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Financial Regulation:

A Post-Crisis Perspective

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Introduction

I'd like to begin by thanking the Brookings Center on Regulation and Markets, and Aaron Klein, for the invitation to speak here today.

I joined the FDIC Board as Vice Chairman in August 2005, and was confirmed as Chairman in November 2012. As a result, I've had the opportunity to serve at the FDIC prior to the recent financial crisis, during the crisis, and during this post-crisis period. I thus have some perspective to offer on this extraordinary period of U.S. financial history and that is my purpose here today.

Much has changed in banking and bank regulation since I started at the FDIC. Yet, I confess to having a certain sense of déjà vu. Banking conditions today are strong and the possibility of a serious downturn anytime soon is generally viewed as remote. That was certainly true during the pre-crisis years as well. If I have one key point to make today, it is that we should guard against the temptation to become complacent about the risks facing the financial system. That, to me, is the key lesson we should learn from the crisis. In my remarks I will outline the experience of the crisis and the post-crisis reforms, and draw on that experience in regard to the situation today and going forward.

Costs of the Crisis

When I joined the FDIC Board in 2005, banks were benefitting from a decade of benign economic conditions, interrupted only by a relatively mild recession in the early 2000s. The FDIC was in the midst of a 2 ½ year period without a bank failure, the longest such period in its history. The number of problem banks was approaching historic lows. Strong loan growth helped insured banks set six consecutive annual earnings records from 2001 through 2006. Banking conditions seemed so favorable that friends asked me at the time if I really wanted to become a member of the FDIC Board—after all, nothing was happening in the banking industry and I might be bored.

In retrospect, it is now clear that we—both the public and private sectors—greatly underestimated the risks we were facing. The economic boom that occurred during the first half of the decade of the 2000s masked a significant buildup of risk in the banking industry. The banking agencies did not appreciate the full extent of these risks, and the bank regulatory

framework did not provide adequate safeguards for financial stability. The activities of financial institutions operating under the pre-crisis rules fueled the housing bubble and contributed to the collapse of the financial system. Examples include the excessive use of financial leverage and inadequate liquidity at a number of large financial institutions, the securitization of large volumes of poorly underwritten mortgages, and the growth of a large and opaque network of credit derivatives backing those securitizations. The confluence of these factors led to the need for taxpayer bailouts on an unprecedented scale.

Our country paid a high price for not recognizing the magnitude of the risks we were facing in the pre-crisis years, and for the weaknesses in the bank regulatory framework. The effects of the financial crisis and accompanying recession on the U.S. economy were profound and nearly catastrophic. Nearly 9 million people lost their jobs, more than 12 million home owners faced foreclosure, and millions of other households remained underwater on their mortgages for many years. Most estimates put the loss of U.S. GDP from the crisis at between $10 trillion and $15 trillion. Without massive assistance from the Federal Reserve, Treasury, and FDIC, things could have been much worse.

Post-Crisis Reforms

In the aftermath of the crisis, the banking agencies implemented a number of prudential reforms to address weaknesses in the regulatory framework. Many—but not all—of the reforms were directed primarily at large institutions. The core reforms address risk-based and leverage capital, liquidity, proprietary trading, margin for non-cleared swaps, and tools to enable the orderly resolution of systemically important financial institutions (SIFIs) to prevent taxpayer bailouts. I would like to touch briefly on each of these reforms.

Capital absorbs losses and reassures counterparties about a bank's viability. It supports a bank's ability to lend and grow prudently, and helps address moral hazard problems by ensuring banks have meaningful equity stakes at risk. The banking agencies strengthened the quality of regulatory capital and the level of risk-based capital requirements. The agencies also required large or internationally active banks to meet an enhanced supplementary leverage capital requirement that accounts for certain off-balance-sheet assets. The strengthened risk-based and enhanced leverage requirements complement each other. Risk-based capital is risk sensitive, but

is also complex and is premised on the idea that the risks facing banks can be reliably measured; leverage capital is not risk sensitive, but is simple and provides assured loss-absorbing capability.

