Unedited Event Transcript

Presentation on Global Vulnerabilities

Richard Berner (US Office of Financial Research) and Simon Johnson (PIIE)

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Adam Posen: Good afternoon, ladies and gentlemen, welcome back to the Peterson Institute for International Economics, I'm Adam Posen, the institute's president and it is a source of both great interest and great pleasure for me to be able to host Richard Berner and Simon Johnson today.

Global financial stability is one of those slippery terms that we all talk about incessantly, particularly since 2008. We talk about it quite a bit within this building but doing something tangible about it; it's like the weather that our friends fought through to get here today. You can complain about it, but what do you actually do?

And in my opinion, the office of financial research under Richard Berner's founding leadership has made a real contribution actually doing something to helping us identify where the rain is, how heavy it is, what we should be wearing and what are the patterns out there?

And you need that before you can plant anything, whether its real investment, whether its people's savings. And it's in that context we're delighted to have Dick and Simon with us who are going to take us through what we know and don't know, to some degree, about the sources of risk around the world; what we know about how these issues, how these risks get transmitted to the US economy and the spillover effects and the risks here.

All in the context of practically what does the OFR do to give policy makers and the American public the knowledge they need? Speaking second will be our colleague Simon Johnson, who is of course, Ronald A. Kurt's professor of entrepreneurship in MIT's Sloan school of management. But as I think, I hope he proudly, I know often refers, he is a nonresident fellow senior here at Peterson Institute, Simon's leadership on financial supervision and regulation issues dealing with banking and especially too big to fail, but a whole host of issues has been quite evident.

He has, since July 2014, been a member of the Financial Research Advisory Group of the OFR, and he chairs the new recently formed, Global Vulnerabilities Working Group. I'm not going to go through Simon's whole CV, but I think we

can all agree that his independence of thought and his global breadth make him very well suited to contribute in that role, so thank you.

But first let me introduce, or last let me introduce Richard Berner, director of the Offices of Financial Research. I had the privilege to get to know Dick through the years, as so many people did in his private sector role where he was co-head of Global Economics at Morgan Stanley and previously was chief economist at Mellon Bank, at Solomon Brothers, Morgan guarantee Trust Company. Like many of the best people, he started his career under the research staff of the Federal Reserve Board.

He's got an academic and having been an adjunct professor of economics and Carnegie Mellon in George Washington University and he and I both were on the panel of advisors congressional budget office for many years and I got to see his presentations and hear his macro insights there. But again, I think Richard is one of the people who stepped up in recent years since the financial crisis and made a real contribution along with Nellie Lang who recently stepped down at the Federal Reserve.

And making the U.S and the world better prepared for what might happen next and helping us try to prevent or ameliorate future financial crises. Prior to his confirmation as the regional OFR director in January 2013, he served as councilor to the secretary of treasury. Please join me in welcoming Richard Berner.

Richard Berner: Well, Adam, thanks so much for that kind introduction and thank you for inviting me to be here to share the podium with Simon and with you. What Simon and Adam asked me to do to start, was to basically level set a little bit, some of this may appear a little basic to some of you but I'm going to use the obligatory slides to do this. But it thought I'd start by really level setting some of the things that we want to talk about today and when we get into the meat of the discussion, this may serve us in good stead as a framework.

So I wanted to talk first about the lessons that we learned from the crisis, some of the basic ones. Second, how we define financial instability because I think that's very important in thinking about what we do about it. And as Adam was implying, second or third rather, what are the institutions we now have in the United States that are charged with promoting it.

And fourth and very importantly, what data do we need and what analytics do we need that we didn't have in the crisis that, to asses, to monitor the vulnerabilities in the financial system so that we can base our decisions on those things. And last, to talk a little bit about some of the risks.

So as we think about these issues, I think particularly, I think appropriate, to remember that, prior to the crisis we had over sight of the financial system, it was primarily oriented towards institutions and markets. And in the United States, we had different organizations aimed at each.

Those things are very important to ensure safety and soundness, market integrity in the proper functioning of markets and investor protection. But clearly, the crisis brought to the floor the need to focus on risks that went across the whole financial system.

It's pretty clear to me, maybe not to some others that we really don't have any ability to predict or prevent financial crises. So in that sense, Adam, it is a little bit like the weather. We can't stop the rain from coming but we need to know what to do about it in advance.

And what we need to know, what we need to do about it in advance is to try to make our financial system as resilient as it can be and prepare for crises when they arise because I think that, it's safe to say, that we're going to have more of them, how frequently they arrive and what they look like, that's unclear.

But by making the financial system more resilient, we can be ready. So really, when we talk about financial stability, it is about resilience and it occurs, in my view, the financial system can still function even under stress. In various publications that we put out, we identify six basic functions you might want to add to that list if you want to.

I skipped over in thinking about this, on slide, which is very important. This one relates to data because another lesson from the crisis is clearly that we did not have all the data that we needed in order to monitor, in order to identify risks in the financial system.

And that's obviously very important. Let me just go back a little bit here because I also skipped over this slide. Analytically, we didn't understand the extent of leverage and maturity transformation in the financial system; how activity could migrate from one part of the financial system to another.

Presumably to more opaque and less resilient parts in the financial system. And we didn't understand completely the potential for disruptions in the system to spread across the system as a whole. As a whole, and to interfere with its functioning.

So on to data. And this is really very important for us. When we think about the data that we need, you probably are all aware that we have a lot of data on the financial system primarily from banking, but also, we have a variety of data that relate to financial activity.

Unfortunately, those data were too limited in scope or they may not have existed in order to identify some of the things that were going on in the financial system. I would argue that the data were also not as sufficiently high quality so they weren't consistent.

We couldn't aggregate them, we couldn't look at them in a coherent way and make comparisons across markets or institutions. And because in part of our regulatory framework, they weren't accessible to everybody at the same time.

So back to oversight, I think that we can prepare for crises and resilience is really what we're talking about. When we think about threats to financial stability, they really arise from vulnerabilities in the system that represent failures for any of these functions either individually or perhaps together.

