

For release on delivery  
9:30 a.m. EDT (8:30 a.m. CDT)  
May 5, 2011

Implementing a Macroprudential Approach to Supervision and Regulation

Remarks by

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at the

Federal Reserve Bank of Chicago

47th Annual Conference on Bank Structure and Competition

Chicago, Illinois

May 5, 2011

The recent financial crisis revealed critical gaps and weaknesses in the U.S. financial system and the financial regulatory framework. The Congress and the Administration last year provided a roadmap for addressing many of these problems, in the form of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act)--the topic of this year's conference.

Legislative reforms in any complex area always face the risk of fighting the last war, responding to the causes of the last crisis without sufficient attention to where new problems may arise. To their credit, the authors of the Dodd-Frank Act attempted to reduce this risk by building in a number of features aimed at helping our system of financial oversight adapt over time to changes in the financial environment. Notably, a central element of the legislation is the requirement that the Federal Reserve and other financial regulatory agencies adopt a so-called macroprudential approach--that is, an approach that supplements traditional supervision and regulation of individual firms or markets with explicit consideration of threats to the stability of the financial system as a whole. The act also created a new Financial Stability Oversight Council, whose membership comprises a diverse group of federal and state financial regulators, to coordinate the government's efforts to identify and respond to systemic risks.

The explicit incorporation of macroprudential considerations in the nation's framework for financial oversight represents a major innovation in our thinking about financial regulation, one that is taking hold abroad as well as in the United States. This new direction is constructive and necessary, I believe, but it also poses considerable conceptual and operational challenges in its implementation. In my remarks today I will briefly discuss the rationale for macroprudential supervision and regulation, describe the

new structure of macroprudential supervision and regulation in the United States, and explain how we at the Fed are doing our part to implement the macroprudential approach to financial oversight.

### **Macroprudential Supervision and Regulation**

Ultimately, the goal of macroprudential supervision and regulation is to minimize the risk of financial disruptions that are sufficiently severe to inflict significant damage on the broader economy. The systemic orientation of the macroprudential approach may be contrasted with that of the traditional, or “microprudential,” approach to regulation and supervision, which is concerned primarily with the safety and soundness of individual institutions, markets, or infrastructures.

Relative to traditional regulation and supervision, executing a macroprudential approach to oversight can involve heavier informational requirements and more-complex analytic frameworks. In particular, because of the highly interconnected nature of our financial system, macroprudential oversight must be concerned with all major segments of the financial sector, including financial institutions, markets, and infrastructures; it must also place particular emphasis on understanding the complex linkages and interdependencies among institutions and markets, as these linkages determine how instability may be propagated throughout the system. Moreover, broadly speaking, macroprudential regulators must be concerned with at least two types of risks. The first type encompasses aspects of the structure of the financial system--such as gaps in regulatory coverage or the evolution of shadow banking--that pose ongoing risks to financial stability. The second class of risks are those that vary over time with financial

or economic circumstances, such as widespread buildups of leverage in good times that could ultimately unwind in destabilizing ways.

To be sure, a macroprudential approach to oversight does not avoid the need for careful microprudential regulation and supervision. The oversight of individual institutions serves many purposes beyond the enhancement of systemic stability, including the protection of the deposit insurance fund, the detection of money laundering and other forms of financial crime, and the prevention of unlawful discrimination or abusive lending practices. Equally important, however, is that microprudential oversight also provides the knowledge base on which a more systemic approach must be built; we cannot understand what is going on in the system as a whole without a clear view of developments within key firms and markets. Without a strong microprudential framework to underpin them, macroprudential policies would be ineffective.

That said, a key lesson of the crisis is that a purely microprudential approach, focused on the conditions of individual firms or markets, may fail to detect important systemic or cross-cutting risks. For example, a traditional microprudential examination might find that an individual financial institution is relying heavily on short-term wholesale funding, which may or may not induce a supervisory response. The implications of that finding for the stability of the broader system, however, cannot be determined without knowing what is happening outside that particular firm. Are other, similar financial firms also highly reliant on short-term funding? If so, are the sources of short-term funding heavily concentrated? Is the market for short-term funding likely to be stable in a period of high uncertainty, or is it vulnerable to runs? If short-term funding were suddenly to become unavailable, how would the borrowing firms react--for

example, would they be forced into a fire sale of assets, which itself could be destabilizing, or would they cease to provide funding or critical services for other financial actors? Finally, what implications would these developments have for the broader economy? The analysis of risks from a systemic perspective, not just from the perspective of an individual firm, is the hallmark of macroprudential regulation and supervision. And the remedies that might emerge from such an analysis could well be more far-reaching and more structural in nature than simply requiring a few firms to modify their funding patterns.

