulated banking system. Gaping holes in regulatory coverage allowed systemically important companies in the shadow banking system to escape oversight. The disasters at Lehman Brothers and AIG demonstrated that we needed a new approach. Specifically, we had to find ways of addressing the problems caused by financial institutions that were "too big to fail," that is, institutions whose failure could have unacceptable systemic consequences. The result, Chairman Bernanke recently said, is that the Fed "reoriented itself from being ... primarily a supervisor of a specific set of financial institutions toward being an agency with a broader focus on systemic stability as well."[3]

I would cite several key lessons learned from the crisis in this regard. First, we needed to identify and apply tougher regulatory treatment to institutions whose failure could jeopardize the financial system as a whole, whether they are banks or nonbanks. Second, truly addressing too big to fail required a credible mechanism to liquidate troubled systemically important institutions

[3] Bernanke (2012).

in a way that didn't endanger financial stability. Third, and more generally, we needed to be forward-looking in identifying and responding to emerging threats.

On the first point, during the crisis, fear of failure of some of our largest financial institutions had catastrophic effects on the financial system and the economy. In crafting a macroprudential regime, we concentrated on the nation's large, systemically important financial institutions—SIFIs in the new regulatory lexicon. Many of these institutions were so tightly connected with other institutions that their failures would have implications far beyond their individual resolution costs. In this way, individual failures could amplify the effects of shocks and potentially become systemic events. For example, if an institution is sufficiently large and interconnected, its failure can trigger abrupt deleveraging by its creditors and counterparties. Such an event can cause widespread declines in asset values. Those in turn can touch off a new round of deleveraging. Financial institutions that seemed to have solid balance sheets may suddenly become vulnerable.

A key milestone came early in 2009 when the Fed and other agencies conducted the first round of stress tests on 19 of the largest banking companies. We examined whether they had enough capital to withstand an even more severe recession than the one then under way. These were mainly microprudential exercises, but they included some macroprudential elements. For example, we assessed whether these institutions would have the capital they needed not just to survive, but to remain effective providers of financial services.

The Dodd-Frank Act, passed in 2010, codified the most important elements of systemic supervision. It creates incentives for systemically important institutions to reduce their size, complexity, and interconnectedness. Bank holding companies with more than $50 billion in

assets are subject to requirements that include tougher capital and liquidity standards, limits on incentive compensation, and development of living wills that provide for orderly liquidation.

Dodd-Frank also created the Financial Stability Oversight Council, including the Fed and other agencies, in part to coordinate the regulation of systemically important nonbank institutions. Last month, the Council issued a rule spelling out how it will identify nonbanks that could potentially threaten U.S. financial stability. It will take into account characteristics such as size, interconnectedness, leverage, and reliance on short-term funding. The new law also helps address the too-big-to-fail problem by allowing troubled systemically important financial institutions to be shuttered. It gives the Federal Deposit Insurance Corporation "orderly liquidation authority" to close such institutions in a way that minimizes spillovers into the financial system.

Another integral part of all financial regulation is the need to be forward-looking. At the microprudential level, book value capital ratios are often lagging indicators of a bank's condition.[4] An adequate assessment of a bank's vulnerabilities must consider not only current capitalization, but also asset concentrations, trading activities, exposures to other institutions, and ability to withstand financial and economic shocks.

The crisis taught us that macroprudential regulation must also be forward-looking in identifying emerging threats to the system. Part of the Oversight Council's charter is to watch for red flags in the financial system, such as excessive growth in credit, leverage, and asset prices. Moreover, a forward-looking macroprudential approach must consider how the financial system is likely to evolve over time. For example, what systemic issues are raised by new financial products, such as complex derivatives?

[4] Tarullo (2012).

The key point about regulation in the post-crisis era is that we need a distinct regime for systemically important institutions. For such institutions, the main public interest is preventing economically damaging financial crises.

Of course, issues such as systemic risk and too big to fail don't apply to community banks. Supervision of smaller financial institutions remains focused on microprudential issues. Dodd-Frank appropriately exempts smaller banks from most of the tests and requirements applied to bigger banks. For example, the Dodd-Frank stress testing requirements only cover institutions with more than $10 billion in assets.