The crisis was also a reminder of the dangers to banks of operating with insufficient holdings of liquid assets, and of excessive reliance on short-term and potentially volatile funds to finance lending and investment activities. There were no regulatory liquidity requirements in effect for large banking organizations before the crisis. The agencies addressed this by finalizing the Liquidity Coverage Ratio rule, or LCR, to require sufficient liquid asset holdings to meet a short-term period of liquidity stress. The agencies have also proposed the Net Stable Funding Ratio rule, or NSFR, to constrain the extent of longer-term funding imbalances between assets and liabilities.

The Volcker Rule addresses certain types of speculative trading and investment activities and reduces the likelihood that federal deposit insurance will subsidize them. As an example, some collateralized debt obligations (CDOs) that were an accelerant to the crisis, such as CDOs backed by derivatives or by other securitizations, would have met the Volcker Rule's current definition of "covered fund." Had it been in place then, the Volcker Rule would have constrained the proliferation of such instruments.

The margin rule is another core reform. The build-up of large, uncollateralized swaps positions between and among large financial institutions before the crisis made the financial system more fragile and interconnected, and contributed to the rapid unraveling of the system that occurred in 2008. The margin rule, which requires the prudent posting of collateral to backstop non-cleared swaps positions, reduces the systemic risks associated with large derivatives exposures.

Systemic Resolution Authority

Another key post-crisis reform is the development of a framework to address the potential failure of a systemically important financial institution.

Broadly speaking, prior to the recent financial crisis, we in the United States—and, fair to say, other major jurisdictions around the world—had not envisioned that globally active, systemically important financial institutions could fail. These institutions, although large and complex, were

considered well-diversified with operations spanning global markets and different business lines, putting them, it was thought, at a low risk of failure. It was assumed that these institutions had ready sources of liquidity and, should problems arise, that they would be able to raise large amounts of equity or debt.

Looking back, it is clear that we were unprepared for the challenges we faced. Lacking the necessary authorities to manage the orderly failure of a SIFI, U.S. policymakers were forced to choose between two bad options: taxpayer bailouts or financial collapse.

Since the crisis, addressing this challenge became a top priority in jurisdictions around the world. It became clear that the financial regulatory structure needed to be strengthened for resolution with defined authorities, designated agencies, and demonstrable operational capabilities and resources.

The Dodd-Frank Act included provisions that addressed these critical gaps in authority in the United States and established a framework designed to ensure that policymakers and taxpayers would not be put in the same position as in the fall of 2008.

Bankruptcy is the statutory first option under that framework. In order to improve SIFI resolution in bankruptcy, the act requires that the largest bank holding companies and designated non-bank financial companies prepare resolution plans, also referred to as "living wills." These plans must demonstrate that the firm could be resolved under bankruptcy without severe adverse consequences for the financial system or the U.S. economy. Living wills have proven enormously helpful to firms and regulators, and they have facilitated significant structural and operational improvements within firms to improve their resolvability.

As an additional and important safeguard, the Dodd-Frank Act created the Orderly Liquidation Authority for circumstances when an orderly failure in bankruptcy might not be possible. This authority allows the FDIC to manage the orderly failure of a firm when failure in bankruptcy might threaten financial stability.

Coupled with the Federal Reserve's Total Loss-Absorbing Capacity—or TLAC—rule, which requires a minimum amount of long-term unsecured debt that can be converted to equity in resolution, these authorities work together to increase the likelihood that financial markets and

the broader economy can weather the failure of a systemically important financial institution; that shareholders, creditors, and culpable management of the institution will be held accountable without cost to taxpayers; and that such an institution can be wound down and liquidated in an orderly way. The fact that the credit rating agencies have lowered the credit ratings of the eight U.S. globally systemic banking organizations (G-SIBs) because of a reduced expectation of taxpayer support in the event of failure is a sign of progress.

