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Navigating Global Financial Rules, Risks, and Realities
Remarks by Terrence J. Checki
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Thank you, Dick, for the kind introduction, and for the opportunity to be here with such a distinguished panel.

Let me note, for the record, that my comments are personal, and should not be taken as reflecting the views of either the Federal Reserve Bank of New York, or the Federal Reserve System.

Many of you know I am not responsible for financial supervision at the New York Fed – which provides me a little distance on the regulatory reform debate. That distance could cause me to miss some important nuances. But I am under close supervision up here from my fellow panelists, and I am sure they won't hesitate to highlight any errors of omission or commission in my remarks.

In the brief time I have, let me comment on four, mainly qualitative, issues: the balance between prudential interests and market efficiency; the scope of regulation and supervision; incentives and market discipline; and the culture of the industry.

First, on the balance of prudential interests v. market efficiency:

1. In the run-up to the crisis, concerns about financial market efficiency and, in some cases, commercial interests, were allowed to override prudential objectives. Recent regulatory reform efforts and the greater emphasis on safety and stability reflect an understandable attempt to rebalance that situation.

2. The scope and scale of the regulatory response has, as we all know, been quite ambitious. Authorities around the world have set in motion a range of initiatives to help address the substantial deficiencies revealed in the crisis, and to enhance the resilience of the financial system through higher capital and liquidity buffers in particular.

3. Getting agreement across the numerous jurisdictions and issues involved, in a relatively short period of time, has been a significant challenge. Given the number of stakeholders (including regulators, finance ministries and legislatures) in various jurisdictions who are all pursuing reform initiatives, it shouldn't be surprising that, best intentions notwithstanding, these efforts have not always been as well coordinated in terms of priorities, timing and objectives as might be desirable. And while a great deal has been accomplished, much remains to be done.

4. Pushback and attempts by the industry to water-down implementation were predictable, and have been viewed with a degree of what I think should be understandable skepticism.

5. Nonetheless, given the large number of moving parts involved, there are very real questions about how we make sure *the parts fit together*, and the *various parties work together.*

6. So, as we go about the business of shoring up regulations, closing gaps, and containing excesses and opportunities for regulatory arbitrage, it is important that we be mindful of the cumulative impact that the changes underway could have on intermediation, on the nature and location of risk taking, both institutionally and geographically - - and the potential for well-meaning changes to produce unintended outcomes.

7. Minimizing those risks will require continuous efforts on the part of regulators to monitor market functioning and systemic concerns, maintain robust channels of communication and coordination, and to sort through differences as necessary.

8. In this context, I wonder if an environmental impact study of sorts might be a useful addition to the mix to ensure that national and international initiatives are appropriately aligned and consistent with producing the desired outcomes. [Perhaps an additional role for the FSB?]

Second, with regard to the scope of regulation and supervision

9. I think it is important to be realistic about what regulation and supervision can achieve. Regulation and supervision cannot and should not prevent risk taking and losses, but must promote the resilience of financial institutions and the system –through stronger buffers, sturdier architecture, and better processes to deal with distress or failure. In pursuing these goals, however, it is important to recognize that supervision faces a daunting imbalance in numbers – the financial system is simply too diverse, too expansive, too complex, and supervisory resources too constrained – to get caught up in an "arms race" of rules and regulations, attempting to match complexity with complexity.

10. I have to confess that I have some sympathy for the view that less might ultimately prove to be more in this regard – that is to say, that more simple, straightforward, easily monitored rules, such as aggregate leverage ratios and perhaps straightforward guidance on duration matching, might ultimately produce more efficient, predictable outcomes than a web of rules involving complex (and perhaps easily gamed) calculations and restrictions.

11. Building a stronger system requires both regulatory reform and supervisory reform. Capital is a good example, where raising standards for the quality and level of regulatory capital needs to be complemented by supervisory efforts to promote innovations in stress testing and capital planning, as seen in the SCAP and CCAR exercises in the US. Supervision needs to continue to evolve in the wake of the crisis and there is tremendous opportunity for supervisors worldwide to learn from one another and to coordinate efforts and propagate best practice.

Third, with regard to market discipline:

12. I wonder if we have the balance right in the degree of emphasis being placed on official oversight rather than market transparency and discipline. To be sure, market discipline was not effective in reining in risk before the crisis. But since the crisis, supervision has been most effective where it has been linked

with greater transparency and appropriately aligned with market incentives, such as the 2009 stress test exercise. The say-on-pay rule is another example of attempting to employ market discipline rather than a potentially highly prescriptive regulatory approach. We should be looking at other ways to promote transparency that work with the grain of the market to motivate desired behaviors.

Finally,

13. I wonder if we haven't underestimated the importance of culture. Many of the problems that surfaced during the crisis and more recently are indicative of a culture that emphasizes short-term gain at the expense of institutional sustainability – a culture in which regulation is viewed as an obstacle to be arbitraged or circumvented, rather than as a check on objectives that firms and employees should follow.

14. That culture is a by-product of a number of developments, including the evolution of accounting and compensation practices (such as booking profits and paying bonuses long before positive cash flows are realized); changes in corporate organization, including the demise of the discipline inherent in the partnership model; the head-long expansion of the size and scope of many firms' activities; and a trading perspective that increasingly seems to dominate industry management.

15. That needs to change. That change will require a realignment of incentives, and leadership from the top. Management, directors, and shareholders must lead the way, because if they do not, the likelihood of success isn't very high. [Recent moves by several firms to realign compensation, return objectives, and, in some cases, business lines are encouraging, but we are still at the early stages of this process.]

16. Let me conclude by noting that notwithstanding all of the reform efforts, confidence in the banking system, as judged by opinion surveys, is at a record low – with US banks ranking just above Congress in public esteem. Such findings may produce a collective shrug in the industry, but I think we should all be concerned about the longer-term effects of weak confidence in an

industry whose lifeblood is confidence. As an old friend of mine has wisely observed: the root cause of crises is not loss of credit, but loss of confidence.