So very importantly, resilience has two aspects to it. One is, does this system sufficient shock absorbing capacity to absorb shocks as they inevitably arise. And second, are incentives aligned to limit excessive risk-taking in the financial system?

And think we pay a lot of attention to the first but maybe not sufficient attention to the second. I think both of these things are really important, because clearly you need the shock absorbers to buffer the hits. But you also want to harness market forces using what I call guard rails or the incentives that affect behavior in order to increase the cost of risk taking behavior that might threaten the financial system and create some vulnerabilities in the financial system.

We can talk about some examples of that. What about the institutions that we have in the United States that are charged with looking over the financial system? Well we didn't have one, obviously, before the crisis and so Congress created the Financial Stability Oversight council which consists of all the regulators in the United States and some other folks including the office of financial research, which was created as well under Dodd-Frank.

The council has three responsibilities. One is to identify threats to financial stability; the second is to respond to emerging threats by taking steps to mitigate those threats. Third is to promote market discipline. Market discipline means using those incentives, particularly aimed at reducing or even eliminating, Too Big to Fail. The OFR was created to serve the needs of the council, to provide the data and analysis that is needed in order to look across the financial system so the council can do its job.

Our job is to improve the quality, the scope and accessibility of financial data. Our job is to fill the gaps in analysis and to complement the council's work by assessing and monitoring threats. Our job also is to do some basic research and look at the building blocks that help us understand the functioning of the financial system better. And to evaluate policies, not to make them but to evaluate policies and promote best practices in financial risk management because there is an alignment between the things that we do as policy makers and the things that financial firms do in managing their own risks.

So when we think about data, I mentioned that the data that we had were really not adequate to our task. One key area that I just wanted to mention, I'll focus

on a couple, is in the area of secure order called Security's Financing Transactions or short-term wholesale funding is part of that. And that's obviously critical for functioning of the financial system. We understood that broadly because firms engaged in short-term wholesale funding to fund their inventories of securities or for other purposes.

So broker-dealers were engaged in them and others. And the repurchase agreement market and other short-term wholesale funding markets are extremely important for financial system functioning. We didn't have then a holistic view of how those markets worked; we understood that during a crisis that didn't work too well. Liquidity dried up and we needed to take a holistic view in order to understand better where the problems arose and how the markets were functioning, and how they might be changing.

So in order to do that, we need to map out the landscape, not just in these transactions but also in others. In mapping out the landscape, you can see that we look at both sides of transactions and intrinsically these transactions involve an exchange of cash for securities and that can happen in both directions.

So you have securities dealers in the middle, for example, you have a variety of sources of funds. For example, securities lenders, real money investors like insurance companies or others. And on the other side, you have borrowers like hedge funds and broker-dealers. You notice that they're on both sides of the transaction or they can be on both sides of the transaction. They can be both borrowers and lenders. And that's what made the analysis a little bit complicated but by mapping out the transactions that do occur, we can have a better hope of understanding where the data gaps are and how to fill them.

We can also have a better understanding of how we want to analyze the functioning of these markets. Likewise, when it comes to money funds, by now you are familiar with the problems that we had with money funds. Money funds are money like liabilities and most people prior to the crisis believed that pretty much money funds were redeemable at par and that worked out pretty well until stress hit and they were no longer redeemable at par when one of them broke the buck and we saw a substantial exodus from money funds.

So in response, we the regulatory community, particularly the SEC filled the gaps in data that we needed to analyze that the issues were with money funds by collecting data on so-called form NMPF. And the SEC has been collecting those data since 2011 and you see a representation of those data here in what we call our money market fund monitor. If you look in our website, you can see interactive version of this monitor.

In gives you, in great detail, information about who's exposed to who, how people are borrowing, how people are lending in these markets that are important sources of funding for the financial markets. So filling these gaps in data is extremely important. Let me turn now some of the risks. One of the ways

that we want to think about risks and financial stability looking across the financial system, is to separate them into buckets of risk.

We think about 5 buckets of risk, macroeconomic, market, which include interest rates and volatility and other asset prices, it includes credit risks, funding and liquidity risks and contagion risks. Contagion, of course, is the risk that might occur when a shark hits one part of the financial system and gets transmitted to other parts of it. We have created this financial stability monitor which uses those five buckets of risk to assess using this heat map on a preliminary basis.

How we might want to frame our overall risk assessment and that's a red, yellow, green kind of traffic light kind of system. And you can see that as of the first quarter of 2016, we'll be updating and publishing in a couple of weeks or so, that the risks are not severe. You can see that they're sort of in the middle of the road for these things. Macro risks declined over the past year as growth has started to improve. But one of the things inevitably, in overall assessment, in overall monitor or heat map, like this can really can tend to hide is the details.

The granular details. And as we think about macro risks in particular, we think about risks in the global economy and how they might affect the U.S economy. So in our risk assessment, we think about some of the primary macro risks that might arise overseas.

If European banks experience more difficulty, could that spill over in to the U.S financial system? That's one set of risks that we want to look at. Second, if for whatever reason we see a greater slowdown in China or in other large regional blocks in the global economy, how would that affect U.S economy in the U.S financial system?

So shocks from abroad are a key factor in our thinking and that's one of the reasons that we want to have a conversation in a minute or two about some of those risks. Those aren't reflected here in detail but if you look at our, again, if you look at our website you can drill down into these risks and see some of the details in this monitor.

I'm going to leave it there so at this point, that's just a stage setter and we can then have a conversation in detail about some of these issues with Simon and Adam.

Adam Posen: Thank you very much. As frequent attendees at these lunches and in fact, anybody in Washington knows, to have an official who says, I really want to have time for discussion and actually means it by cutting their remarks, their prepared remarks short, is a big deal. And joking aside, I think it reflects, well not just on Dick, but on the OFR's commitment to being a publicly engaged and open institution. And I know from talking to some of the people here at lunch, there are a lot of people who are already using their data.

But maybe Simon who has been engaged but is independent of the OFR can offer us a bit more of his take on where things stand.