Improved resolution mechanisms for the largest financial institutions have not been limited to the United States. Other leading jurisdictions around the world also have enacted expanded authorities for the resolution of their large, complex financial institutions, and we have worked together to foster the cross-border coordination crucial to effective implementation of these tools.

Until we actually execute a resolution using these authorities we should be cautious about bold statements. However, we have a domestic and international framework in place today that would have been extremely helpful in 2008, and that should promote a better outcome in the future.

Post-Crisis Performance

These core reforms have been strongly in the public interest. Large banking organizations now operate with roughly twice the capital and more than twice the liquidity relative to their size than they did entering the crisis. Simply put, they can now absorb more losses and are less likely to fail. Beyond that, having more capital helps banks mitigate the contraction in lending that typically occurs during a downturn.

I also would emphasize that the core reforms have promoted a strong banking industry that can support economic activity. By any traditional measure, the performance of the U.S. banking industry and its support to economic growth has been strong in this post-crisis period. Let me touch on a few of these measures.

Earnings growth for insured banks as a group has been strong, with annual increases in net income averaging 7.8 percent per year during the five years ending in 2016. FDIC-insured institutions reported a record $171.3 billion in net income for 2016, a 44 percent increase from the 2011 level. Through the second quarter of 2017, the earnings picture for insured banks continued to improve. Second quarter net income for insured banks as a group was up 10.7

percent from a year earlier, while the average return on assets of 1.14 percent was the highest in 10 years.

It is worth noting that these earnings gains have come in spite of significant headwinds. These include working through crisis-era nonperforming assets (a process that is largely complete); litigation expenses for some larger organizations; and an interest-rate environment that has compressed net interest margins. To the extent interest rates return to more normal levels, we will likely see improved net interest margins and even stronger bank earnings performance. We already see evidence that increases in net interest margins and net interest income are beginning to drive growth in bank profitability.

At the same time, the U.S. banking industry is supporting the credit needs of the U.S. economy. Annualized loan growth at U.S. banks during the three years 2014−2016 averaged 5.7 percent—significantly outpacing nominal GDP growth in each year. This comparison suggests that banks are supporting economic growth rather than constraining it. Moreover, total bank loans outstanding have grown faster than loans held by non-bank sources of credit in six of the last seven years. In international comparisons, large U.S. banking organizations as a group are better capitalized than their European counterparts. Yet, both economic growth and bank loan growth have been substantially stronger in the United States than in Europe.

Large U.S. banking organizations are supporting economic activity through their investment banking subsidiaries as well. The top five investment banks in the world by fee income in 2016 and the first nine months of 2017 all were investment banking subsidiaries of U.S. globally systemic banking organizations. Supported by the bond underwriting activities of these and other U.S. investment banks, corporate bond issuance for both investment and speculative grade debt has been at a record-setting pace during much of the post-crisis period.

In the secondary market for corporate bonds, trading volumes have grown steadily in the U.S. during much of the post-crisis period, while trading volumes in Europe have been flat. Transaction costs of trading corporate bonds as measured by bid-ask spreads are trending downward and are generally at pre-crisis levels. The federal banking agencies' second-quarter

2017 staff report to Congress on corporate bond liquidity, for example, described liquidity conditions in the primary and secondary corporate bond markets as accommodative.[1]

The takeaway is that U.S. banking organizations are recording strong earnings growth and are supporting U.S. economic activity. The improved cushions of capital and liquidity at large U.S. banking organizations are *not* a source of competitive weakness relative to banks in other jurisdictions. They are a competitive *strength* for our banking industry and our economy, and one that is directly attributable to the strong U.S. response to the crisis as reflected in the core reforms. Moreover, it is now more likely that in the next downturn, large U.S. banking organizations will play a stabilizing role, rather than contributing to a deeper economic contraction.

One final point. The strong post-crisis performance has applied across the U.S. banking industry, from small to large institutions. In fact, as documented in the FDIC's Quarterly Banking Profiles, community bank performance during this post-crisis period has generally outpaced the banking industry as a whole.

