CURRENT THREATS TO FINANCIAL STABILITY

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My presentation at the GBRS in Rome reviewed the reasons that help construct the Dodd-Frank Act. In addition, it focused on the current threats to financial stability.

Although failures of large financial institutions cause tremors to the economy of a nation, the complication with the bankruptcy of Lehman Brothers deepened the understanding of the complexity of the damage it caused. For that reason the attention in the Dodd-Frank was paid to fortify financial institutions and assured their stability by stress testing and 'living wills.'

Furthermore, the damage of the Great Recession pointed that our monetary policy that is designed to provide price stability and full employment does not guaranty financial stability. That meant that we need some new tools to assure that the financial institutions remain stable. This was only possible by developing macroprudential policies whose purpose is to strengthen the financial system so that it can absorb a sudden shock while continuing to perform its daily activities.

Since the Great Recession several macroprudential tools were developed to address financial stability. But are there any other threats that still presents a threat to our financial stability? Below a short description of the macroprudential tools are presented, along with their shortcomings and challenges that remain to be resolved.

Stress tests

Stress tests assure that the largest and complex financial institutions can continue activities in times of financial stress (Brainard, 2018). Stress testing is forward looking to anticipate rapidly changing risks and business conditions. Liquidity is a critical component of financial condition for regulators; From 2011 the largest banking firms increased their holding of high liquid assets from 12% to 20% in 2017. That is a good result but more work is required as the 2017 stress test results note the eight largest and most complex banking organizations (SIFI) had still some deficiencies.

Resolution planning - living wills

Until this year bank holding companies with assets greater than $50 billion as well as non-banks (identified by FOSC) were required to submit resolution plans to unwind operations in an orderly fashion in the event of bankruptcy. These plans or living wills are submitted to the Federal Reserve and the FDIC. Regulator concerns noted a need for clear identification of unwind procedures to avoid movement of assets among legal entities to allow orderly bankruptcy without legal challenges. The added complexity of resolution planning are that they have to change as firm's activities, structure, and risk profile change.

There are challenges that remain: What if market conditions make it difficult for liquidation to occur? It is doubtful that much more than one SIFI or G-SIB failure can be wound down speedily

in order to stabilize the financial system. So far the discussion of multiple failures at the same time did not take place, but it should be considered.

On May 24, 2018, the *Economic Growth, Regulatory Relief and Consumer Protection Act* became law. It brought the reduction of regulatory burden for smaller, less complex firms presently subject to supervisory stress testing, e.g. regional banks. The threshold for enhanced supervision for SIFIs was raised to $250 bn. This results in 12 large financial firms out of 38, continuing under stringent monitoring. However, the FRB is authorized to apply any prudential standard to bank holding companies with total assets of at least $100 bn.
Regulation is disruptive and costly, and as not all institutions are complex it is not fair to treat them the same as the larger ones. Yet, the knowledge that relaxing regulation has often taken place before financial downturns is worrisome.

Countercyclical buffer (CCyB)

CCyB, part of Basel III and approved as policy by the FRB, applies to firms with more than $250 billion in assets, to absorb shocks in declining credit conditions. In turn, when the conditions that caused the application of such buffers change, these buffers would be removed or reduced (FRB, Press Release, 2016). The application of CCyB intended to be gradual, not to be disruptive. The FRB will vote at least once per year to assess whether CCyB are needed. However, CCyB have not been activated yet in the US.

The only challenge with CCyB is that we do not have any experience in using it or at what specific point to apply it. No doubt the discussion on this topic will continue.

Market structure

Market structures of firms change over time due to the impact of technology and changing business models. That could become disruptive to the market functioning efficiently; there is a danger of intensity of concentration leading to an increase in oligopoly power. With financial firms there are two additional concerns: Financial disruption and government regulation.
While the issue of market structure may not rise to be a major concern among market participants, there are situations where lack of substitutability, having a solitary provider of a service, can cause a market disruption. For example, in a market for settlements of US Treasury securities and repurchase agreements this role was played by JP Morgan Chase & Co, and Bank of New York Mellon Corp. In July 2016, JP Morgan Chase exited this business leaving BNY Mellon as the sole provider of this service. In the market for triparty repo transactions, an important source of funding for large banks and other financial firms, BNY Mellon will remain the sole operator. In the event of financial stress, BNY Mellon would leave its clients to seek alternative funding sources in disrupted markets, thus creating a liquidity squeeze.

Conclusion

Banks and large financial institutions are in better shape when compared to 2006, due to the policies and tools implemented under the Dodd-Frank Act. Result: financial institutions can withstand an economic crisis much better than before. Some threats continue to exist, as

mentioned in this presentation, but over time they could be addressed, for much more focus is placed on assuring financial stability. New regulation that modifies the Dodd-Frank Act does focus easing the regulatory burden for smaller financial institutions. This is consistent with the need to review regulation ex post as evidence points to some elements of over regulation. However, our experience from the Great Recession should be enough to warn us against further removals of tools that have contributed to a higher level of financial stability.

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