Richard Berner: Before he starts, let me just point out if I could, Adam. You mentioned that Simon is a member of our financial research advisory committee. The committee is comprised of 30 members drawn from different walks of life. We have a research committee and Adam serves a subcommittee; Adam serves on that.

Adam Posen: Assignment services.

Richard Berner: Adam serves on the subcommittee, maybe will Adam will sometime in the future. Simon serves on that subcommittee and you can see the list of people on the website but we wanted to create a committee that was broad in scope and diverse. People often say, in diversity, there's strength and nowhere can you find that better than in our subcommittee and given we have outspoken members like Simon and others, we've got very lively discussions. They're all transparent, they're all in the public domain, we webcast them and so kind of this discussion is exactly what we're looking for.

Adam Posen: Okay, so now that we have all patted each other on the back and I may even get a future appointment, Simon please.

Simon Johnson: Okay. Thanks very much Adam and Dick. And thanks Adam for hosting this event and thanks Dick for coming out today. Maybe I can just say three things briefly and then we'll discuss more freely and, obviously, with all the participants in the room, as well.

So the first point, I have done a little bit more back patting, if it's okay. I do want to be on the record, very clearly, as saying OFR has done a truly terrific job in terms of addressing the issues that Dick laid out. This was an important problem that was agreed across partisan lines after 2008 and OFR was given the fairly difficult task of addressing it. I like the weather analogy a lot, Adam. I would focus on hurricanes and think about hurricanes.

Because if hurricanes, and we've got a lot better at forecasting hurricanes including the conditions that create them and the precise path. And it matters a lot whether or not you call it right in terms of do you evacuate people but it also matters, sort of Dick's point, whether we prepare properly to the resilience of our buildings and our communities to severe weather events including hurricanes.

So I think OFR has really done a terrific job within its mandate of addressing this. Now the second point is, of course, about the mandate and this is not a criticism of OFR or a criticism of Dodd-Frank because Dodd-Frank is an American Law. It's the jurisdiction of that law and the jurisdiction and the agency created by that law is only the United States. But what if we had hurricane forecasting only

within a 12-mile distance of the American Coast? I think it would be a lot less useful.

So I think financial crises in the modern world are in inherently global. I'm looking at Chiang Yung reading here and I've worked on these issues for a long time. Chiang Yung, now a senior official of the IMF. I'm trying to remember last time we had a major crisis that wasn't global in some way Chiang Yung. I think we'd have to go back before the 1980's perhaps to think about that.

So they're intensely global, the spread in unexpected ways and I think part of the challenge that OFR has and part of what Dick is, I think, one of the reasons he's here and to talk to all of us, is how do we think about the world outside of the United States? What kind of data do we have? What kind of data is available to OFR or anyone privately or any official capacity, including the IMF, do we share this data well? Do we share it in real time? What are the -- more specifically in this is the task that the working group who are involved in OFR is trying to grapple with right now.

And I'm absolutely open to ideas and suggestions on this. But what's the set of problems in the world that matter for the United States, that's OFR's mandate, about which we don't have enough data, either in real time or with any lag that would make it useful.

And I've got a couple of big problems in my mind. I'm just speaking for myself here, to be totally clear, European banks, what's the exact status of European banks? What happens if one major European bank is in trouble? What's the potential domino or spillover effect within Europe or to the US in some way and frankly, Chinese banks.

I think I had the same issues there. Now I do agree with Dick that we can focus, drill down into loss absorbing capacity or shock absorbers and I like to think in terms of capital in the financial system and I like very much Morris Goldstein's book, which is coming from the institute that, I think, all of you should read as soon it becomes available in any kind of undercover, underground copy.

Sorry, as soon as it is officially published. It is this fantastic book that really drills down into this—

Adam Posen: I have to say for the record, Morris had been invited multiple times to give previews to his book and he has always declined. So you do have to get your tickets now for the roll out—

Simon Johnson: The anticipation is building, Morris, let's be clear about that. So I think that you can't know everything. So one question is, what does OFR, what would they benefit from knowing, how could they know this? Is it through cooperation with other authorities? Is it through private markets publicly published information?

Is it through data entrepreneurs who make this available? But I think the issue of capital and everything that goes into capital solvency determinations in key, markets, I think that's where I would focus and that's where I think our working group might or might not end up.

But I'm absolutely here to listen to everybody in this room and everybody listening on the webcast to ideas in that direction.

Adam Posen: Before we open it up to everybody, a couple of points. First I do have to make the plug that we will be publishing Morris' book but also Bill Cline's forthcoming book on bank capital as well.

We have two very strong independent assessments of the way forward. There are some differences between them but both of them I think are going to be extremely impactful contributions to the public debate so look for you invitation in this early spring back to the Peterson or actually late winter back to the Peterson Institute.

But let me push you on the data thing. So one of the issues that is always sort of amazing to us nerds is data is a public good and on bank capital, at least, unlike some of the scurrilous accusations that were made, unfounded against the Bureau of Labor Statistics. I don't think anybody has been accusing any of the U.S or the European or even Chinese regulatory agencies, supervisor agencies of bad faith.

So can you gives just a bit more sense of where are the black holes? Where are the dark, I shouldn't say black holes, where are the dark parts? The dark parts that we can't see into and why is it in the FSB process, that we haven't gotten there. I mean, I obviously don't expect the Chinese government to tell us everything about a regional bank in Chengdu, but for the SIFIs for all these things that were agreed on at the international level, why hasn't that turned into data yet?

Richard Berner: Let me first respond a little bit to Simon's comment and answer, it's all three. So you know, obviously firms or global markets, we are national and that requires that we collaborate with our global counterparts, and we do extensively in a lot of ways which I can describe.

But one of the ways that we do that is to engage with them in agreements, memoranda of understanding. So that we can exchange data in a way that keeps the data secure and safe and yet in a way that we can, in the public sector we can access those data for our needs to evaluate threats that might originate or be amplified or be transmitted across national borders.

And there's a mutual, obviously, benefit bother for them, our counterparts and for us in order to do that. Now we're not the only ones who do that. The members of the financial stability oversight council also clearly do that other US regulators.