The community bank business model is characterized by careful relationship lending funded by stable core deposits focused on a local geographic community that the bank understands well. This model has held up remarkably well during the post-crisis period. In particular, community banks continue to play a critical role in small business finance in the United States. They hold 13 percent of banking assets but account for 43 percent of small loans to businesses and farms. Consolidation pressures from narrow interest margins, regulatory compliance costs, IT management, and succession planning will continue. But the evidence suggests that the community banking sector will continue to be vitally important to the U.S. financial system and economy for the foreseeable future.

The Current Outlook

That brings us to today. Similar to 2005 when I started at the FDIC, the U.S. economy is experiencing a period of prosperity. Growth in real GDP has averaged 2.2 percent in this

[1] These reports, which are in response to a statutory requirement and have been submitted quarterly starting in the first quarter of 2014, are available at https://www.federalreserve.gov/foia/corporate-bond-liquidity-reports.htm.

expansion, and was right around 3 percent in the second and third quarters of this year. Our stock market has reached new highs and real estate prices have been rising. Global economic growth appears to be picking up, with the IMF raising its growth forecasts for Japan, China, and Europe.

The post-crisis economic expansion is now in its 101st month, making it the third longest expansion in U.S. history.[2] This coming June, it would become the second longest expansion in our history. The current consensus is this will occur. None of the economists polled by the Blue Chip Economic Indicators foresees a recession this year or next.

This improvement in the economic outlook is a positive development for banks and bank regulators. We know, however, that economic expansions eventually come to an end. We also know that financial shocks can come from unexpected sources at any time.

Following the Savings & Loan crisis of the 1980s and the banking crisis of the late 1980s and early 1990s, we entered a 10-year economic expansion—the longest in U.S. history. Even that period was punctuated by a series of domestic and international crises that tested the effectiveness of risk managers. Banking and economic crises emerged during the 1990s and into the early 2000s in Scandinavia, Mexico, east Asia, Russia, and Argentina. Domestically, severe disruptions were averted in 1998 following the collapse of Long-Term Capital Management that resulted from its use of high-risk arbitrage trading strategies. The 2001 crash in dot-com equity prices was soon followed by the sudden bankruptcies of Enron and WorldCom. Finally, the development that would ultimately trigger the recent financial crisis was the decision by financial institutions in increasing numbers, and of increasing size, to enter the business of originating or securitizing subprime and alternative mortgages.

Such experience is a reminder that, despite the good conditions we currently see, there are always challenges that could quickly change the outlook. Even though the current expansion appears more sustainable than the boom that occurred in the years leading up to the 2008 crisis, there are vulnerabilities in the system that merit our attention.

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[2] The National Bureau of Economic Research dates U.S. business cycles going back to 1854. No U.S. economic expansion exceeded 50 months until the Second World War (80-month expansion from June 1938 to February 1945). No expansion exceeded 100 months until the 1960s (106-month expansion from February 1961 to December 1969).

One vulnerability relates to the uncertainties associated with the transition of monetary policies—both here and abroad—from a highly expansionary to a more normal posture. Market responses to changes in monetary policy can be hard to predict. Recently, the Federal Reserve has embarked on a gradual reduction in the size of its balance sheet. Thus far, there has been no apparent market reaction. Nonetheless, higher interest rates could pose problems for industry sectors that have become more indebted during this expansion.

By many measures, stocks, bonds, and real estate are richly priced. Stock price-to-earnings ratios are at high levels, traditionally a cautionary sign to investors of a potential market correction. Bond maturities have lengthened, making their values more sensitive to a change in interest rates. As measured by capitalization rates, prices for commercial real estate are at high levels relative to the revenues the properties generate, again suggesting greater vulnerability to a correction.

Taken together, these circumstances may represent a significant risk for financial market participants. While banks are now stronger and more resilient as a result of the post-crisis reforms, they are not invulnerable.

