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Janet L Yellen: A challenging decade and a question for the future

Speech by Ms Janet L Yellen, Chair of the Board of Governors of the Federal Reserve System, at the 2017 Herbert Stein Memorial Lecture, National Economists Club, Washington DC, 20 October 2017.

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I am delighted to address the National Economists Club, and I am also honored on this occasion to be associated with Herb Stein, whose public service and scholarship—characterized by careful analysis, clear-eyed pragmatism, and sharp wit—exemplified the best in our profession. Herb was willing to consider new ideas and new approaches to government policy, and that openness fits with the subject of my remarks today. Namely, I will discuss the unconventional monetary policy tools used by the Federal Reserve since the start of the financial crisis and Great Recession and the role that those tools may play in addressing future economic challenges.

Nearly 10 years ago, with our nation mired in its worst economic and financial crisis since the Great Depression, the Federal Open Market Committee (FOMC) confronted a key challenge to the pursuit of its congressionally mandated goals of maximum employment and price stability: how to support a weakening U.S. economy once our main conventional policy tool, the federal funds rate, had been lowered to essentially zero. Addressing that problem eventually led to a second challenge: how to ensure that we could scale back monetary policy accommodation in an orderly fashion once it was no longer needed. Failure to meet either challenge would have significantly compromised our ability to foster maximum employment and price stability, leading to serious consequences for the livelihoods of millions of Americans.

I will argue today that we have met the first challenge and have made good progress to date in meeting the second. Thanks in part to the monetary policy accommodation provided in the aftermath of the crisis—especially through enhanced forward rate guidance and large-scale asset purchases—the U.S. economy has made great strides. Indeed, with the economy now operating near maximum employment and inflation expected to rise to the FOMC's 2 percent objective over the next couple of years, the FOMC has been scaling back the accommodation provided in response to the Great Recession. In no small part because of our authority to pay interest on excess reserves, the process of removing policy accommodation is working well.

After discussing a few issues related to our recent decision to start reducing the size of the Federal Reserve's balance sheet, I will address a key question: What is the appropriate future role of the unconventional policy tools that we deployed to address the Great Recession? While I believe that influencing short-term interest rates should continue to be our primary monetary policy lever in normal times, our unconventional policy tools will likely be needed again should some future economic downturn drive short-term interest rates back to their effective lower bound. Indeed, empirical analysis suggests that the neutral federal funds rate—defined as the level of the federal funds rate that is neither expansionary nor contractionary when the economy is operating near its potential—is much lower than in previous decades. Consequently, the probability that short-term interest rates may need to be reduced to their effective lower bound at some point is uncomfortably high, even in the absence of a major financial and economic crisis.

I will return to the question about the future of our various policy tools, but first I would like to review our experience this decade, which I view as instructive for addressing that question.

Meeting the challenge of providing additional accommodation

A substantial body of evidence suggests that the U.S. economy is much stronger today than it would have been without the unconventional monetary policy tools deployed by the Federal Reserve in response to the Great Recession. Two key tools were large-scale asset purchases and forward guidance about our intentions for the future path of short-term interest rates. The rationale for those tools was straightforward: Given our inability to meaningfully lower short-term interest rates after they reached near-zero in late 2008, the FOMC used increasingly explicit forward rate guidance and asset purchases to apply downward pressure on longer-term interest rates, which were still well above zero.

Longer-term interest rates reflect, in part, financial market participants' expectations of the future path of short-term interest rates. As a result, FOMC communications that affect those expectations—such as the enhanced forward rate guidance provided in our post-meeting statements in the aftermath of the Great Recession—can affect longer-term interest rates. [1] In addition, longer-term interest rates include a term premium, which is the compensation demanded by investors for bearing the interest rate risk associated with longer-term securities. When the Federal Reserve buys longer-term securities in the open market, the remaining stock of securities available for purchase by the public declines, which pushes the prices of those securities up and thus depresses their yields by lowering the term premiums embedded in those yields. [2] Several studies have found that our forward rate guidance and asset purchases did appreciably reduce longer-term interest rates. [3]

The FOMC's goal in lowering longer-term interest rates was to help the U.S. economy recover from the recession and stem the disinflationary forces that emerged from it. Some have suggested that the slow pace of the economic recovery proves that our unconventional policy tools were ineffective. However, one should recognize that the recovery could have been much slower in the absence of our unconventional tools. Indeed, the evidence strongly suggests that forward rate guidance and securities purchases—by substantially lowering borrowing costs for millions of American families and businesses and making overall financial conditions more accommodative—did help spur consumption and business spending, lower the unemployment rate, and stave off disinflationary pressures. [4]

Other central banks also deployed unconventional policy tools in the years that followed the financial crisis. [5] Evidence accumulated from their experience also supports the notion that these tools have helped stimulate economic activity in their countries after their short-term interest rates were lowered to near-zero—and, in some cases, even below zero. [6]

Meeting the challenge of scaling back accommodation

By 2014, the U.S. economy was making notable progress toward the FOMC's goals of maximum employment and price stability. The unemployment rate had dropped to 6 percent by midyear— well below its Great Recession peak of 10 percent—and other measures of labor market conditions were also showing significant improvement. In addition, inflation, as measured by the change in the price index for personal consumption expenditures, had reached about 1-3/4 percent by mid-2014 after hovering around 1 percent in the fall of 2013. Reflecting that progress, the Federal Reserve's focus was shifting from providing additional monetary policy accommodation to scaling it back. [7] A key question for the FOMC then was how to reduce the degree of accommodation in the context of a vastly expanded Federal Reserve balance sheet.