### **Implementing the Macroprudential Approach in the United States**

Let me be more concrete and talk about the implementation of the macroprudential approach in the context of the evolving U.S. regulatory system.

The first required element of macroprudential oversight is a system for monitoring evolving risks to financial stability. Beyond assigning individual regulatory agencies this responsibility, the Dodd-Frank Act took the additional step of setting up a new body, the Financial Stability Oversight Council, as I mentioned earlier. The council is charged with monitoring the U.S. financial system, identifying risks that threaten the stability of that system, and promoting market discipline and other conditions that mitigate excessive risk-taking in financial markets. The council is made up of 10 voting members--including the Federal Reserve--and 5 nonvoting members, who serve in an advisory capacity.<sup>1</sup>

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<sup>1</sup> The Secretary of the Treasury serves as the chairman of the Financial Stability Oversight Council. Other voting members include the heads of the Office of the Comptroller of the Currency, the Securities and Exchange Commission, the Federal Deposit Insurance Corporation, the Commodity Futures Trading Commission, the Federal Housing Finance Agency, the National Credit Union Administration, the Bureau of Consumer Financial Protection, and an independent insurance expert appointed by the President. The latter two seats are not yet filled.

The regulatory agencies represented on the council oversee a wide range of participants in the U.S. financial system. The broad membership of the council is intended to limit the tendency of regulators to focus narrowly on the institutions and markets within their jurisdictions while overlooking risks from interdependencies that cut across jurisdictions. The council also facilitates coordination and information sharing among member agencies. By breaking down the silos that in the past sometimes discouraged agencies from looking beyond their specific responsibilities, the council should help identify and eliminate gaps and weaknesses within the regulatory structure.

The Dodd-Frank Act also established--within the Treasury Department--the Office of Financial Research, which is responsible for improving the quality of financial data available to policymakers. The oversight council may direct the research office to collect information from certain individual financial companies to assess risks to the financial system. This collection and analysis of financial-sector data should allow regulators to see more of the financial landscape and better equip them to identify systemic risks and other emerging threats.

To digress for a moment, it's interesting that the United States isn't the only jurisdiction that has recently created a new institutional structure to implement macroprudential policies. Notably, the European Union (EU) established the European Systemic Risk Board, which is responsible for the macroprudential oversight of the EU's financial system. The board will collect and analyze information on the EU's financial system, identify and prioritize systemic risks, and issue warnings and recommendations to national and European authorities. It will also work closely with the three newly created European Supervisory Authorities, which in turn are charged with coordinating

prudential regulations for banking, insurance, and securities among EU member states.<sup>2</sup> In the United Kingdom, the government plans to move its microprudential regulatory authority back into the Bank of England and create a new Financial Policy Committee to implement macroprudential policies. (Former Federal Reserve Board Vice Chairman Donald Kohn has been tapped to serve on the Financial Policy Committee, which must make him one of the few people to have served as a top financial regulator in two different countries.) The U.K. committee is expected to identify and monitor systemic risks and take actions to remove or reduce them. And it will operate a new resolution regime for failing financial firms.

The monitoring efforts of the Financial Stability Oversight Council in the United States are already well under way. Staff members from the member agencies have established working groups with responsibility for specific sectors or aspects of the financial system and are making regular presentations to the council. This work will also be reflected in the council's required annual report to the Congress on financial stability, which is expected to be released in the summer.

Of course, the identification of threats to financial stability must be followed by appropriate remedies. The powers of the council itself are relatively limited in this regard, at least under most circumstances. Perhaps its most important responsibility is the designation of certain nonbank financial firms and financial market utilities as systemically important and thereby subject to additional regulation and oversight by the Federal Reserve and other member agencies, including the Commodity Futures Trading Commission and the Securities and Exchange Commission (SEC). To make those

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<sup>2</sup> The three authorities are the European Securities and Markets Authority, the European Banking Authority, and the European Insurance and Occupational Pensions Authority.

designations, the council will need to determine criteria for identifying firms whose financial distress would impose the greatest risks to financial stability. Of course, this task requires continued development of an analytical framework for understanding systemic risk and its sources.