That said, it's important that all of us keep in mind the microprudential lessons of the financial crisis. Bankers and regulators alike need to be forward-looking in evaluating risk, which means asking the kinds of what-if questions that come up in stress tests. For example, in today's low-rate environment, it's very important that all banks evaluate their sensitivity to changes in interest rates. And scenario planning is especially appropriate for community banks with concentrations in particular asset classes, such as commercial real estate. It's particularly important to think through these risks when a bank is considering a capital redemption or return of capital to shareholders.

At community banks, these exercises don't have to rely on complex econometric models. In many cases, a simple spreadsheet will do. The point is that supervisors are looking for community bankers to think along these lines as a regular part of risk management.

I fully recognize that there are costs to increased regulation. In its design and implementation, Dodd-Frank has tried to reduce those costs by focusing on institutions whose operations bear most critically on the stability of the financial system as a whole. However, we understand there could be spillovers and unintended consequences that affect financial

institutions of all sizes. The truth is, there's plenty of uncertainty for all of us about how recent reforms will play out. For that reason, we believe it's essential to clarify supervisory expectations as they take shape. Moreover, we recognize how vital it is for the Fed to consider your views on proposed policies.

That brings me to a critical point: The Fed has always had a two-way dialog with the banking industry. Now, in this period of heightened regulatory scrutiny, it's all the more important that we take full advantage of our lines of communication. Listening to bankers attentively and clearly explaining our supervisory policies help minimize unintended regulatory burdens.

With this in mind, we've taken a number of steps to broaden and deepen our dialog with the industry, particularly the community banking sector. In 2010, the Fed created Community Depository Institutions Advisory Councils, or CDIAC, for each of the 12 Reserve Banks and the Federal Reserve Board. The Councils provide a forum for representatives from smaller banks, credit unions, and savings associations to tell us what's on their minds—not only about local market conditions, but also about supervisory policies. Hearing from bankers makes us better supervisors and helps us understand what's happening on the economy's front lines. Such conversations complement the other information and data I look at in formulating my views about the economy and the policy recommendations I make in the Federal Open Market Committee.

At the San Francisco Fed, we have several long-standing programs that allow us to meet with bankers outside the supervisory context. In our Community Perspectives program, Reserve Bank officers visit senior managers of District financial institutions. The Banker Forum program conducts meetings with small groups of bank CEOs and directors.

Increasingly, we rely on technology to help bankers understand the changing regulatory landscape and emerging supervisory policies. At the national and Reserve Bank levels, we have several telephone and Internet offerings in which officers and examiners discuss supervisory initiatives, sound practices, and red flags they're seeing in the field. Nationally, our most popular programs are Ask the Fed conference calls and the Outlook Live webinar series.

For example, last month, a San Francisco Fed examiner and other Fed experts took part in a discussion of real estate lending in Lexington, Kentucky, before a live and nationwide telephone audience of 1,200 bankers. The discussion covered market conditions and supervisory policies, including debt restructurings, appraisal reviews, and allowances for loan and lease losses.

Of course, the legacy of the financial crisis is much more than a regulatory matter. The crisis has had a profound effect on the economy over the past few years. Monetary policymakers are still dealing with its aftereffects. Let me briefly outline how this is playing out.

Congress assigned the Fed two key goals in conducting monetary policy: maximum employment and price stability. We've done pretty well on our price stability objective. Despite the turmoil of the past five years, inflation has averaged almost exactly the 2 percent rate that the FOMC designated as our medium-run target.

We are still very far from our maximum employment mandate, but things are clearly improving. We have now regained about 40 percent of the 8.8 million jobs lost during the downturn. All the same, the unemployment rate remains far too high.

I am increasingly hopeful that the recovery has entered a phase of self-sustaining growth. Consumer confidence and spending have improved. The manufacturing sector has revived notably, thanks to demand from businesses, households, and overseas customers.

Overall though, the expansion has lacked the vigor of many past recoveries. This is not surprising. Recessions associated with financial crises tend to be more severe and last longer than other downturns, and recoveries from them tend to be weaker.[5] The economy faces significant risks as well. I'll mention two: global economic stresses, especially the European sovereign debt situation, and budget trends at all levels of government in the United States.