One possible approach was to start by reducing the Federal Reserve's securities holdings while short-term interest rates remained at the lower bound. We could allow securities to roll off the Federal Reserve's balance sheet and even sell securities, thereby putting upward pressure on long-term rates while calibrating the pace and configuration of the reduction in our holdings as warranted by our maximum employment and price stability objectives. Eventually, once our securities holdings had shrunk sufficiently, the FOMC could start nudging up its short-term interest rate target.

One problem of this "last in, first out" approach was that the FOMC does not have any experience in calibrating the pace and composition of asset redemptions and sales to actual and prospective economic conditions. Indeed, as the so-called taper tantrum of 2013 illustrated, even talk of prospective changes in our securities holdings can elicit unexpected abrupt changes in financial conditions.

Given the lack of experience with reducing our asset holdings to scale back monetary policy accommodation and the need to carefully calibrate the removal of accommodation, the FOMC opted to allow changes in the Federal Reserve's securities holdings to play a secondary role in the Committee's normalization strategy. Rather than balance sheet shrinkage, the FOMC decided that its primary tool for scaling back monetary policy accommodation would be influencing short-term interest rates.

As we explained in our "normalization principles" issued in September 2014, the FOMC decided to maintain the overall size of the Federal Reserve's securities holdings at an elevated level until sometime after the FOMC had begun to raise short-term interest rates. [8] Once normalization of the level of the federal funds rate was "well under way" and the Committee judged that the economic expansion was strong enough that further increases in short-term interest rates were likely to be warranted, the FOMC would gradually and predictably reduce the size of the balance sheet by allowing the Federal Reserve's securities holdings to "run off"—that is, we would allow our balance sheet to shrink passively by not reinvesting all of the principal payments from our securities. [9]

One advantage of the FOMC's chosen approach to scaling back accommodation is that both the FOMC and the public have decades of experience with adjustments in short-term interest rates in response to changes in economic conditions. Nonetheless, the post-crisis environment presented a new test to the FOMC's ability to influence short-term interest rates.

Before the crisis, the FOMC could raise the federal funds rate—the rate at which banks with excess reserves lend to banks with a reserve need—by removing a small amount of reserves from the banking system. That would translate into a higher federal funds rate because reserves were relatively scarce to begin with. The intuition was simple: The FOMC would signal that it was going to tighten conditions in the reserve market, and the cost of obtaining reserves in the market —the federal funds rate—would rise. Other market interest rates would then increase accordingly.

After the crisis, however, reserves were plentiful because the Federal Reserve funded its large- scale asset purchases through adding reserves to the system—crediting the bank accounts of those who were selling assets to the Fed. Moreover, in light of the FOMC's decision not to sell the longer-term securities it acquired, reserves were likely to remain plentiful for the foreseeable future. Consequently, when the time came to remove accommodation, a key question for the Committee was how to raise the federal funds rate in an environment of abundant reserves. [10] An important part of the answer to that question came in the Federal Reserve's authority to pay interest on excess reserves. The Congress granted the Federal Reserve that authority in 2006, to become effective in 2011. However, in the fall of 2008, the Congress moved up the effective date to October 2008.

Having authority to pay interest on excess reserves means that the Federal Reserve can influence the federal funds rate and other short-term interest rates regardless of the amount of excess reserves in the banking system. The mechanics of the new framework are straightforward: Banks will generally only provide short-term funding at an interest rate around or above what they could earn at the Fed. As a result, if the Federal Reserve raised the rate it paid, other short-term lending rates would likely rise as well. [11] This new approach for raising short- term interest rates is working well: Since December 2015, we have raised the interest paid on excess reserves and the target range for the federal funds rate by 100 basis points, and the effective federal funds rate has risen accordingly. [12]

A closer look at our balance sheet strategy

In light of our recent decision to start reducing our securities holdings this month, I would like to discuss a few aspects of our balance sheet strategy. [13] The FOMC anticipated that its decision

to maintain the size of the Federal Reserve's securities holdings at an elevated level until sometime after the beginning of rate hikes would keep some downward pressure on longer-term interest rates well after the end of its asset purchase programs. Although estimates of the effect of our securities holdings on longer-term interest rates are subject to uncertainty, a recent study reported that the Federal Reserve's securities holdings were reducing the term premium on the 10-year Treasury yield by roughly 1 percentage point at the end of 2016. [14]

The guidance that the FOMC would eventually start a gradual and predictable reduction of the Federal Reserve's securities holdings implied that the downward pressure on longer-term yields would likely diminish over time as financial market participants came to expect that the start of balance sheet normalization was nearing. Indeed, with that process now under way, it is likely that our securities holdings are now depressing the term premium on the 10-year yield by somewhat less than the 1 percentage point estimate reported for late last year.