This speaks a little bit to Adam's question, why is it taking so long? Why are there still gaps in data when A, this is a public good and B, the need for having high quality data that are accessible to people who need them in order to make these risk assessments is still transparent.

I think the reason is that a lot of the data are not shared publicly and if they fell into the wrong hands, whether they have commercial value or other kinds of important value, it would have an impact if they fell into the wrong hands.

The natural instinct is not to share them and that's totally understandable and so what we've tried to do is work towards what we call best practices in data sharing in order to make sure that we can do that in a way that is secure. That is safe so that a supervisor in the U.K or down the street if the Federal Reserve can go to sleep at night know that their data is just as secure as they kept them themselves if they share them.

A good example of sharing is, I think you're all familiar with a very important tool that was developed at the beginning of the crisis. It's not a completely new tool but stress testing is one of the real tent poles, if you will, of financial reform that's enabled us to assess the resilience of financial institutions and increasingly the system as a whole although that is a lot or work to do in that regard.

The Federal Reserve has a process that's known as the comprehensive capital and review process and they use stress tests of large financial institutions in order to prescribe to them what their capital policy, what their dividend policy ought to be.

And this is a very important part of our regulatory infrastructure. As you can image the data that are collected for that purpose are highly confidential, have a lot of commercial value and so understandably, the supervisory team at the Fed doesn't want to share those to a lot of people.

But after three years of legal work and other work, we in the Fed have agreed that the Fed would share those data with us appropriately and we are therefore better able to carry out our mandate to evaluate stress tests, to look at the way that the stress tests are being done.

Not necessarily to say that they are bad or not, but really to say look, here's what we learned from this evaluation, here's how we can make improvements, and having the data is important in being able to do that. And as a consequence, we've been able to have discussions with the Fed about where improvements might be made and they've given us feedback on our work and that kind of collaboration is very important.

Another example goes cross border, we have MOU with a bank of England and all of its constituent parts in the ecosystem of the bank of England. And we

share not just pure data but information that is pre-decisional so that we can benefit from each other's insights and we understand where risks are going on around the world.

But I think it takes a long time to do this work. It takes a lot of patience and perseverance. I know, I can speak to that from 5-and-a-half years of doing this. I love that it goes more quickly and more smoothly but I think it's worth putting in the effort to get to where we need to go.

And I would say that we've made a lot of progress in filling those gaps but there's still are big holes. I showed you securities financing transactions. It's shocking that half of the repo markets in the United States, we had no comprehensive data for that. So we're filling that gap in the office of financial research.

The flash rally that occurred in the treasury market on October 15th 2014, more than two years ago. That data threw into sharp relief the fact the shocking fact, that we didn't have very good data on secondary market activity in the US treasury market, the deepest, broadest and most liquid market in the world and the benchmark for pricing other securities around the globe.

And so the five regulators involved, among them the board of governors, the New York fed and so on, put out a request for information and those data are now going to be collected FINRA in sync with their other data collection processes. So we are filling those gaps and maybe we're slow to recognize where the gaps are but I think there's another aspect to it that's important and that is working closely with market participants and the industry in order to share ideas about where the gaps are and how better to fill them and how we can do it faster. I think that's another aspect that will help solve this problem.

Adam Posen: Let me push you both for a second. So you seem to be saying it's largely a matter of we'll achieve a certain amount of trust and we'll get a certain technical fix and it will happen. The data sharing, the filling of the gaps-

Richard Berner: That's in an ideal world.

Adam Posen: In an ideal world but we're not going to worry about that. In the present situation, so there are a lot of people who are quite concerned about the Chinese financial system. Our friends in the Asia department at the fund and MCM at the fund are doing their bit, others are doing theirs, what kind of information in today's world are you able to give the public and policy makers and Simon, of course, is a little freer to talk. Given that we face this now in real time for all the benefits of your patience and persistence, what can we know now about China's financial fragility?

Richard Berner: I think much less than we'd like to know simply because it's very difficult to get our hands on the data and I think Chin Wan can testify to that. We all have snippets and anecdotes and every once in a while we see through the curtain

and then we see glimmers of what the problem might look like and it's pretty amazing the growth and the debt relative to the GDP in China has been pretty rapid especially in the last 2 years.

And so not knowing however the details makes it very difficult to say this is a huge problem or this is something that's manageable and I think that it's getting those details that's important. So it's not just the bank of England or the ECB or developed country institutions we need to work and we as a regulatory community need to work with but we need to work with Chinese authorities to persuade them that's in their interest and ours to have more information about that so that we can both address these problems if shocks arise that threaten the system.

Adam Posen: Thank you. Simon?

Simon Johnson: This is the question that our working group is trying to pursue, Adam, precisely and I think that first you need to assess what the priority is, so you say China, I say China and we can think of other countries that have trouble around the world. So we have to think about are they big enough? Do they have enough financial flows or other interactions?

Europe, would also I think be on both our agendas. And then if we have that sense of priority, I have various ideas about how we might address it and to tip my hand slightly, I'm hoping that the IMF will be able to be more involved in facilitating these exchanges in integrating this information.

There are plenty of responsible officials in these various countries who you and I know personally, who care all about financial stability and know that shocks go both ways so they don't want to be the cause of the disturbance all on the receiving end on some anticipated fashion.

So I think we can work on that and I'm hoping that our group can be constructive to OFR particularly because we're not official or were official only in this advisory capacity so we can have slightly broader conversations perhaps. I think the longer term issue that interests me a great deal is the structure of data in the financial sector is clearly changing very rapidly and this is because the advent of what we somewhat call loosely blockchain technologies.

So more decentralized way of managing data within large financial firms. It's a huge issue. Across market, so within all those market participants in the security's financing transaction, for example, data is very fragmented, very disperse, it will not be like that in 5 years. It will be much more integrated and managed in a decentralized fashion.

That's my prediction but there's hundreds and millions of dollars going into that technology so I'm fairly confident making that prediction and we have a big project at MIT, as you know, which spends a lot of time with industry participants and thinking about that.

