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How Well Is Our Financial System Serving Us?
Working Together to Find the High Road

Remarks by

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at the

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Thank you for inviting me to the Graduate School of Banking at Colorado to share some thoughts about your future and our common work. First, I want to offer my sincere condolences to the families and friends who lost loved ones in the terrible shooting in Aurora last week and wish a speedy recovery to those who were injured. This is a terrible tragedy and everyone across the country shares in the shock and sadness that the people of Colorado are experiencing.

Turning now to the topic of my speech: We've all faced business decisions that offer the opportunity to choose between taking the high road and the low road. In the banking industry, the high road offers a way to do business and to succeed over the long term by building enduring relationships; structuring profitable, win-win arrangements; and treating customers and communities as meaningful stakeholders in the bank's work. But sometimes choosing this high road just doesn't seem to take us where we want to go fast enough. Suddenly, the low road can seem attractive and tantalizing, and it may offer short-term rewards that can be hard to resist. Taking the low road can be an exhilarating and profitable ride for a while, but it almost always leads to disaster and wreckage, and, when banks are the vehicle, taking the low road can cause significant economic and financial problems. As we've experienced over the last several years, when your car is wrecked, it's a long walk home.

At the Federal Reserve, we are working with our fellow regulators to realign the restraints and incentives—the guard rails and HOV lanes, if you will—of the regulatory system to promote use of the high road and warn bankers off of the low roads where the rocks are falling, the curves are sharp, and many calamitous accidents happen.

But this is not a task that the regulators can accomplish alone--any more than police officers can stop cell-phone use on the roads without the active participation of motorists, parents, telephone companies, the media, and so on. New laws and regulations may lay the

groundwork for change, but necessary, sustainable results are realized only when the regulated—be they drivers or banks—get on board.

If drivers are key players in ending texting-while-driving, then the banks themselves are essential actors in our economic comeback, and community banks play a central role. Community banks were not major culprits in the subprime mortgage crisis, but they definitely suffered from it and took some hard hits because of it.

The best community banks exemplify the high-road virtues that we seek to revive as standard operating practices throughout the banking system generally. I am referring to close customer service, long-term vision and sustained relationships, investment that benefits both the bank and the community, commitment to sound underwriting, and consistently legal and ethical practices and transparent governance.

Here at the graduate school, I imagine these high-road virtues to be one of the core values of the program, not peripheral after-thoughts to the course work that you are engaged in. This is good because, while I have been discussing the low road and the high road as though they are distinct and different physical destinations and directions, in fact it can often be difficult to tell the difference between the two. And just as a detailed map, GPS system, and sound experience and judgment can help a driver know which road to take, it can require deep study, careful analysis, and commitment to be prepared to see the positive and negative dynamics intrinsic to any situation and then to make the right choice.

I believe your institutions have the capacity to do a lot of good, and that in fact your banks are doing good work every day. And that is why it is a privilege to be here to address you as future leaders of our country's community banks.

The Role of Banks

Large-scale economic and financial events provide an opportunity to re-think basic assumptions--that is, once we get through the period of crisis management. But it takes a while to get there, and reactions to financial crises consist, first, of strategic containment, and then, of developing techniques of prevention. In terms of our recent financial crisis, the Federal Reserve attempted to provide the containment through the use of both traditional and innovative macroeconomic tools. Congress, in turn, attempted to supply the subsequent preventative tools. In that regard, the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), which embodied Congress' strategy for preventing another crisis, was passed in July 2010.

But in addition to containment and prevention, there is a third component to a meaningful response that we ignore at the public's peril. And that is a significant probing of the more fundamental aspects of how well our financial system is serving us, and at what cost. In fact, I have spent a lot of time, post-crisis, thinking about the role that banks and other financial market entities play in the U.S. economy and in local communities, how well they play that role, and how much it costs us as a society to encourage or enforce that role through regulation.