Several factors suggest that the downward pressure on term premiums exerted by our securities holdings is likely to diminish only gradually as our holdings shrink. For instance, as I have already noted, our intention to reduce our balance sheet by reducing reinvestment of repayments of principal on our holdings—rather than selling assets—has been well communicated for several years now. As a result, we do not anticipate a jump in term premiums as our balance sheet reduction plan gets under way. In addition, the maturity distribution of our securities holdings is such that it will take some years for the size of our holdings to normalize via runoff. [15]

The judgment that the downward pressure on term premiums will decline only gradually as we reduce the size of our balance sheet stands in sharp contrast to evidence suggesting that this pressure built up rather quickly when we were expanding our balance sheet. To understand this contrast, remember that, unlike our plan to shrink our balance sheet, the various phases of our asset purchases had, to differing degrees, an element of surprise, with asset purchase announcements occasionally leaving a distinct imprint on the path of longer-term yields. Moreover, each of our asset purchase programs resulted in a rapid increase in our securities holdings during a relatively short period, whereas the normalization process will play out gradually over many years.

I have focused thus far on the likely response of term premiums to our balance sheet reduction plan. Let me turn my attention briefly to the likely response of longer-term yields, which, as I have noted, reflect both a term premium component and expectations of the future path of short-term interest rates. While the available evidence points to a strong reaction of longer-term yields to our asset purchases, it is conceivable that those yields will react much more modestly to our balance sheet reduction plan.

Consider, for instance, a hypothetical scenario in which the FOMC has decided not to rely on balance sheet reduction to scale back accommodation, choosing instead to continue to reinvest indefinitely all principal payments from the Federal Reserve's securities holdings. If financial market participants perceived no change in the economic outlook and no intention on the part of the FOMC to alter the overall stance of monetary policy, the FOMC's inclination to leave the size of the balance sheet unchanged would be taken as an indication that the FOMC would instead rely more on increases in short-term interest rates to scale back accommodation, resulting in a faster pace of short-term interest hikes. On net, longer-term yields may be little affected by this hypothetical scenario: While the decreased emphasis on balance sheet reduction would depress term premiums and hold longer-term yields lower, the expected faster pace of short-term interest rate increases would push longer-term yields higher. [16]

A key question for the future

As the financial crisis and Great Recession fade into the past and the stance of monetary policy gradually returns to normal, a natural question concerns the possible future role of the unconventional policy tools we deployed after the onset of the crisis. My colleagues on the FOMC and I believe that, whenever possible, influencing short-term interest rates by targeting the federal funds rate should be our primary tool. As I have already noted, we have a long track record using this tool to pursue our statutory goals. In contrast, we have much more limited experience with using our securities holdings for that purpose.

Where does this assessment leave our unconventional policy tools? I believe their deployment should be considered again if our conventional tool reaches its limit—that is, when the federal funds rate has reached its effective lower bound and the U.S. economy still needs further monetary policy accommodation.

Does this mean that it will take another Great Recession for our unconventional tools to be used again? Not necessarily. Recent studies suggest that the neutral level of the federal funds rate appears to be much lower than it was in previous decades. [17] Indeed, most FOMC participants now assess the longer-run value of the neutral federal funds rate as only 2-3/4 percent or so, compared with around 4-1/4 percent just a few years ago. [18] With a low neutral federal funds rate, there will typically be less scope for the FOMC to reduce short-term interest rates in response to an economic downturn, raising the possibility that we may need to resort again to enhanced forward rate guidance and asset purchases to provide needed accommodation. [19]

Of course, substantial uncertainty surrounds any estimates of the neutral level of short-term interest rates. In this regard, there is an important asymmetry to consider. If the neutral rate turns out to be significantly higher than we currently estimate, it is less likely that we will have to deploy our unconventional tools again. In contrast, if the neutral rate is as low as we estimate or even lower, we will be glad to have our unconventional tools in our toolkit.

The bottom line is that we must recognize that our unconventional tools might have to be used again. If we are indeed living in a low-neutral-rate world, a significantly less severe economic downturn than the Great Recession might be sufficient to drive short-term interest rates back to their effective lower bound.

Conclusion

Let me conclude with a brief summary. As a result of the Great Recession, the Federal Reserve has confronted two key challenges over the past several years: One, the FOMC had to provide additional policy accommodation after short-term interest rates reached their effective lower bound; and two, subsequently, as we made progress toward the achievement of our mandate, we had to start scaling back that accommodation in the presence of a vastly expanded Federal Reserve balance sheet.