Although the council's own powers are circumscribed to some degree, the potential benefits of its ability to foster cooperative work among U.S. regulatory agencies should not be underestimated. To cite just one example, the stability of money market mutual funds--which suffered dramatic runs that worsened funding conditions at the height of the crisis--is clearly a systemic issue, not just an industry issue. The SEC, which has already issued rules to increase the stability of money market mutual funds, is appropriately taking the lead in investigating whether further steps are necessary. Under the aegis of the council, however, the SEC has consulted with other agencies, including the Federal Reserve, which have provided their own analyses and perspectives. In particular, interagency consultation has helped clarify the potential systemic implications of instability in the money market mutual fund industry. The Federal Reserve will be among the agencies participating in a roundtable on money fund regulation sponsored by the SEC later this month.

Understandably, given the damage wrought by the crisis, the council and its members remain focused on addressing possible sources of financial instability, including both structural problems and risks arising from ongoing economic or financial developments. However, no one's interests are served by the imposition of ineffective or burdensome rules that lead to excessive increases in costs or unnecessary restrictions in the supply of credit. Increased coordination and cooperation among regulators, under the



auspices of the council where appropriate, should serve not only to improve our management of systemic risk, but also reduce the extent of duplicative, inconsistent, or ineffective rulemakings. More generally, in evaluating alternative approaches to mitigating systemic risks, regulators must aim to avoid stifling reasonable risk-taking and innovation in financial markets, as these factors play an important role in fostering broader productivity gains, economic growth, and job creation.

### **Macroprudential Policy at the Federal Reserve**

As I have mentioned, besides creating new institutions like the Financial Stability Oversight Council, the Dodd-Frank Act has also imposed a macroprudential mandate on individual agencies, including the Federal Reserve. This mandate comes, in some cases, with changes in the powers and responsibilities of key agencies. In the case of the Federal Reserve, in addition to membership on the Financial Stability Oversight Council, our new responsibilities include the supervision of thrift holding companies as well as oversight of nonbank financial firms and certain payment, clearing, and settlement utilities that the council designates as systemically important. In consultation with other agencies, we also are responsible for developing more-stringent prudential standards for all large banking organizations and for nonbank firms designated by the council as systemically important. These enhanced standards include tougher capital and liquidity requirements, the development of resolution plans (so-called living wills), mandatory stress tests conducted by the Federal Reserve and by the firms themselves, new counterparty credit limits, and more-demanding risk-management requirements.

The Federal Reserve has made and will continue to make significant organizational changes as needed to best fulfill our responsibilities. Even before the

enactment of the Dodd-Frank Act, we had begun to overhaul our supervision of the largest, most-complex financial firms. An important milestone in this regard was the Federal Reserve's leadership in the spring of 2009 of the Supervisory Capital Assessment Program, popularly known as the bank stress test, which comprehensively evaluated the health of the largest banking organizations in the country. We learned valuable lessons from that exercise, including an appreciation of the additional insights that can be gained by examining a number of major institutions simultaneously, with a focus on comparative performance. Another lesson of the stress test was the value of a multidisciplinary approach to supervision, one that combines the skills of economists, financial experts, payments systems analysts, and other specialists with those of supervisors and examiners.

Drawing on this experience, we created a high-level, multidisciplinary working group within the Federal Reserve to oversee the supervision of large financial institutions. Under the auspices of this committee--called the Large Institution Supervision Coordinating Committee, or LISCC--Federal Reserve supervisors, supported by economists and other experts, now routinely use horizontal, or cross-firm, reviews to monitor industry practices, common investment or funding strategies, changes in the degree or form of financial interconnectedness, or other developments with implications for systemic risk. Supplementing its individual and horizontal reviews, the LISCC has also made increasing use of improved quantitative methods for evaluating the health and performance of supervised firms as well as the risks they may pose to the broader financial system. A similar committee structure within the Federal Reserve is being developed to help us meet our obligations to supervise systemically important financial market utilities.

To improve our monitoring of the financial system and to coordinate work bearing on financial stability, we have also created a new office within the Board, called the Office of Financial Stability Policy and Research. This office brings together staff with a range of backgrounds and skills and works closely with other groups at the Federal Reserve. The office helps monitor global financial risks and analyze the implications of those risks for financial stability; works with our bank supervisory committees, for example, on the development of quantitative loss models and alternative scenarios to serve as the basis for stress tests; serves as a liaison to the Financial Stability Oversight Council and its various working groups; and helps develop and evaluate alternative approaches to implementing macroprudential regulations.

