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Reflections on Financial Stability

Remarks by

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Thank you, Professor Metrick, for the kind introduction and the opportunity to return to Yale to speak to the Yale Program on Financial Stability today.[1] I have long admired and been a grateful consumer of all the insightful work you have done here since its inception in 2013. I know that a number of the staff of the Board of Governors have been contributors to, and are avid consumers of, your work. I place a high priority on using novel sources of information to address data gaps. Given that, let me commend the effort to turn the information gathering and analysis the program conducted into a standardized, research-friendly platform. That impressive work includes a data set covering over 850 years of banking crises, which must have been a true labor of love on the parts of Andrew Metrick and Paul Schmelzing. These data-collection efforts provide a valuable public good to the finance and financial stability communities, as well as to the broader research community.

This is my third trip to New Haven and my first since becoming a Governor on the Federal Reserve Board in 2022. One of the parts of my job that I find most intriguing is my work on the Board's Committee on Financial Stability. Indeed, financial stability is a long-standing research and policy interest of mine. Early in my career, I studied how underdevelopment in Russia's banking system hampered post-Soviet growth and how poor regulation fuels instability. Later, as an economist on the Council of Economic Advisers, I saw how financial system weaknesses contributed to instability in the euro area. Shortly after arriving at the Fed, I became a member of the committee and, since 2023, have had the honor of serving as chair. After four years of careful attention to this

[1] The views expressed here are my own and are not necessarily those of my colleagues on the Federal Reserve Board or the Federal Open Market Committee.

topic, it seems like an appropriate moment to reflect on and share lessons I have learned in this role.

Today I will start by discussing the financial stability committee itself and then move to reflections on the Fed's *Financial Stability Report* (FSR) and scenario analysis, the analytical workhorse of financial stability analysis. I will then conclude with a few thoughts about the real-world complexity of making financial stability policy.

Committee on Financial Stability

Following the Global Financial Crisis (GFC), the Board adopted a revised approach to financial stability. This approach emphasized bringing together insights and analyses from all parts of the Federal Reserve System—economists, market experts, bank supervisors, and payment system experts. This work, coordinated by the then-new Office of Financial Stability Policy and Research, focused on the connections across sectors and their implications for the macroeconomy. The Board and the Federal Open Market Committee began receiving periodic briefings on this work. As part of this evolution, the Board created the Committee on Financial Stability in 2014. The committee provides a venue to discuss financial stability issues.

Let me take a moment to acknowledge the contributions of the committee's first chair, the late Stanley Fischer. He made seminal contributions to the literature on financial stability, as well as open-economy macroeconomics, and he was a dedicated public servant who took on several roles as a central banker. Specifically, he played key roles in managing financial crises—first as a senior official at the IMF through the turbulence of the Asian financial crisis of the late 1990s and then as governor of the Bank of Israel through the GFC. As Vice Chair of the Board from 2014 to 2017, he recognized

the value of having a dedicated forum where policymakers could learn the lessons of the GFC and other crises and discuss and evaluate financial stability issues. It is my great honor to continue in the tradition that Stan established.

Many of the topics that Stan focused on and spoke about during his time at the Board remain highly relevant to policymakers a decade later. For instance, Stan pointed out in several speeches that while post-crisis regulatory measures had significantly bolstered bank resilience, certain activities were going to migrate to nonbank intermediaries that were not subject to the same regulatory safeguards.[2] He noted in his aptly named speech "Financial Stability and Shadow Banks: What We Don't Know Could Hurt Us" that the data gaps and limited visibility into some of these activities were their own source of systemic risk.[3] We are working to better understand these issues with an eye toward improving our financial stability monitoring, and I will continue to work with my Board colleagues to find concrete ways to do so.

Stan also appreciated the value of giving policymakers a venue in which to discuss tail risks and longer-horizon questions related to the evolution of the financial system. These considerations do not always have immediate bearing on the near-term

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[2] See Stanley Fischer (2015), "The Importance of the Nonbank Financial Sector," speech delivered at the "Debt and Financial Stability—Regulatory Challenges" conference, the Bundesbank and the German Ministry of Finance, Frankfurt, Germany, March 27, https://www.federalreserve.gov/newsevents/speech/fischer20150327a.htm; Stanley Fischer (2015), "Nonbank Financial Intermediation, Financial Stability, and the Road Forward," speech delivered at the "Central Banking in the Shadows: Monetary Policy and Financial Stability Postcrisis," 20th Annual Financial Markets Conference sponsored by the Federal Reserve Bank of Atlanta, Stone Mountain, Georgia, March 30, https://www.federalreserve.gov/newsevents/speech/fischer20150330a.htm; and Stanley Fischer (2015), "Macroprudential Policy in the U.S. Economy," speech delivered at the "Macroprudential Monetary Policy," 59th Economic Conference of the Federal Reserve Bank of Boston, Boston, Massachusetts, October 2, https://www.federalreserve.gov/newsevents/speech/fischer20151002a.htm.