Today I highlighted two points about the FOMC's experience with those challenges. First, the monetary policy tools that the Federal Reserve deployed in the immediate aftermath of the crisis —explicit forward rate guidance, large-scale asset purchases, and the payment of interest on excess reserves—have helped us overcome these challenges.

Second, in light of evidence suggesting that the neutral level of short-term interest rates is significantly lower than it was in previous decades, the likelihood that future monetary policymakers will have to confront those two challenges again is uncomfortably high. For this reason, we must keep our unconventional policy tools ready to be deployed again should short- term interest rates return to their effective lower bound.

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[1] Before the Great Recession, the FOMC occasionally provided forward rate guidance, but that guidance was typically confined to a relatively short horizon.

[2] In addition to depressing term premiums, large-scale asset purchases by the Federal Reserve can lower longer-term yields if those purchases are perceived by the public as a signal that short-term interest rates are likelyto remain lower for longer than previouslyanticipated.

[3] See, for instance, Eric T. Swanson and John C. Williams (2014), "Measuring the Effect of the Zero Lower Bound on Medium- and Longer-Term Interest Rates," American Economic Review, vol. 104 (October), pp. 3154–85; Joseph Gagnon, Matthew Raskin, Julie Remache, and Brian Sack (2011), "The Financial Market Effects of the Federal Reserve's Large-Scale Asset Purchases (PDF),"International Journal of Central Banking, vol. 7 (March), pp. 3-43; and Stefania D'Amico, William English, David Lopez-Salido, and Edward Nelson (2012), "The Federal Reserve's Large-Scale Asset Purchase Programmes: Rationale and Effects," Economic Journal, vol. 122 (November), pp. F415–46.

[4] See, for instance, Eric M. Engen, Thomas Laubach, and David Reifschneider (2015), "The Macroeconomic Effects of the Federal Reserve's Unconventional Monetary Policies," Finance and Economics Discussion Series 2015–005 (Washington: Board of Governors of the Federal Reserve System, January).

[5] The Bank of Japan had deployed unconventional tools well before the crisis.

[6] See, for instance, Andrew G. Haldane, Matt Roberts-Sklar, Tomasz Wieladek, and Chris Young (2016), " QE: The Story So Far (PDF)," Staff Working Paper No. 624 (London: Bank of England, October); and Luca Gambetti and Alberto Musso (2017), "The Macroeconomic Impact of the ECB's Expanded Asset Purchase Programme (APP) (PDF)," ECB Working Paper 2075 (Frankfurt: European Central Bank, June).

[7] See Janet L. Yellen (2017), "From Adding Accommodation to Scaling It Back," speech delivered at the Executives' Club of Chicago, Chicago, Ill., March 3.

[8] Information on the FOMC's Policy Normalization Principles and Plans is available on the Board's website at www.federalreserve.gov/monetarypolicy/policy-normalization.htm.

[9] The FOMC announced in December 2015 that it anticipated maintaining its reinvestment policy until normalization of the level of the federal funds rate was "well under way." That announcement is available on the Board's website atwww.federalreserve.gov/monetarypolicy/files/monetary20151216a1.pdf. More recently, in June 2017, the FOMC provided additional details regarding its approach to reduce the Federal Reserve's securities holdings, indicating that once the balance sheet normalization plan began, principal payments received from securities held by the Federal Reserve would be reinvested only to the extent that those payments exceeded certain monthly caps. The caps would rise gradually but would remain in place during the normalization process. The June 2017 announcement, Addendum to the Policy Normalization Principles and

Plans, is available on the Board's website at www.federalreserve.gov/monetarypolicy/files/FOMC_PolicyNormalization.20170613.pdf.

[10] For a discussion of the pre- and post-crisis frameworks for implementing short-term interest rate decisions, see Jane E. Ihrig, Ellen E. Meade, and Gretchen C. Weinbach (2015), "Rewriting Monetary Policy 101: What's the Fed's Preferred Post-Crisis Approach to Raising Interest Rates? (PDF)" Journal of Economic Perspectives, vol. 29 (Fall), pp. 177–98.

[11] The Federal Reserve created supplementary tools to be used as needed to help strengthen its influence over short-term interest rates when reserves are plentiful. For instance, the overnight reverse repurchase agreement facility allows a variety of counterparties, including eligible money market funds, government-sponsored enterprises, broker-dealers, and depository institutions to invest funds overnight with the Federal Reserve at a rate determined by the FOMC.

[12] For a discussion of how increases in the FOMC's target range for the federal funds rate have transmitted to other short-term interest rates, see Alyssa Anderson, Jane Ihrig, Mary-Frances Styczynski, and Gretchen C. Weinbach (2017), "How Have the Fed's Three Rate Hikes Passed through to Selected Short-Term Interest Rates?" FEDS Notes (Washington: Board of Governors of the Federal Reserve System, June 2).