To date, much of the public discussion of the recent financial crisis has focused on the specific symptoms of this particular episode of financial malfunction. Most people are aware that the staggering loss of jobs, income, and wealth we experienced were associated with what went wrong in the financial sphere. But we cannot forget the need to relate these results to the role that banks and other financial market entities should play in the first place. We need to ask how well banks and financial market entities are performing that role and how to assess the public and private sector costs associated with assuring that they play this role.

In many ways, the choice of which road to take is a function of the particular business model that the financial institution chooses for itself. As community bankers, you have embraced a business model for your banks that is based almost exclusively on pure financial intermediation between borrowers who want to engage in economically productive activities--many of which are for businesses and homeowners in your communities--and depositors who have funds to advance for such activities.

This high-road business model means that your financial institutions easily understand the impact of your actions on local homeowners, businesses, and communities. As a state financial regulator, I saw the individual impact that financial institutions had on the local and overall economies of the state; at the Federal Reserve Board, I see the collective impact that these activities have on the economy as a whole. Your institutions factor those considerations into their business processes, practices, and decisions, which ultimately both create and reflect the culture at your banks. The high-road business model embodies a public and economic imperative that unifies and animates your banking cultures and decisions. Indeed, the high-road business model of a bank allows you to continually challenge the model with the question: Does this banking model interfere with a notion of public welfare and economic common good? Or advance it?

But there are also flawed business models that create misaligned incentives that lead to what I believe are low-road outcomes. Such outcomes stem from a banking model that blithely ignores the core function of banks as financial intermediaries between those who have credit and those who need it. The low-road banking model leads to a series of business choices emanating from a business plan and culture focused largely on quick profits with little consideration of longer-term risks and costs, not only to individual firms, but also to the financial system more

broadly. The model implies indifference to the consequences of poor risk management, executive compensation schemes that encourage unmitigated and unmonitored risk-taking, and reliance on public dollars to save financial institutions from their own folly and the injuries that their folly creates for the people of our country.

Some may argue that we have learned our lessons and left the low road behind us in the wake of the financial crisis. That may be true. I was tempted to think so in a speech I gave in February 2011 called “Putting the Low Road Behind Us,” which focused on high-road and low-road models for mortgage servicing.¹ Yet we know that low-road business models exist and persist: for example, when we hear about billions of dollars of losses resulting from what were supposed to be conservative hedging strategies, or about the manipulation of key market interest rates. News like this causes the public to question the banking sector’s commitment to the public welfare and its willingness to help the nation get back on its feet. And while I believe that most consumers understand that community banks did not, by and large, engage in the most egregious practices, institutions that continue to take the low road tar the image of the entire banking sector. A recent *Wall Street Journal* article did a good job of characterizing how these events have affected the public’s perception of the industry, saying: “Scandals emanating from the boom years should have lost their power to shock. But evidence unearthed by...regulators...is enough to stir even the most jaded cynic.”²

¹ See “Putting the Low Road Behind Us,” speech delivered at the 2011 Midwinter Housing Finance Conference, Park City, Utah, February 11, www.federalreserve.gov/newsevents/speech/raskin20110211a.htm.

² Nixon, Simon (2012). “Lie Bores Into Credibility of Barclays and the City,” *Wall Street Journal*, June 28, <http://online.wsj.com/article/SB10001424052702304830704577492963344243348.html>.

The Role of Regulation

New regulation may not always be popular, but, when crafted appropriately, it can effectively alter the actions of those financial institutions that follow low-road business models. Given that the recent crisis in the financial system contributed to a sharp downturn in the economy that had broad effects, including the loss of millions of jobs, we have seen how all Americans are on the hook for financial institutions' decisions. The relationship between financial markets and the public compels decisionmakers to correct the adverse incentives and moral hazards created by low-road business models.

In my view, though, the regulation of low-road banking models is not without cost. Indeed, some banking models are so complicated that they cannot be regulated without the expenditure of significant public or private dollars. When these business models have such a distant connection to meaningful financial intermediation, I believe that we as a society may very well want to rethink whether we want to support these business models at all. The costs of supporting them, simply put, may be prohibitive.