[3] See Stanley Fischer (2015), "Financial Stability and Shadow Banks: What We Don't Know Could Hurt Us," speech delivered at the "Financial Stability: Policy Analysis and Data Needs" 2015 Financial Stability Conference sponsored by the Federal Reserve Bank of Cleveland and the Office of Financial Research, Washington, December 3, https://www.federalreserve.gov/newsevents/speech/fischer20151203a.htm.

macro forecast, but you do not want to lose sight of them. That is why staff briefings to the financial stability committee explore the plausible range of severe shocks that could hit the economy and the ways in which such shocks could ramify through financial markets and institutions, with a view to understanding the ultimate effects on the macroeconomy.

However, in response to a negative shock, financial conditions tighten. One way to see the work of financial stability is as the quest to understand how much, or how rapidly, that tightening would occur. Answering that question requires thinking about the plausible range of shocks that could hit the economy, as well as the resilience of key financial markets and institutions.

While macroeconomics has made great strides in the past 15 years to incorporate the lessons of the financial crisis, it is fair to say that models cannot yet reflect the full institutional richness of the modern financial system. And the public's attention to these issues can fade because financial crises are, thankfully, rare. However, policymakers at the Fed remain vigilant. For families negatively affected by the financial crisis, we know the scars linger. In the spirit of an ounce of prevention is worth a pound of cure, the financial stability committee is a place of consistent focus on this vital issue.

This is the impetus for the Board's staff examining and Board members receiving periodic briefings and updates on a range of topics related to the financial system's behavior under stress. These updates occur even during the extended periods of relative calm we have seen over the past few years. Recently, among the issues we have discussed are hedge fund trading strategies, the rise of private credit arrangements, and the connections between banks and a range of nonbank financial entities.

Some of this work appears in the Fed's twice-yearly assessment of vulnerabilities in the financial system.

Financial Stability Report

When he introduced the first FSR in November 2018, Chair Powell noted that he hoped it would provide transparency into the set of indicators the Fed monitors for financial stability and that it would prompt feedback and engagement from the public.

Thus, since its inception, the FSR was designed to act as a platform that policymakers build upon to develop their own views about the system's overall resilience rather than expressing a centralized view. The FSR carefully works through a long list of data series relevant to the four key vulnerabilities or amplification channels we track: asset valuations, borrowing by businesses and households, leverage in the financial sector, and funding risk. It comments on whether these vulnerabilities are high or low relative to history.

This disciplined approach is helpful in coming to a view on the system's resilience. But, by itself, the approach is insufficient. Policymakers concerned with the system's ability to withstand shocks also need to take a view on the interaction among vulnerabilities and the most plausible shocks that might hit the system. Some policymakers might be more concerned about the consequences of a rapid decline in asset prices or view contractionary shocks as more likely than inflationary shocks. These perspectives would lead them to place different weights on the four vulnerabilities in forming their overall view of the system's resilience.

The value in the FSR lies in the consistent attention to, and updating of, the underlying indicators of both the resilience and evolution of the financial system. Let me

give you one example. Since its inception, the FSR has contained a chart based on the Board's data showing bank lending commitments to nonbank financial institutions. We affectionately refer to this graph as the "rainbow chart" because it comprises 10 separate colors, each reflecting a different type of nonbank borrower.

This category of loans has been growing quite rapidly, much faster than overall lending to nonfinancial businesses—a category known as commercial and industrial (C&I) lending. During the past decade, large bank credit commitments to nonbank financial institutions have grown at an annualized rate of about 9 percent, roughly three times the pace of C&I lending. This growth is tracked in successive editions of the FSR. Observers would also see changes in the composition of the rainbow in the report. For example, that category that includes special purpose entities, collateralized loan obligations, and asset-backed securities has expanded in recent years. This work gives us deeper insights into the evolution of private credit and other important sectors, helping us better understand how stress in one area might affect other parts of the financial system. And even without real-world stress, getting refined and more precise estimates of the linkages between sectors proves useful in scenario analysis, my next topic.