[13] The FOMC's announcement of the beginning of implementation of the balance sheet normalization plan is available on the Board's website; see Board of Governors of the Federal Reserve System (2017), "Federal Reserve Issues FOMC Statement (PDF)," press release, September 20.

[14] See Brian Bonis, Jane Ihrig, and Min Wei (2017), "Projected Evolution of the SOMA Portfolio and the10-Year Treasury Term Premium Effect," FEDS Notes (Washington: Board of Governors of the Federal Reserve System, September 22).

[15] Moreover, as the FOMC announced in June, the Committee decided to cap the monthly run-off in the Federal Reserve's securities holdings, making the balance sheet normalization

process even more predictable and gradual. The FOMC's announcement is available on the Board's website; see Board of Governors of the Federal Reserve System (2017), "FOMC Issues Addendum to the Policy Normalization Principles and Plans," press release, June 14.

[16] In contrast, when the Federal Reserve was purchasing assets, short-term interest rates were at their effective lower bound, and they were expected to remain there for the foreseeable future. As a result, decisions to buy additional assets—and the resulting additional downward pressure on term premiums—were not offset by expectations of a higher path for short-term interest rates. The end result was that there was greater potential for asset purchases to have a discernible effect on longer-term yields in the years immediately following the financial crisis than in current circumstances.

[17] See, for instance, James D. Hamilton, Ethan S. Harris, Jan Hatzius, and Kenneth D. West (2015), "The Equilibrium Real Funds Rate: Past, Present, and Future," NBER Working Paper Series 21476 (Cambridge, Mass.: National Bureau of Economic Research, August); Olivier Blanchard (2016), "Three Remarks on the U.S. Treasury Yield Curve," Peterson Institute for International Economics, RealTime Economic Issues Watch (blog), June 22, piie.com/blogs/realtime-economic-issues-watch/three-remarks-us-treasury-yield-curve; and Kathryn Holston, Thomas Laubach, and John C. Williams (2016), "Measuring the Natural Rate of Interest: International Trends and Determinants (PDF)," Working Paper Series 2016–11 (San Francisco: Federal Reserve Bank of San Francisco, December).

[18] FOMC participants' most recent projections of the federal funds rate are discussed in an addendum to the minutes of the Committee's September 2017 meeting, available in an October 11, 2017, press release on the Federal Reserve Board's website at www.federalreserve.gov/newsevents/pressreleases/monetary20171011a.htm.

[19] See Janet L. Yellen (2016), "The Federal Reserve's Monetary Policy Toolkit: Past, Present, and Future," speech delivered at "Designing Resilient Monetary Policy Frameworks for the Future," a symposium sponsored by the Federal Reserve Bank of Kansas City, held in Jackson Hole, Wyo., August 26; and David Reifschneider (2016), "Gauging the Ability of the FOMC to Respond to Future Recessions (PDF)," Finance and Economics Discussion Series 2016–068 (Washington: Board of Governors of the Federal Reserve System, August).

Fonte: Bank For International Settlements (BIS)

http://www.bis.org/review/r171024d.htm

Jerome H Powell: Financial innovation - a world in transition

Speech by Mr Jerome H Powell, Member of the Board of Governors of the Federal Reserve System, at the 41st Annual Central Banking Seminar, sponsored by the Federal Reserve Bank of New York, New York City, 18 October 207.

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We live in a world defined by the rapid pace of technological change. Four of the five largest U.S. companies by market capitalization are classified as “technology companies,” where the term describes the products that these companies sell and how they operate. Thanks to decades of investment in information technology, especially in electronic communication networks, consumers now expect services to be available instantly at their fingertips. This statement is true for almost every industry and every aspect of daily life, including financial transactions.

This evening, I will consider how technology is changing the delivery of retail banking and payments services. I will discuss the roles of banks, fintech companies, and other stakeholders in moving the United States forward to a better payment system. I will also review the Federal Reserve’s collaboration with these payment system stakeholders in pursuing that goal. I will argue that, for policymakers as well as the private sector, the challenge is to embrace technology as a means of improving convenience and speed in the delivery of financial services, while also assuring the security and privacy necessary to sustain the public’s trust. As always, the views I express here are my own.

Retail Banking Innovation

As with so many sectors of the economy, technology is transforming the retail banking sector. The banking industry has traditionally been characterized by physical branches, privileged access to financial data, and distinct expertise in analyzing such data. [1] But in today’s world companies need not be bound by physical infrastructure and related overhead expenses. For example, companies can take advantage of an explosion in available data, and leverage advances in computing power, via cloud computing, analytical tools, and off-the-shelf machine learning tools, to make sense of those data. The banking industry is adjusting to this world, and facing significant challenges to traditional banking business models.

