The Path of Reform:
The Journey So Far, and the Road Ahead

Joyce M. Hansen
Senior Vice President and Deputy General Counsel
Federal Reserve Bank of New York

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Two Years of Firefighting

- Systemic Risk Arising from Single Institutions
  - Bear Stearns
  - Lehman Brothers
  - AIG

- Market Failures (for example)
  - Commercial Paper Funding Facility
  - Term Asset-Backed Lending Facility
Lessons for reform

- With Bear, Lehman, and AIG, the Government faced the difficult choice of either brokering a merger and/or committing significant taxpayer dollars on the one hand, or placing the troubled firm into bankruptcy on the other, with all of the negative consequences for the market.

- Chairman Bernanke: “[M]arket participants must be convinced that if one of these firms is unable to meet its obligations, its shareholders, creditors, and counterparties will not be protected from losses by government action. To make such a threat credible, we need a new legal framework that will allow the government to wind down a failing, systemically critical firm without doing serious damage to the broader financial system.”
The means of reform

- A popular tendency to focus on reform by legislation
  - In some areas, quite urgently needed

- The reform that has already happened tends to get less attention, but it has been, to my eyes, dramatic
A changed landscape

- There used to be 5 investment banks, supervised at the holding company level, on only a voluntary basis.
  - Now, none. Either became supervised bank holding companies (Morgan, Goldman) or became part of supervised bank holding companies (Bear, Merrill, Lehman).

- Other institutions choose to became supervised bank holding companies.
  - American Express, GMAC, CIT

- GSEs were placed under Federal conservatorship.

- AIG threatens to rupture financial system and undergoes restructuring.
Consolidated supervision

- Federal Reserve: a holding company supervisor with oversight over a greater part of the financial markets
- Consolidated supervision, defined:
  - “A robust consolidated supervisory framework...provides a supervisor the tools it needs to understand, monitor and...restrain the risks associated with an organization's consolidated or group-wide activities.
- These tools include the authority to:
  - establish consolidated capital requirements for the organization,
  - obtain reports from and conduct examinations of the organization and any of its subsidiaries, and
  - require the organization or its subsidiaries to alter their risk-management practices or take other actions to address risks that threaten the safety and soundness of the organization.” (Gov. Tarullo, 3/9/09)
Changes in consolidated supervision

- Shift in focus from protection of depository institution to risks that can arise anywhere in the organization
  - Resilience of bank is crucial, but crisis revealed regulatory gaps in capital markets and trading activities: for example, derivatives, securitization, commercial paper
  - Supervision needs apply to all forms of financial intermediation
  - One implication: enhanced need for collaboration with functional regulators of subsidiaries
Supervisory Capital Assessment Program

- To me, the “SCAP”; to you, the “Stress Test”
- Horizontal analysis of 19 large firms
  - Created conditions for recovery – public confidence and capital raising capability
- Some lessons of the Stress Test:
  - Horizontal
  - Forward-looking
  - Multidisciplinary
- Lessons of the Stress Test are being reflected in our supervisory process
Capital and liquidity reform

- **Capital**
  - December 2009 Basel Committee consultative document
    - Raise quality of capital base
    - Strengthen capital requirements for counterparty credit risk exposures

- **Liquidity**
  - March 2010 interagency guidance
    - Specifies supervisory guidance for liquidity management
  - December 2009 Basel Committee consultative document
    - Introduces short and long-term liquidity monitoring metrics
Strengthening infrastructure for OTC derivatives market

- Encouraging central clearing for appropriate OTS products
- Creation of trade repositories for collection of data and distribution to public
- Enhancing greater pre- and post-trade transparency
Legislative reform – three crucial areas

- Resolution authority
  - Chairman Bernanke: “If we achieve nothing else in the wake of the crisis, we must ensure that we never again face such a situation.”

- Systemic risk regulation
  - All systemically important financial institutions must be subject to consolidated supervision

- Payment, clearing and settlement systems
  - Ensure that all systemically important payment and settlement systems are subject to supervision
Thank you

- A broad agenda for reform, both legislative and regulatory

- Much work has been done, but much more lies ahead