As far as global risk is concerned, the euro area's trouble with the debt of many member nations is my biggest worry. Already, the crisis has taken a serious economic toll in Europe. Moreover, events last year showed that financial turmoil in Europe could quickly spread to markets here. European leaders have managed to avoid a blowup for now. But the underlying problem of unsustainable debt hasn't been solved. Even if Europe staves off a renewed financial crisis, the region's economies are likely to struggle for a long while as they carry out wrenching structural reforms and aggressive fiscal austerity measures. This will cut into demand for U.S. exports for some time.

Second, in our own country, budgetary troubles have forced state and local governments to sharply cut spending. At the national level, a number of spending cuts and tax increases are scheduled to kick in at the end of the year, including an end to the payroll tax holiday and expiration of the Bush-Obama tax rate reductions. These abrupt changes, if they occur, could make it harder for the recovery to gain further momentum.

These risks weigh on the economy even if the worst doesn't happen. They cause businesses and consumers to feel uncertain about the economy's prospects. Such uncertainty may prompt entrepreneurs to shy away from hiring and investing, and may make households wary of spending.

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[5] Reinhart and Rogoff (2009) and Jordà, Schularick, and Taylor (2011).

In sum, the economy is doing much better, but is still fragile. On balance, I expect the economy's moderate growth pace to continue. My forecast calls for real gross domestic product to expand about 2½ percent this year and 2¾ percent next year. The unemployment rate is likely to be around 8 percent through the end of the year and a little below that next year. Inflation should be close to our 2 percent target for 2012 as a whole, and somewhat below that in 2013 and 2014, as still-subdued labor compensation growth damps inflationary pressures.

Banking conditions reflect this mixed economic picture. Clearly though, the recovering economy has benefited the industry. Across the nation, banks are returning to health. Stress tests of the nation's largest banking organizations were completed earlier this year. They showed that capital levels at most of these banks would still be adequate, even if the economy went through an extreme, and highly unlikely, downturn.

Smaller banks are in better shape too. Here, in California, where the recession was ferocious, community banks are slowly improving. Many have strengthened asset quality, liquidity, and capital. This is very encouraging.

Loan demand has been weak, but it appears to be picking up as the recovery gains traction. While businesses continue to invest in productivity improvements, they remain cautious about taking on big capital projects. But that may be changing. The aggregate volume of new commercial and industrial loans has been rising slowly, which bodes well for earnings.

At the Fed, of course, we want banks to make soundly underwritten loans. In the 12th District, financially healthy banks with solid balance sheets are generally extending credit in a way that's good for the economy. In the fourth quarter of 2011, loans grew at an annual rate of almost 8 percent among the District's strongest banks—those with a regulatory rating of 1 or 2

on the 5-point CAMELS scale. It's the weaker banks with financial problems left over from the crisis that aren't in a position to expand lending.

What about monetary policy? In terms of the Fed's dual mandate, I expect us to be in line with, or slightly below, our inflation target over the next few years. We're making progress on the employment part of our mandate, but we have a long way to go. Substantial risks remain that could cause the economy to perform worse than I expect. Under these circumstances, it's crucial that we continue our highly accommodative monetary policy.

Of course, very low interest rates won't last forever. As the economy picks up, the Fed will reduce accommodation and begin to raise interest rates. In addition, we will unwind the unconventional monetary policies, which have involved purchases of Treasury and mortgage agency securities.[6] But, that day is still far off.

I realize that low interest rates create a tough operating environment for banks. However, in setting monetary policy, our mandate from Congress is to focus on the economic goals of maximum employment and price stability. Clearly, a solid economic recovery is in the best interest of the banking system as well.

Let me close by reiterating that the economic health of our country depends on strong and vibrant community banks. Close communication with community banks and others in the financial industry will make us better supervisors and better monetary policymakers. If we do our job right, then you are in a better position to do your job right. And doing our job right means that we don't wait to interact until examination time. We hope that you take advantage of our educational and training opportunities, and forums for communication. We need your ideas, suggestions, and constructive criticism. We value our continuing dialog with you.

Thank you very much.

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[6] Board of Governors (2011).

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