For example, today financial technology can support access to credit through innovative approaches to gathering and analyzing data. Historically, a customer seeking a loan has provided financial statements to a bank or other traditional lending institution. More recently, the use of a fintech platform may allow a lender to quickly monitor and analyze more up-to-date data from a broader range of sources, including those outside of the traditional lending process, to verify an applicant’s identity and make inferences about the applicant’s overall financial health. For example, a business loan applicant could submit information such as shipping data or customer reviews as additional input to more traditional data sources. With this additional information, the bank would have a more complete picture of an applicant's day-to-day activity and overall financial capacity, and potentially a greater ability to provide credit to customers, including some who might have been otherwise denied a loan based on traditional data.

Fintech firms are also finding ways to use banks' data, in some cases without entering into an explicit partnership with the bank. With customers' permission, fintech firms have increasingly turned to data aggregators to "screen scrape" information from financial accounts. In such cases, data aggregators collect and store online banking logins and passwords provided by the bank's customers and use them to log directly into the customer's banking account. This information can be used to provide consumers with convenient real-time snapshots of their financial information across multiple banks and accounts.

These examples highlight that there is a balance that needs to be achieved in this innovative environment. [2] On the one hand, new technologies have enabled banks and other firms to find

different ways of meeting consumers' demand for speed and convenience. On the other hand, these same technologies raise new considerations about data security and safety, as well as consumer privacy and protection. Policymakers and the financial industry must assure that enhanced convenience and speed in financial services do not undermine the safety, security, and reliability of those services.

Retail Payments Innovation

Technology is also shaping changes in retail payments. As with retail banking, retail payments will need to evolve to meet consumer expectations of constant connectivity and instant access while assuring security and privacy.

It is not news that consumers' lives, including the way they pay, are now intertwined with mobile phone usage. While the overall amount of time we spend on our phones continues to grow, the duration of individual phone sessions is actually shrinking. In late 2015, Google estimated that the average mobile session lasts only 70 seconds, and may be repeated dozens of times per day. [3] As a result, payment innovators have had to create new ways to move money that are not only fast and mobile-focused, but also sufficiently "frictionless" that consumers can now fit commerce into these brief interludes.

This development has ushered in a world of multiple smartphone apps that allow for "instant" payments. We can use a payments app to move funds instantly to anyone who has that app. [4]

Some banks have similarly collaborated to build faster payments applications that leverage their deposit account systems. And we are already moving to a world in which we need not open a special app or go to our bank's website in order to send money. Many people here will have taken an Uber or Lyft, and then paid your driver without relaunching the app, much less reaching for your wallet. Similarly, payment providers can now leverage the application programming interfaces (APIs)—essentially the protocols—of smartphone messaging services to integrate their payment tools directly into messaging applications: Nowadays, consumers can simply “attach” money while messaging a friend.

Innovation in retail payments can also offer tangible benefits to consumers beyond convenience. Improvements in security, such as our ability to authenticate consumers and detect fraudulent transactions, are also possible through innovation. For instance, mobile payments introduce a wide array of ways to authenticate a consumer’s identity, including two-factor authentication codes sent via text message to the phone; biometrics, like a fingerprint or face scan; device identification information; IP address; and geolocation data. Similarly, increased access to transaction data and cloud computing resources means that we have smarter, faster computational processes—like enhanced neural networks—to detect payments that do not match a consumer’s spending patterns and help prevent fraudulent transactions. Both security and convenience are crucial elements for successful payments innovation. Consumers will not store their funds in a system that is not secure and will not want to transfer funds out of an otherwise secure system if the process is cumbersome.

The Role of Banks in Payments Innovation

The examples I have highlighted so far illustrate payments innovations from fintech firms and banks alike. I want to spend a moment highlighting the special role of banks in the payments process, and how banks are needed in order to create innovations that can be used broadly across the economy.

The traditional role of banks in the payments process has been to hold deposits and enable their transfer from one individual or business to another. A depositor might withdraw cash from the bank’s ATM to pay a friend or write a check to make a payment. Over time, we have moved from ATMs and paper checks toward electronic payments and online payments through banking platforms—payment methods for which banks are still perceived as essential. More recently, consumer-facing technology has become front and center. At times, the payments process is so seamlessly integrated that one can forget that there is even a bank in the process, as with the Uber and Lyft example. But despite this shift in focus, payments innovation is still fundamentally about how, when, and where an individual’s deposits can be held, transferred, and packaged with other information. And banks are still important players in making that happen. Even where this reality is obscured by several layers of technology, there is almost always a bank involved in consumer transactions.

Given their importance in holding and transferring funds, banks continue to have a key role to play in the design and safety of more efficient retail payment systems. Without bank participation, it would be difficult to change how funds are transferred in a way that brings pervasive benefits to consumers. For example, if the aim is to capture the speed and continuous nature of today’s commerce in the payment system as a whole—as has become a focus for many countries, including the United States—it would be difficult to do so without banks allowing the transfer of their deposits on a 24x7 real-time basis. Of course, individual payment systems are already doing this for consumers within their own network. But achieving these benefits on a broad scale would be challenging without the banking system's participation, because of the large role banks have in holding and transferring funds.