History shows that surprising and adverse developments in financial markets occur with some frequency. History also shows that the seeds of banking crises are sown by the decisions banks and bank policymakers make when they have maximum confidence that the horizon is clear. It is also worth keeping in mind that the evolution of the global financial system towards greater interconnectedness and complexity may tend to increase the frequency, severity, and speed with which financial crises occur.

It would be a mistake to assume a severe downturn or crisis cannot happen again.

The Road Ahead for Prudential Regulation

These considerations should inform our approach to financial regulation. While the banking system is much stronger now than it was entering the crisis, continued vigilance is warranted. The core prudential reforms were put in place to address issues that helped precipitate a crisis we do not wish to repeat.

The post-crisis reforms collectively constitute a large body of new regulation, and they could benefit from review. There is doubtless room to simplify or streamline some aspects of prudential regulation without sacrificing important safety-and-soundness objectives. Examples include the prospect of a simpler Volcker Rule compliance regime, ways to reduce compliance costs associated with company-run stress tests and resolution plans, and simplifications to capital rules for smaller banks. The FDIC has been part of these discussions and will remain engaged.

At the same time, the danger is that changes to regulations could cross the line into substantial weakening of requirements. Let's be clear: Our largest banking organizations are not *voluntarily* holding the enhanced capital and liquid asset cushions required by current rules. Some have made quite clear that, left to their own devices, they would operate with less capital and less liquidity. If and when some banks go down such a path, others will be pressured by their shareholders to do so as well, to boost return on equity by operating with less capital.

A well-functioning bank regulatory system should provide a set of guardrails that allows for healthy and sustainable access to credit without endangering stability or unduly exposing the Deposit Insurance Fund. Our aim should be a regulatory framework in which banks provide a sustainable volume of well-underwritten credit that can support the economy.

Bank lending has been growing at a healthy pace that exceeds GDP growth, and the financial strength and resilience of the banking industry has greatly improved. In contrast, the unsustainable loan growth in the years immediately preceding the crisis, and the excessive leverage and reliance on short-term funding at a number of large institutions, were signs of financial system fragility and not of strength.

Weakening the core reforms that apply to our largest banking organizations would increase the risk of future banking crises that would be very costly for the U.S. financial system and economy.

As I have indicated in the past, I would particularly raise a concern in regard to weakening capital requirements for systemically important financial institutions. I refer specifically to the idea of removing central bank exposures, Treasury securities, and initial margin from the calculation of the Enhanced Supplementary Leverage Ratio and lowering the ratio. These changes would be at odds with the purpose of the leverage ratio, which has served for many

years in the United States as a simple, unweighted measure that limits excessive leverage, and complements, rather than mimics, the risk-based capital framework.

Taken together, such changes could cut the leverage capital requirements for the eight U.S. G-SIBs by amounts ranging from 25 percent to more than 50 percent for some institutions. The Enhanced Supplementary Leverage Ratio, which currently represents a strengthening of the pre-crisis leverage requirements for U.S. G-SIBs, would for some institutions become a weaker requirement than they were subject to even before the crisis. Such a change would significantly weaken the resilience of large systemically important banking organizations and the financial system.

Conclusion

In conclusion, I was recently reminded of a speech I gave in May 2006 at a meeting of the Conference of State Bank Supervisors. The subject matter was Basel II, a capital framework that would have substantially reduced capital requirements. The speech included the following statement:

> *"While we all hope that the current high level of economic activity will continue, it would be a mistake, it seems to me, to take for granted that the next 10 years will be equally benign. We should therefore be particularly cautious and prudent in making changes to our system of bank capital."*

It seems to me the statement in that speech remains relevant today.

The U.S. banking industry has transitioned from a position of extreme vulnerability to a position of strength. Operating with the stronger cushions of capital and liquidity required by the post-crisis reforms, large U.S. banking organizations are experiencing strong earnings growth and are providing support to the U.S. economy through their lending, investment banking, and other activities. Moreover, they are better positioned to support economic activity in the next downturn and avoid a financial crisis such as occurred in 2008.

All of us have a stake in preserving these hard-won improvements in the strength and stability of our banking system.

Thank you.