Indeed, there may not be worthwhile regulatory approaches to all problems, even where the benefits of an activity outweigh the costs to regulate it. For example, when considering the "cost-to-regulate" perspective, some regulatory structures consist of rules that are based solely on metrics. While such rules may have the advantage of being less costly and easier to implement than a more subjective rule, as a regulator, I have to ask whether a metric-based rule will foster the development of internal controls, processes, and cultures that are capable of correcting the problems embedded in a low-road business model. Metrics-based oversight regimes do not work well in correcting misaligned incentives if the metrics in the regime can be

manipulated. It is the potential of metrics manipulation that leads me to favor, in certain instances, clear restrictions on the scope of particularly unproductive activities.

Let's look at the "Volcker Rule" and consider the benefits of a specific activity and the costs to regulate this activity. The Volcker Rule, which was included in the Dodd-Frank Act and should have the biggest impact on the largest and most complex financial institutions, prohibits proprietary trading by federally insured banks and their affiliates, such as broker-dealers. Proprietary trading by such financial institutions is a capital markets activity quite distinct from the prototypical banking relationship that exists to allocate financing from depositors to projects that produce value. I view proprietary trading as an activity of low or no real economic value that should not be part of any banking model that has an implicit government backstop.

Nonetheless, the Volcker Rule, as written by Congress, provides limited exemptions to this proprietary trading ban, so activities that would otherwise constitute proprietary trading can be permitted if those activities constitute hedging or market-making and do not threaten the soundness of the bank or the stability of the financial system as a whole. Stated in terms of the analogy I have been using here, federally insured financial institutions and their affiliates can operate in narrow circumstances along the lines of a low-road banking model where there are sufficient guard rails in place to protect the integrity of the banking system. These guard rails are those limited exemptions based on safety and soundness and financial stability.

The law mandates that the five regulators craft their implementing regulations to reflect the broad prohibition on proprietary trading activities by regulated banks, albeit with exemptions. The regulators then need to carefully examine whether exemptions like market-making or hedging can be conducted by the financial institution within the guard rails of safety and soundness and financial stability and therefore fit within the exemptions as Congress intended.

I dissented in the vote for approval of the proposed implementation of the Volcker Rule. Let me say a bit about that dissent now. One reason for my vote was my sense that the proposed regulation's guard rails were insufficient. I was concerned that, as proposed, the guard rails were too broad and would allow banks to be able to go too far off the road. Further, I was concerned that the guard rails as crafted could be subject to significant abuse--abuse that would be very hard for even the best supervisors to catch.

I feel it is very important that the guard rails be strong and be set very close to the road because of the potentially severe dangers of, and costs associated with, proprietary trading by institutions that have access to the federal safety net. In fact, it is not inconceivable to think that the potential costs associated with permitting hedging and market-making within these exemptions still outweigh the benefits we as a society supposedly receive from permitting these capital market activities. The potential compliance, supervisory, and other costs could be so great as to eliminate whatever value may arguably be derived by virtue of these capital market activities.

What might such benefits be? Improved market liquidity and reduced credit spreads are among the benefits of proprietary trading I've heard discussed.

First and foremost, it is traditional banking of the sort engaged in by community banks that promotes true liquidity in regions and within sectors, through deposit-taking and lending. Sure, liquidity in opaque financial markets may have increased in recent years by virtue of proprietary trading, but how has this market liquidity benefited consumers, retail investors, small business owners, and homeowners? Second, the Volcker Rule does not prohibit proprietary trading by all entities. Rather, it focuses solely on government-backstopped banks and their affiliates. Thus, even if federally insured banks are precluded from making markets, these

markets can continue to be supported by conventional investment banks, hedge funds, and other financial market participants. Thus, any supposed impact by the Volcker Rule on overall market liquidity or credit spreads is, to me, questionable.

Moreover, much of this so-called liquidity, especially in opaque over-the-counter markets, is potentially illusory and destabilizing, especially during adverse market conditions, which does not benefit the public. Indeed, proprietary trading involves buying and selling purely for speculative purposes that have little to do with a true assessment of a financial position's underlying value. Price discovery actually is impeded by this hyper-liquidity that is introduced by such speculation. This hyper-liquidity, motivated by nothing more than expectations of short-term price movements, creates inefficient subsidies to buyers and sellers with no compelling public benefit.