Now I'm hoping that if those block chains are structure appropriately, there will be better sharing with supervisors. Instead of I get data, I tell the supervisor with some lag and that's an annoying process, of course, to fill out those forms, the supervisor should be one mode in the block chain and they should be involved in verifying transactions in securing the data just like other participants.

So that changes how supervisors get information. Of course, there is this key issue that you and Dick are flagging, which is okay the supervisors have got it, what good is that for the rest of us? Well here's I think a role for OFR, which is developing tools that preserve confidentiality to an appropriate degree but allow them either to have an overall financial stability look at what's going on or ideally, in my view, a view that they can publish and make available to people.

Now that one's probably more tricky but for OFR and the people working with the OFR to have that real time in depth sensible, analytical view across supervisory data within a core set of countries, I think that's completely attainable. It doesn't compromise national sovereignty.

I think it's purely in the interest of financial stability and better understanding where the hurricanes are or about to hit.

Richard Berner: Let me just pick up on another aspect of that point more broadly than just DLT or Blockchain technology. We have to think that financial innovation is a constant. It's going to evolve, it has evolved. It's not just technology, it has economic incentive that create, the incentive to move activity from one part of the system to another.

So the venues in which activity takes place are always changing and are migrating. The nature that activity may change, people in the financial community are always looking for creative ways to meet client needs or to do other things whether it's to manage risk or to hide risk or something in between. So I think we have to recognize that we're going to be trying to follow where the puck is going, to use a hockey analogy, not where it is.

And the portrayal that we have here is in our money fund monitor, for example, may help us do that by understanding where the funds are moving and how they're moving because changes in regulation clearly affect changes in business models. The clearly will affect how people invest and how people manage risk and that's going to change the sources and the way we collect the data that are available to us.

Adam Posen: One final question I'll put up because we have a lot of great people in the audience. Let me put this to Simon and then Dick but, you know, we're looking now at battalion banks. We're looking at Europe again. And a number of my colleagues and myself included don't think this is the end of the world by any means. But there is this interesting aspect that part of the problem seems to be

that some of the European governments and supervisors have a different vision for how to provide for financial stability than some of the American supervisors now do.

They don't like stress tests. They don't think you need to raise a lot of capital. They like having, like in the German system [inaudible 00:41:34] reserve and hidden reserves. As we move from the technical good process, into where there's genuine differences over policy, over what constitutes financial instability, how do we cope with that?

How should people on the outside, I mean, should we be sort of throwing up our hands in a sense and saying, they don't do good practices on supervision in Europe, stay away. How should we think about that kind of issue because Simon you've written on the genuine differences between European and American approaches.

Simon Johnson: Absolutely. My only idea on this at this point, Adam, is that we have to measure carefully what happens. People have different ideas at the building codes with Hurricanes, okay these are genuine differences, everybody is acting in good faith.

We'll see what happens when hurricanes hit and let's measure it carefully and my colleague Andrew Lowe at MIT had an idea at the time of the crisis that hasn't been picked up and I think it's a little unfortunate at having at NTSB, National Transportation Safety Board for finance.

So in other words, either you have an accident or a near accident, NTSB investigates incidents when there was no loss of life when the US airline plane came down on the Hudson, nobody died. In fact, the injuries, fortunately were all quite minor. That was a big NTSB report, I've read that report, extremely insightful including where you might want to sit on certain planes. I think we need that on finance and we need it across countries and we need it in depth and you know like the flash rally, well there is a very good report on that.

I think we need to be encouraging authorities in different countries to the extent that one can do it from the outside, of course, is limited. That goes back to the data-trying to push them and say, look this is what we understand has happened in Portugal or Italy or Spain or Germany, challenge us, show us the data that we're wrong and that we're not interpreting this right and I hope that they see that in a positive light and I hope that leads us in this direction but frankly, I am a bit frustrated at this stage.

Richard Berner: The only thing I'd add to that is to say that I think we in the United States have an obligation, an opportunity to show a global leadership in that regard and to show what best practices look like. To demonstrate that there is not only one way to do something, but there are maybe a set of things that we can do. I listened to Mervin King yesterday at breakfast who said, in effect, Basil is dead,

at least that's the way I understood him to speak and that global coordination was something that you know we really shouldn't pursue.

And I think the kernel of truth in what Mervin was saying is look, we need to get our own house in order and I think demonstrating best practices in that regard. And actually doing the things that balance the need to have a strong and resilient financial system with one that, after all, does continue to provide its basic services and can attract capital from investors.

Finding that balance, I think, is very important and it's pretty clear that in the European banks, in many cases, it's very difficult for them to attract capital from private investors and they need to do the things that will help them do that. So think that's where we can show leadership.

Adam Posen: Great. Let me now open it up. So this meeting is totally on the record. We have a travelling mic up front with Jessica, we have a standing mic at back. Please wait to be recognized, you can stand up at standing mic and get yourself in the queue. Please identify yourself when you speak and the more what you say sounds like a question, the more time you get. So at the back mic.

Barry Wood: Barry Wood, RTHK in Hong Kong. You touched on the European banks, but in light of European or an Italian referendum on Sunday. And the concern about Deutsche Bank how would you assess the general vulnerability of European banks?

Simon Johnson: Well I'll obviously only give you my personal opinion, I'm not speaking for any other organization or person on this stage, I'm very worried. We have a simulation that we run at MIT every fall with an executive program and the last three years, we've done the European crisis and we did April 2017 as a scenario this year and a number. So this is a war game type table top with some very smart and well informed people participating and what comes out of this, I think, will be some further action by the European central bank because they don't have any other good options. I don't think that leads the real economy or the financial system actually in a good direction.

So I think it's in the extremely worrisome part of -- whatever color that is in the red, okay it's red in my color code.

Adam Posen: Let me just add two seconds. I spoke at a conference in Frankfurt two weeks ago; it was specifically to try to bring non-German perspectives to Germany on these issues. I think the issue has got to be where we're looking and Bill Cline did a publication for us on this recently. I think the issue in Italy and Germany and Deutsche Bank and some of the medium sized Italian banks in particular, is not an information issue. I think when we talk about China, this is just me speaking for myself, when we talk about China's banks, there's an information issue.