The recent Comprehensive Capital Analysis and Review, in which the Federal Reserve evaluated the internal capital planning processes and shareholder distribution requests of the 19 largest bank holding companies, is an example of a horizontal assessment with a macroprudential approach. In the wake of the crisis, banks' capital payouts had been kept to a minimum. As banks' earnings and capital positions continued to improve in 2010, however, some firms sought approval to increase dividends or restart share repurchase programs. The simultaneous assessment of the payout requests in the capital review allowed the Federal Reserve, working through the LISCC, to evaluate not only the conditions of individual banks but also the potential implications of capital payouts for aggregate credit extension and the sustainability of the economic recovery. Thus, the program had both microprudential and macroprudential goals. From a traditional safety-and-soundness perspective, we wanted each firm to demonstrate that it had robust risk-management systems as well as a capital plan that would allow it to

manage potential losses in stress scenarios while comfortably meeting Basel III capital requirements as they are phased in. But, with the help of macroeconomic and capital market analysts, we also considered the implications of the requests for the capital available to the banking system as a whole, with the objective of ensuring that bank credit would still be available to households and businesses even if the economy were to perform more poorly than expected.

We now also routinely apply macroprudential methods to the analysis of significant economic developments, whether domestic or foreign. The sovereign debt concerns in Europe provide one example. As yields on European sovereign debt and bank debt rose in the spring of 2010, Federal Reserve supervisors began to evaluate U.S. banking firms' exposures to European banking firms and sovereigns. In addition to evaluating direct exposures, we analyzed scenarios under which sovereign debt concerns might lead to broader financial volatility. Our focus was on the possibility that financial disruptions might impede credit flows and economic activity in both Europe and the United States. In our work we conferred extensively with European bank supervisors; for example, we discussed potential risks to European banks' abilities to obtain dollar funding and the implications of European banks' need for dollars on U.S. money markets. This work suggested that providing a backstop for the dollar-funding needs of European financial institutions could mitigate the potential for spillovers to the United States from European sovereign debt concerns. In accord with this analysis, in May 2010 the Federal Open Market Committee announced that it had authorized dollar liquidity swap lines with other central banks in a preemptive move to avert a further deterioration in liquidity conditions.

Macroprudential considerations have also been important for the Federal Reserve's rulemaking, particularly those rules implementing the Dodd-Frank Act. For example, with other regulators, we recently proposed rules to set margin requirements for over-the-counter derivatives that are not cleared through a central counterparty. The proposed rules reflect not only safety-and-soundness concerns but also macroprudential goals; specifically, the rules seek to increase the resiliency of the financial system as a whole by reducing the potential for contagion between swap market participants. Under the proposed rules, the most-stringent margin requirements would apply to derivatives contracts between swap dealers or other major swaps market participants, as such arrangements could otherwise involve a risk of "default chains" in which distress at one major firm could cascade through the swap markets.

As I mentioned earlier, the macroprudential approach to financial regulation is gaining increasing adherence internationally. Along with our efforts to implement reforms domestically, the Federal Reserve has for some time been working closely with foreign counterparts to help coordinate the reform process at the international level. The objectives of international coordination are of the highest importance. These goals include maintaining a level competitive playing field across countries, minimizing opportunities for multinational firms to take advantage of weaker or inconsistent regulations in some jurisdictions, establishing consistent and complementary standards, and ensuring effective oversight of internationally active firms and markets. The Group of Twenty has devoted considerable attention to financial-sector policies in its meetings during the past couple of years. The Financial Stability Board, the Basel Committee on

Banking Supervision, and other international groups also have undertaken substantial work to coordinate macroprudential policies across borders.

Much of the Federal Reserve's international effort has involved working with other regulatory agencies and central banks to design and implement new prudential requirements for internationally active banks. This work resulted in the adoption of more-stringent regulatory capital standards for trading activities and securitization exposures in the summer of 2009, as well as the agreement last fall on the major elements of the new Basel III framework for globally active banks. Consistent with the macroprudential approach, the Basel III framework requires the largest, most globally active banks to hold more, higher-quality capital, reflecting the greater systemic risk associated with financial distress at the largest institutions.

## **Conclusion**

The financial crisis demonstrated clearly that supervisory and regulatory practices must consider overall financial stability as well as the safety and soundness of individual firms. The Dodd-Frank Act requires regulators to mitigate the buildup of financial excesses and reduce vulnerabilities, and it created an interagency council to monitor financial markets, to identify emerging threats, and to help formulate policies to contain those risks. For our part, the Federal Reserve has restructured its internal operations to facilitate a macroprudential approach to supervision and regulation and to monitor systemic risks. We are committed to working closely with the oversight council and other agencies to promote financial stability. While a great deal has been accomplished since the act was passed less than a year ago, much work remains to better understand sources of systemic risk, to develop improved monitoring tools, and to evaluate and

implement policy instruments to reduce macroprudential risks. These are difficult challenges, but if we are to avoid a repeat of the crisis and its economic consequences, these challenges must be met.