I think that certain markets should feature large credit spreads because they involve truly risky products. Thus, a reduction in proprietary trading may have the effect of increasing spreads, but that is actually a public benefit, not a cost, because those wider spreads will more accurately reflect the risk involved in those positions.

Indeed, banks backstopped by government funding are constrained in their ability to conduct market making, which only creates market pressure for financial instruments that represent proprietary trades to move to established exchanges where transparency is enhanced and exposure to counterparty default risk is greatly reduced.

All of this is to say that liquidity is not an inherent public benefit that justifies the expenditure of significant compliance, oversight, examination, and enforcement costs. In other words, certain capital market activities for federally insured banks should not be supported by vast amounts of public and private expenditure.

Taking the High Road

But what does all of this have to do with you?

Importantly, your being here at the Graduate School of Banking today means that you have embraced high-road business models for your banks. We need bankers like you to remind us of the positive role that you and your institutions play and how you contribute to the revival of a financial system that serves the goal of common and widespread prosperity.

The path that we collectively travel is influenced by the fact that we live in a society populated by institutions with radically different business models: The low-road models can be incredibly large and complex or they can be small and predatory. Because there are costs associated with financial regulation, I am advocating that we understand the public benefits that the financial activity dictated by the model is intended to deliver.

Is this our regulatory fate, to be weighed down as a society with the costs and burdens of regulating the complexity of our financial sector while promoting the public benefit of traditional community banking at the same time? I will not be able to supply you an answer in the next two minutes, but I will give you one small part of an answer. And that part is you. You are an essential ingredient for bringing innovation to real banking. Innovation comes in many forms, of course. To give one example, technology is revolutionizing banking, and that does not apply only to the largest banks.

Depending on how old you are, you may take the ubiquity of technology for granted. But when I reflect on what I've seen and how different my teenagers' world is than the one that I grew up in, I can tell you that the pace of technological development in my own lifetime has been breathtaking. At the risk of dating myself, we have moved from a time when we still wrote our college term papers on typewriters to a time when the processing power of the phones in our

pockets and purses is making even desktop computers increasingly irrelevant. (By the way, if you're wondering what a typewriter is, you can look it up on your smartphone.)

Not surprisingly, banks have taken advantage of this trend and developed tools and systems to enhance both customer service and internal operations. Think about your own banks and how you interface with your customers. A number of customers may still prefer the personal touch of coming into the branch, but I'm also willing to bet that an increasing number of your customers expect to be able to do business electronically when it is convenient for them, not necessarily during the bank's regular business hours. Going back to the automated teller machine and continuing through telephone banking, internet banking, and now mobile banking, the banking industry has strived to deploy technology to be more cost-efficient while meeting customer needs. Of course, the greater use of technology has its own risks as well, so I believe that community banks that are able to harness the power of technology while mitigating risks will be well positioned to better meet the demands of their customers in an innovative manner.

Innovation is about much more than technology, however. You have a special responsibility--and ability--to combine your knowledge of your communities' financial needs with real relationship lending in a way that benefits your local markets and is profitable to your banks. As we have seen during the financial crisis, healthy, profitable banks are well positioned to continue lending to creditworthy borrowers.

Your personal experience with the people of your towns---your knowledge of their needs and resources--is the best path toward maintaining a high-road business model.

Your knowledge of how to pair the needs of your communities with holistic, boots-on-the-ground, due diligence and underwriting means that you have a powerful antidote to the mechanistic low-road approach to finance that has imperiled our economic well-being so

palpably in recent years. With this knowledge, and the actions you take as bankers to implement that knowledge, you can be the engines of banking innovation and, in turn, promote regulatory innovation.

Those of you who have been immersed in the needs of your communities and understand the fundamentals of your business models are poised to exercise not only intelligence, but also wisdom, judgment, empathy, and ethical rigor.

We need you to show the nation how to plow the path toward a higher road.

Thank you very much for your attention and best wishes in all of your work.