When we're talking about things in the midst of the crisis, there's an information issue. There were information issues in the US, in some of the clearly dark pools so to speak, that were out there. So it's not, but what we're looking when we're looking at Deutsche, when we're looking at and we're looking in the Italian mid-sized banking system are instances of moral hazard and failure of will.

So in Italy, it's about they just allowed them to sell bank bonds to small savers and so you'll have a conflict between the European stated desire to bail in private investors and a political strength necessary to recapitalize these banks. And that's just a pure political hard call, it's not about information, we all know what's there.

Similarly, I think for Deutsche, I think there is definitely a technical assessment to be made. Bill has done one and various sector people have done one. There's a technical assessment but the real issue is the German government just doesn't want to force a recapitalization for the dilution there. And that's not an information issue. So, again, I'm not suggesting my colleagues on stage were suggesting everything is an information issue, it's just to remember that everything is not an information.

Sometimes we all know too well we've seen this movie part 6,7,8,9 before and the question is how does this particular sequel been resolved.

Morris Goldstein: I'm Morris Goldstein from Peterson. In thinking about where the next hurricane might come, I would suggest we look closer to home in the following sense. If you look back at what is the best single explanation for systemic banking crisis, empirically, I would say the best explanation is credibleness paired with overvalued property prices. I think that's what works best.

So when you ask yourself, what's going to happen in the US, judging from a new administration's pronouncements, we're going to have a big fiscal stimulus. Growth will probably pick up, at least in the short term, so loan demand will be up. If the Fed leans against that fiscal push, interest rates will be up. The term premium will be up, banks will be earning more maybe they'll use a little bit of that to build capital but I would predict they would use much more of it to pay dividends and to do share buybacks.

And we have the man, I think cited to be treasury secretary in today's papers and said, well, we need financial deregulation and particularly we need to do that for banks and others because we just need to pump up loans and if we have too much capital, that's going to lower loans.

So we seem to be having a resurgence of light touch financial regulation coming and so I would be interested, I know this is speculative, no one knows exactly what will happen but I wonder whether someone on the panel would address that home grown source of potential financial vulnerability.

Adam Posen: Just to buy one second more time, maybe one way of addressing, not that you need my guidance, is to say were the things Morris says to happen without you having to put a probability on them, how would they show up in your heat map? How would you track them?

Richard Berner: Let me do it in a slightly different way from what Adam has suggested and that is when we think about some of the risks that are out there, we've already seen a very substantial increase in leverage in non-financial business. And a very substantial rise in commercial property prices. Two of the ingredients that you talked about, those aren't clear and present dangers, in our view, but there's something -- both things are worth watching very closely because, typically, they are associated with excesses and financial imbalances that give rise to vulnerabilities in the financial systems.

We're not alone in that sense if you read the minutes of the FMC or you read financial stability reports other than ours, you can see that those things also feature prominently in others. If you read the FSR they came out from the UK, from the Bank of England, they're concerned about the property of price boom that's going on there at the moment. So this is not just a US homegrown phenomenon and it's part consequence of the backdrop that we've had for years now of lower for longer interest rates and volatility.

A rise in asset prices are reaching for yield and a natural -- those are some of the consequences. There are consequences of other things too but it's pretty clear that those are things that we need to watch carefully so I would say that those are the things that we have been focused on for a year or more.

Even if growth does improve, there is still questions about credit quality because underwriting has not been as good as it might have been. The growth of covenant like loans and the growth of loans outside the supervisory perimeter in non-bank financial institutions that are not as closely watched.

A variety of factors contribute to that growth and those are things that we need to watch pretty carefully. The difficulty may be in deciding when they turn from a situation, which you continue to watch carefully into something else. That's why we have monitors in the one I depicted, that's we continue to do analysis, that's why we continue to try to assess what is the probability of default and what's the loss given default and how far down the tail do we chase those risks.

Simon Johnson: I agree that Morris has laid a plausible and worrying potential scenario. I think this is a stress test for our post 2008 institutions. There was a bipartisan consensus that we needed better data and really financial crises are not in the interest of almost anyone.

So are we going to continue to have what we have which is an ability to look at the data and have taken this colleague is telling the truth and if you look at their heat map which is showing on the small screen and on the big screen. Good call on interest rates, Dick, which I know people were skeptical when you put that in

2015, but that was an excellent call and it's going to be fascinating to see how those colors change in the next report which of course I don't have any insight into how you're coming out.

But I think our ability to show what's in the data and to be consistent despite whatever political changes, I think that's really important and we built some structure off of 2008 on a nonpolitical -- I have no idea on this financial research advisory committee which party values people's support.

No idea. It never comes up, it's just a good technical sensible discussion. I think these are nonpolitical issues and I hope they remain nonpolitical.

Adam Posen: Great. Over here at the front.

Luigi: Good evening, my name is Luigi. I'm in the awkward position of representing an Italian bank here in Washington DC.

Adam Posen: Not all Italian banks are the same.

Luigi: Thank you. The point I was about to make. The bank I represent is not very big, our branch subsidiary is in the tune of more than 700 billion Euros so no, we have 35% of the corporate market in Italy, 25 of the retailers. So this is the perspective I'm looking at. You have mentioned Italian banks, it's a bit appalling, if not disappointing when I participate in these kind of venues to hear about Italian banks as if they were all the same. Adam just pointed out this is not the case.

Adam Posen: I kept saying a set of medium sized banks.

Luigi: Right. So the banks that you have mentioned, those who have sold subordinated bonds their retail investors, those who are overloaded with non-performing loans, those like Monte Dei Paschi, where we all know that we were having this discussion before lunch, you run your model and you ended up Monte Dei Paschi needs capital injection.

Well that's not very big news, everybody knows that and they are -- what they are doing now, they are swooping debt into equity and Generali, the largest debt holder of Monte Dei Paschi debt has already said that they would swoop everything into the equity.

So what I'm aiming at is that the problem is extremely well known. The dimension of the problem is extremely well known, the banks which are in trouble have been very carefully ring fenced. We all know what needs to be done and it's being done.