All this is to say that we are at a critical juncture in the payment system's evolution, where technology is rapidly changing many facets of the payments process. Fintech firms and banks are seizing these technological changes in their own ways. But a collective and collaborative effort by all payment stakeholders will also be important as the United States works to achieve a payment system that has broad reach and can seamlessly integrate with other systems to transfer funds in a reliable, secure, and convenient manner. When we pay with cash or write a check, we don't spend a lot of time worrying about who our recipient banks with; that universality seems an appropriate standard for new payment options as well.

Strategies for Improving the U.S. Payment System

At the Federal Reserve, we believe it is important to embrace opportunities provided by technological change to improve the convenience and safety of the U.S. payment system. About five years ago, we launched our payment system improvement initiative, which committed the Federal Reserve to working with the full range of payments system stakeholders to achieve a faster, more secure payment system. We saw that technology was transforming the nature of commerce and end-user expectations for payment services. We saw some players coming to market with innovative product offerings, but it was a fragmented approach. Meanwhile, other countries were advancing on initiatives to improve the speed and safety of their payment systems, creating a gap between the U.S. payment system and those abroad.

While the Federal Reserve does not have plenary authority over payment systems, as is the case in some other countries, we have often played an important role as a leader and catalyst for change. It was in this role that we issued a call to action asking stakeholders to come together in pursuit of a better payment system for the future—focusing on speed, security, efficiency, international payments, and collaboration. [5] I believe a collaborative approach ensures that change is designed by those whose commitment and expertise are needed to improve the payment system.

Stakeholders – including banks, fintech companies, consumer groups, regulators, and others — answered our call to action, signing up for two task forces convened by the Federal Reserve. More than 300 stakeholders joined the Faster Payments Task Force, and around 200 joined the Secure Payments Task Force. Let me first touch upon the Faster Payments Task Force, which has recently completed its work. [6]

The Faster Payments Task Force's mission was to identify and assess alternative approaches for implementing a safe, ubiquitous, faster payments system in the United

States. The task force began its work by developing a set of effectiveness criteria laying out desirable attributes for faster payment solutions covering the broad categories of ubiquity, efficiency, safety and security, speed, legal framework, and governance. While the task force was focused on improving speed and convenience, it also underscored the importance of safety and security by establishing 11 criteria of a total of 36 focused on those objectives.

The task force encouraged its members to submit proposals for faster payment solutions that would meet the criteria that its members had agreed upon. A diverse range of task force members rose to the challenge by submitting 16 proposals to be vetted against its criteria. [7] These proposals represent a broad universe of creative and innovative ways to deliver faster payments by embracing technology. They range in structure from solutions that use a centralized clearing and settlement mechanism to others that focus on distributed networks. Some are based on traditional assets held in transaction accounts, and others depend on new asset forms like digital currencies. The role of the task force process was not to recommend or implement a faster payment solution, but rather to offer a range of ideas to move the United States further along the path to a better payment system. We believe that the task force has successfully carried out this role.

We are very grateful to the members of the Faster Payment Task Force for all of their work and for the collaborative spirit they brought to the job. But there is more to be done to advance our collective vision of a ubiquitous, real-time, secure future payment system. Last month, the Federal Reserve reaffirmed its commitment to that vision in the paper, “Federal Reserve Next Steps in the Payments Improvement Journey,” which outlines refreshed strategies and tactics that we, in collaboration with the payment industry, will employ to make further progress. [8] I will mention just a few.

One of the recommendations from the Faster Payments Task Force work was to establish an industry governance framework for collaboration and decision-making on faster payments. To move forward in creating this framework, the task force established the Governance Framework Formation Team to develop, publish, and solicit public comment on a proposal for a governance framework. This work group will carry out many of the task force recommendations and the Federal Reserve, at the request of the task force, is chairing and facilitating this effort.

In addition, the Federal Reserve is considering providing settlement services—a traditional core function of a central bank—to address the future needs of a ubiquitous real-time retail payments environment. We plan to actively engage with the industry and other stakeholders to further understand gaps and requirements for real-time retail payments settlement and assess alternative models that will support needs over the long term. We also plan to explore and assess the need, if any, for other related Federal Reserve services or capabilities. In carrying out this assessment, we will be guided by current and potential market developments and challenges, as well as our long-established criteria for offering new products and services. These criteria include the need to fully recover costs over the long term; the expectation that the new service will yield clear public benefit; and the expectation that other providers alone cannot be expected to provide the service with a reasonable effectiveness, scope, and equity. [9]

The Federal Reserve will also continue to support the ongoing work of the Secure Payments Task Force. This task force has been working to educate stakeholders on payment security practices, risks, and actions that could enhance payment security. These are challenging topics, because they require stakeholders to be open and forthcoming about potential vulnerabilities if there is to be substantial progress.