Scenario Analysis in Assessing Financial Stability

Scenario analysis is the process of analyzing the implications of a sequence of shocks, or exogenous events. It has proven to be a powerful mechanism for assessing financial stability. Such inspection involves three forms of analysis: the vulnerabilities described in the FSR, an assessment of how sectors interact with each other, and a set of plausible shocks.

Let me start by contrasting financial-stability scenario analysis with the well-known stress test exercise that those tasked with supervision at the Fed have undertaken since the passage of the Dodd-Frank Act of 2010. These stress tests feature a severe but plausible scenario based on the Great Recession and highly quantitative assessments of the first-round effects of such a shock on individual banks. The emphasis is on precision, with the published loss estimates having material consequences for the participating banks. I would characterize these exercises as excellent at addressing the "known unknowns" we face.

In the realm of financial stability, by contrast, we start with scenarios that may never have happened. One could plausibly ask, for example, "What if AI disappoints?" Although tech booms and periods of technological progress have occurred in the past, it is difficult to know if any compares to the current situation. Therefore, any such scenario would not have an historical precedent. Nonetheless, the scenario must both feature a coherent narrative and be quantitatively specific. A good scenario is not path dependent and aids us in thinking about tail, not just modal, risks. That is, it helps us break free of the well-known human tendency to believe that tomorrow will be like today.

The next stage is to assess the effect of the scenario on all the key markets and institutions in the system. This step is where our disciplined approach matters: the FSR starts each section with a table summarizing the most important markets and institutions for a given vulnerability. Fed analysts focus on those at the top of the tables.

Further, estimating losses and liquidity drains from the scenario is inherently imprecise. For instance, we often lack microdata on key exposures and must make

informed guesses, in some cases. This is another difference from the supervisory stress test exercises.

We analyze the interactions across markets and institutions, or second-round effects. Institutions and investors will take losses or watch liquidity being drained in the scenario. They will respond in a given way—deleveraging, for example. Those responses, in turn, will have spillover effects. The question we ask in scenario analysis is, will those second-round effects meaningfully amplify the original shock? This is obviously a difficult question to answer precisely. Indeed, these effects are not modeled in supervisory bank stress tests at all.

We maintain as much specificity and quantitative rigor as possible. For example, when leveraged intermediaries take losses, their leverage increases, and they might choose to, or be forced to, sell assets to deleverage. We aim to be as precise as possible about the plausible range of sales as outcomes. Then, we use several different approaches to measure the effects of these sales, such as direct measurement or comparing sales volumes to purchasing capacity at dealers. Another approach is using historical analogy: has the system handled similar volumes in the past?

Finally, we recognize that our assessments are inherently uncertain. This posture prompts us to look for markers that, should the scenario actually come to pass, would confirm or falsify our assessment. Indeed, scenario analysis is a guide to the financial system's behavior under stress. We need signposts to understand whether the guide is proving valid or whether we missed a key amplification channel.

If we have a valid guide, the work warns us which markets and institutions would come under pressure and whether their distress, in turn, would have severe repercussions.

Sometimes, the most valuable part of these exercises is to familiarize us with the entities that could be most affected.

Reflections on Policymaking

Before I conclude, let me offer some thoughts on policymaking to support financial stability. I am not going to comment on any specific proposals or past actions. My purpose is to describe some of the lessons I have drawn from my years on the Board. If I could send a message to myself four years ago, here is what I would say.

First, I cannot underscore enough how important it is to remain vigilant about obtaining high-quality data to guide financial stability analysis. The stability data challenge is distinct from that we face in our macro work, where we also sometimes have to grapple with measurement issues. In our financial stability work, we confront the evolving nature of the system, where new markets and institutions can rise suddenly. Data permit us to answer key questions. How large is the sector? What share of loans is associated with it? Do borrowers have alternative sources of credit? I have observed a synergy between scenario analysis and data collection. Sometimes when we run a scenario, the most important lesson we take away is the data we need to identify to truly understand how the system might evolve. You can see some of the fruits of that work in our FSR as we add new series or refine our estimates of existing series in response to findings from our scenario analyses.

Second, the policy landscape reflects a long history of decisions that multiple state and federal agencies made in response to a complex mix of mandates and considerations. However, financial stability requires viewing the web of markets and institutions as an ecosystem ultimately designed to support the needs of businesses and

households. This perspective is different from that taken by authorities who are accountable for a particular part of the financial system. If the system is hit with a bad shock, will it continue to function? Would the collapse of one part of the system present an opportunity for a different part to grow?