So my question is, do you honestly and seriously believe that banks that have less than 2% of the market share in Italy, do you honestly believe that they can

jeopardize the financial stability of a G10 country like Italy and the financial stability of Europe?

Do you honestly believe that as an academic? I would be surprised if your answer was yes.

Adam Posen: To be fair to our guest, you did indicate reasonable concern over Italian banks.

Simon Johnson: Yeah I'm not backing down at all from what I said. I didn't come here to bash Italy, I'm not here to destabilize anybody's market situation, I prefer that we talk about it in private, subsequently, which is precisely why I'm concerned and we can have a good discussion about that.

But I can assure you that the spirit of this discussion, just like the spirit of the work that we all do in this room, is about having serious discussions on important issues and I am not in the business of exaggerating risks or trying to bash anyone.

I think if we can't have such discussions in public in this kind of forum in Washington DC, that's another level of problem so I stand by exactly what I said.

Adam Posen: So at the back mic and then these two tables.

Bill Cline: Bill Cline here at the institute. I would be very interested in your view of the concern of people like Scot at Harvard that Dodd-Frank left us within hobbled number of last resort and in particular the fact that article 13-3 can only be applied if there's a class of entities and there has been some further definition.

It could be class of five entities rather than one by one as we pursued in the crisis. And in particular the fact that loans from depository institutions within large bank holding companies, to the investments bank subsidiaries of those holding companies cannot exceed 10% of the capital of the depository parent or the depository affiliate cannot exceed 10% of the capital in the sub.

In short, have tied our hands for an aggressive badge at intervention of the large players because of this set of changes in Dodd-Frank?

Adam Posen: For what it's worth, a year ago in foreign affairs I said yes. It was a terrible thing but, hey that's just me.

Richard Berner: Why don't I start Bill, by issuing a disclaimer. Since lender last resort is really part of the monitory policy, part of the Fed. And I make it a practice not to talk about monitory policy but I will say that we probably can do a better job and I think central banks around the world are and can do a better job of tying their lender last resort facilities to financial to stability issues.

And there's more work to be done on that score but I think-

Adam Posen: What does that mean?

Richard Berner: What it means is to think about the governance and the rules regarding lender last resort facilities to take steps to remove the stigma that might be associated with borrowing at the discount window to do what Mervin King suggested yesterday, which the Fed is doing and the Bank of England are doing to preposition collateral with the central bank. So that they can have a look at the collateral and evaluate it and to lend against that collateral on what they know what they're talking about rather than making it up as they go along.

So I think there are a lot of steps that can be taken in that regard that are well known and I think that those are really important steps when you think about a lot of the people who need access to lending facilities, they have those needs because they have runnable liabilities like securities financing transactions.

And so the question because what kind of lending facilities should we make available either on a temporary or a permanent basis? More work needs to be done on that but I think those are some of the issues.

Adam Posen: Thanks. Simon?

Simon Johnson: No, Bill, I don't agree with what you said but you and I disagree on a monthly basis about all of these issues, that doesn't surprise you. I think that the lender last resort powers do still exist and could be use under many circumstances as Dick just mentioned.

I think the broader issue, though, is that we've allowed the financial system to become very concentrated; we've allowed risk to become very concentrated. In 2008, the authorities were forced into providing forms of assistance to some particular private firms that were not available to other private firms or entities or households.

I think the fundamental unfairness of that, the way that reinforces this distorted form of competition or oligopoly power, in the financial market is a big problem. I'm very worried actually we're going to head in another direction. Obviously, this is a time when we don't know exactly what new legislation is going to come forward but we can see that the proposals coming from the people that that have the majority in the representatives

And I think that those are going of further complicate the task of managing financial stability including that you care about, including lender last resort but obviously, much broader.

Adam Posen: Again one more sense, when you say complicate, what are the proposals and what will they do that you're worried about in particular?

Simon Johnson: So there are proposals to limit the independence of the Federal Reserve, to make it more political. I think we have a lot of evidence that says it's a bad idea

with central banks with a monetary policy point of view and from a financial stability point of view.

So that will be front and center, Adam. There are also very serious proposals on the table to remove the orderly liquidation authority which as Bill, most of you know, rests with the FTAC, but also based on decisions made by federal reserve and by treasury in order to exercise that.

And that ordinary liquidation authority is both a power to act and to stabilize the financial system through direct interventions including in individual firms. It also comes with the requirement that you prepare a living will that explains how your firm can be liquidated both under bankruptcy and under the OLA.

I think that the proposal that's really moving forward would remove that requirement substantially from all firms including some of the ones that are systemically important with the result that when and if they fail, you won't be able to put them through bankruptcy.

You will be forced into these awful situations where it's either bail out, something in a very unpleasant unsavory politically unpopular way or let it collapse and let it have massive global consequences. I don't think we want to be in that position. I think we have retrieved from that position and improved, it's not perfect, I agree, but I think Dodd-Frank significantly improved that situation, backed us away from that. I fear that we'll move back to those kinds of really unpleasant decisions.

Adam Posen: Thank you for spelling it out. So over there.

Neil Rowland: MLex news for Doctor Bernard. Two questions please. First a choice act in congress would eliminate OFR, what in your view would be gained, what would be lost by doing so? Second, with a change in administration, do you have any plans to resign?

Adam Posen: Oh good, real reporter questions.

Richard Berner: I'll answer both questions. On the first, I think we talked a lot today about the benefits of having created the financial stability oversight council and the OFR and I would refer you on the former to a speech that my colleague Antonio Wise gave yesterday at the University of Pennsylvania talking about the benefits of the council.

What I've tried to do today is to talk about the benefits to the members of the council, to the public at large from the work that we do namely to fill gaps in financial data and analysis to improve the quality and the scope and accessibility in financial data.

So if somebody else were to do that then maybe we wouldn't lose all that functionality. But we're charged with that mission and that's the law and that's

what we plan to continue to do. On the second question, my term ends on January 1st of 2019 and that's when, that's the latest date in which I will—

Adam Posen: If I can just add. I think for various reasons, my colleagues on stage are going to put together FSOC and OFR. I, speaking just personally for myself, am willing to go much more to the map for OFR than FSOC, because FSOC is an interagency process is inherently a mess and it reflects the fragmented nature of our regulatory supervisory system which should be fixed on a more fundamental level.

OFR, or something like OFR and I think they've done it basically right, will be of use to the American public to whoever is the regulator to whatever happens and whatever is making the decisions in future, you're going to want an OFR or something like it.

So, to me, even though politically and perhaps legislatively they're the same thing. I actually think we can, if people decide to reopen the governance the FSOC that's one thing but nobody should be questioning the utility of the OFR because whoever is in charge is going to need it. That's just my opinion.

Neil Rowland: Listening carefully to Dr. Berner's response, he said January 1st 2019 was the latest date that could serve, do you have any thoughts about leaving before that.

Richard Berner: No I don't.

Neil Rowlard: That's a direct answer, thank you.

Adam Posen: Sigh. At this table please.

Steve Caitlin: Steve Caitlin from the Federal Reserve. So I noticed that when you had your heat map up that the impact of the external sector on US financial stability gets a light green so I was just wondering how do you basically look at financial stability issues abroad and then how do you translate those risks into a potential impact on US financial stability.

And in that mix, you're looking at, what do you view is the key risk areas abroad that entered into that calculation?

Richard Berner: We raised the screen so we can't put that back up but if you look in our website, you can see that but what Steve is talking about is the first of the five buckets of risk. The macro bucket have recently turned more green than yellow and so that suggests that there's less risk there.

As I said earlier, the macro bucket contains both domestic and global kinds of risks. So while the global risks have continued to increase, they've been somewhat offset by what's going on domestically. That's the first point. The second point is that, as you are well aware, global shocks and global

transmission channels can affect US financial system not just through the macro channel but through any of the other four channels through credit risks, through funding and liquidity risks through contagion and through market risk.

And so some of those are not so benign. If you dig into the details of some of these things, which you can do by going to the website and drilling down, had we more time, I'd show you that on the screen, you would see that dichotomy that I talked about between what's going on abroad and what's going on in the United States.

The third point is this heat map is a tool, one of several but not the only one to use to try to assess where risks are. And it's like a screening mechanism, it's the first thing that we might look at but it's not the only thing that we might look at because we know that when we look at these data, which are primarily because of need for a high frequency, they're primary market prices or quantities and they don't necessarily capture all of the dynamics of what's going on around the world or in the United States.

It's only one such tool. In order to really think deeply about where those risks might lie, we use this as a compass or a guide post to start us off in the right direction. It might be the wrong direction quite frankly. Simon pointed out there that the interest rate risk there is painted red and for a year or so, people said really? Looks like we're in a lower for longer environment forever. The point of our interest rate risk was not such about whether interest rates would rise a lot.

The point was that given the reach for yield behavior, the duration, convexity and other kinds of risks that people had taken on, meant that even a moderate change in interest rates could expose them to vulnerabilities. That's really the point here and I think that applies broadly across the board so this is not a forward-looking tool yet. Considered to be the first iteration. Further development is need to make it a better tool and those are the kinds of things we're working on.

Sorry you asked about where we see the risks. They're actually not to disparate from what Simon and Adam have been talking about. While I think that the US financial system is more resilient certainly than 5 years and that shocks from Europe are likely to be those we can withstand.

I don't think we can be complacent about those either. Certainly, shocks that originate in other parts of the world obviously depends on the severity of the shock, the nature of the transmission channels and the ultimate impact on the US institutions.

And the last thing is that sometimes what we find is that just looking at these things piecemeal is not as helpful as thinking about them holistically. So if we have a shock that originates outside banks, for example, we might actually find that it affects banks indirectly if we look hard enough and that's an important channel as well.

Adam Posen: Simon.

Simon Johnson: Yeah it just made me think, Steve, and this is sort of relevant to the issue of what do we do and what does the Fed do that market can't do? If we only look at prices as predictors of anything, we're going to miss quite a lot. As I recall the credit default swap spread at Citi Bank, was quite low in 2005 and 2006, so I think using the market prices as they do is important but they do a lot more than that and so do you, and I think that's incredibly valuable and important.

The private sector left to its own devices, will not be able or want to do anything like what you guys do in an official sense.

Adam Posen: At the back mic and this will be our last question.

Dave Michaels: I'm Dave Michaels with the Wall Street Journal. I have general journalist questions asking you about the news of the day which is the nomination of Steve Mnuchin to be treasury secretary and it's interesting like Mr. Trump, he's an outsider to Washington but is an insider to banking and finance.

I'm kind of wondering do you expect, I would it if all three of you could answer, but do you expect him to be a break on the urge to completely dismantle Dodd-Frank or to be sympatico with the policy preferences that are contained in the choice act. It seemed to be, at least for now, the blueprint for deregulation in the next congress.

Richard Berner: Thanks for your question but I'll answer it in the following way. I'll say that this treasury secretary, Mr. Mnuchin will also be a chairperson of the financial stability oversight council and in that sense, he'll be my boss and I look forward to working with him.

Adam Posen: Very good, yes of course.

Simon Johnson: So I think the fair answer is we'll see and this is a fair question to ask Mr. Mnuchin as he heads through the confirmation process. The point that I'm surprised no one has picked up on yet, perhaps the journal is ahead of me again is that Mr. Mnuchin is on, I believe, on the board of CIT group is among the 20 or so financial institutions that according to the pending house legislation, would no longer regarded automatically. Systematically important and whether or not they are regulated, supervised more closely, would be at the discretion of the FSOC or if there is no, which of course secretary of chairs.

Or if there is no FSOC, not sure what would happen. Perhaps it would go straight to the secretary of the treasury. So there's an interesting set of questions there for Mr. Mnuchin about how he views systemic risk, how we views CIT group in the context of systemic risk and so on and so forth.

Adam Posen: Great. Thank you all for joining us today and thank you, especially, to Simon and Dick Berner for taking us through the entrails of the financial system.