Furthermore, the tools available to policymakers are typically able to build resilience or constrain activity in one segment of the ecosystem. This practice might make one corner safer, but would such an action lead to a "trophic cascade," or the unwanted growth of a different part of the ecosystem?

Considering an example may be helpful. In the late 1990s, the Australian government undertook conservation efforts to eradicate the feral invasive cats plaguing native, rare birds on Macquarie Island. The effort helped preserve a critical breeding ground for several native, rare bird species, but it also led to an unforeseen consequence: the explosive growth of the rabbit population. Ultimately, after Herculean effort, the Australian government was able to control the rabbit population and that of other invasive rodent species. As a result, critical vegetation has regrown, and rare albatross are nesting on the island again. But even with the happy ending, the experience is a cautionary tale. Inaction itself can have dire consequences, but interventions will also have their effects—anticipated or otherwise. It is all well and good to remove the metaphorical feral cats, but policymakers should be prepared to manage the ensuing boom in rabbits, too.

If you permit me to strain the ecology metaphor further, the global systemically important banks (G-SIBs) are a truly unique genus in our financial ecosystem. The diversity of the U.S. banking sector—with banks of many sizes and business models

serving a variety of customers and communities—can help promote resilience of the overall system. But, for better or worse, G-SIBs are unique and highly interconnected, and the system depends on them for many services. These largest banks can be a source of stability that buffers the entire system in times of trouble. But their resilience is fundamental, because they are connected throughout the ecosystem by extensive networks shuttling resources among them as stress emerges. While I take comfort in the very high levels of resilience of the U.S. G-SIBs, vigilance in ensuring their continued resilience is critical.

Third, we should embrace responsible changes that strengthen our financial system, not hinder them. The Committee on Financial Stability and the Board's staff monitor financial and technological innovations that are in early stages of development, including digital assets and the use of artificial intelligence. The fact that the U.S. financial system is the largest and deepest in the world is the result of decades of successive, and transformative, financial and technological innovations. As a corollary, we need to understand innovations at early stages to see the system's trajectory. We have also observed innovations that have brought unintended consequences, and we need to stay abreast of potential risks in order to better understand where guardrails and industry engagement might be helpful.

And a final note, the tradeoffs between acting to prevent the worst near-term effects at the cost of a larger Fed footprint and moral hazard are real. We know that making policy during a stress event presents the highest degree of difficulty. The stakes are high, with significant real-world losses looming. Time and information are often in short supply. The available options are almost always suboptimal. That is why properly

undertaking scenario analysis in advance is a high priority. This allows policymakers to have some familiarity with the key players and dynamics at play. It is much easier to follow Michel Camdessus's 1994 dictum that "in a crisis, you do not panic," if you have thought through options well in advance.[4]

As we have seen time and again, credible announcements by central banks can have dramatic calming effects. Indeed, a strong initial announcement can result in a smaller intervention than a series of ambiguous or insufficient announcements. But, as with all forms of central bank credibility, this effect is the result of a long history of deep analysis and a consistent track record of following through on previous announcements. The credibility that supports effective financial stability policy interventions is the product of careful, deliberate work, such as the work the FSR details.

Conclusion

Thank you for allowing me to reflect upon my first four years on the financial stability committee. I hope I have made clear that while I, and the Fed, have learned much in recent years, financial stability is an exercise in continual study and improvement. Likewise, it is important to keep you and the public, more generally, informed of this work, which is why we regularly publish the FSR. I trust you are eager to review the next version, when we release the report later this spring. Consistent with the goal of keeping the public informed, I hope my discussion of scenario analysis and the complexities policymakers face when making financial stability policies added to your understanding. Thinking back to the financial crisis, we know the damaging effects

[4] See Stanley Fischer (2011), "Central Bank Lessons from the Global Crisis," dinner lecture delivered at the Bank of Israel conference on "Lessons of the Global Crisis," Jerusalem, Israel, March 31, page 11, https://www.bis.org/review/r110414f.pdf.

of economic downturns on employment and household wealth. Americans depend on a stable financial system to start and support families, buy homes and vehicles, start businesses, and pay for their education. Ultimately, our efforts to maintain financial stability are a service to the American people.

Thank you again to the Yale Program on Financial Stability for the opportunity to speak with you today. I look forward to your questions.