The Federal Reserve will also pursue two new efforts focused on security. Early in 2018, we plan to launch a study analyzing payment security vulnerabilities. This study is similar to other research efforts that the Federal Reserve has pursued to build foundational and collective understanding of the U.S. payment system. We also plan to build upon the contributions of the Secure Payments Task Force to establish work groups focused on approaches for reducing the cost and prevalence of specific payment security vulnerabilities. In a world of ever-escalating threats to the integrity of our payment system, this collective action is needed to sustain public confidence.

These were just a few of our new initiatives. The package of next steps the Federal Reserve outlined in its recent paper confirm that we remain steadfast in our commitment to work with industry and other stakeholders to achieve a better payment system through both leadership and action.

Summary

Rapidly changing technology is providing a historic opportunity to transform our daily lives, including the way we pay. Fintech firms and banks are embracing this change, as they strive to address consumer demands for more timely and convenient payments. A range of innovative products that seamlessly integrate with other services is now available at our fingertips. It is essential, however, that this innovation not come at the cost of a safe and secure payment system that retains the confidence of its end users. The examples I have drawn upon today highlight that fintech firms and banks must each play a role in assuring that enhancements to convenience and speed do not undermine safety and security. More broadly, the Faster and Secure Payments Task Forces demonstrate the importance of broad and diverse stakeholder input, which are essential if the United States is to implement safe, ubiquitous real-time retail payments. Working together, we can achieve a safe and fast payments system that meets the evolving needs of consumers and our dynamic economy.

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[1] See, e.g., Miklos Dietz, Somesh Khanna, Tunde Olanrewaju, and Kausik Rajgopal, "Cutting Through the Noise around Financial Technology," McKinsey & Company, February, 2016, www.mckinsey.com/industries/financialservices/our-insights/cutting-through-the-noise-around-financial- technology.

[2] See Lael Brainard, "Where Do Banks Fit in the Fintech Stack?" (speech delivered at the Northwestern Kellogg Public-Private Interface Conference on "New Developments in Consumer Finance: Research & Practice," Evanston, Illinois, April 28, 2017).

[3] "Your Guide to Winning the Shift to Mobile," Google, Micro-Moments, September 2015, www.thinkwithgoogle.com/marketing-resources/micro-moments/micromoments-guide-pdf-download/.

[4] Cashing the funds out of the app to use for other payments, however, has traditionally taken longer.

[5] See Federal Reserve System, "Strategies for Improving the U.S. Payment System (PDF)," January 26, 2015.

[6] See Faster Payments Task Force (2017), "The U.S. Path to Faster Payments, Final Report Part Two: A Call to Action," fasterpaymentstaskforce.org/.

[7] The task force recommended establishing an external Qualified Independent Assessment Team to conduct objective proposal assessments. On behalf of the task force, the Federal Reserve selected McKinsey & Company to conduct a comprehensive assessment of each faster payment solution proposal against the task force's set of criteria.

[8] See Federal Reserve System, "Federal Reserve Next Steps in the Payments Improvement Journey (PDF)," September 6, 2017.

[9] See Board of Governors of the Federal Reserve System, "Policies: The Federal Reserve in the Payments System," revised 1990.

Fonte: Bank For International Settlements (BIS)

http://www.bis.org/review/r171020g.pdf

Andreas Dombret: Sometimes small is beautiful, and less is more – a Small Banking Box in EU banking regulation

Speech by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at a lunch debate on proportionality in banking regulation at the Representation of the State of Hesse to the European Union, Brussels, 19 October 2017.

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1. Introduction: Striking the right balance

Ladies and gentlemen

At the end of the day, regulation is always about striking the right balance.

Regulators are always torn between "the stronger, the better" and "sometimes less is more".

We need to strike the right balance – to find a middle ground – between too weak and too constraining regulation. Today, I want to focus on a very important – but frequently neglected – aspect of our balancing act: that between setting robust standards for global banks, on the one hand, and allowing different business models of the many small and medium-sized banks in Europe to co-exist, on the other.

We are not quite there yet. The core problem is that our regulatory architecture still lacks sufficient proportionality – in non-technical terms: the rules are too complex for small, locally oriented banks.

Today I want to explain why this is the case – and why Europe's decision makers should care. I will begin by outlining how the current regulatory regime of complex rules that governs virtually all banks in the EU came into being. Then, I will devote most of the rest of my speech to laying out a solution for the EU's banking sector: the Small Banking Box – a separate set of rules for smaller, locally oriented, and less risky institutions.

2. International, complex rules for small, local banks

But let me first outline the challenge at hand: All banks in the EU are subject to a single set of strong, but also complex and detailed, rules. These rules are derived from an international standard developed in a global forum. Why is this a problem?

International standards for the banking business are very important. In fact, they are a key element of global financial stability. That's why the Basel Committee, a global forum of regulatory authorities from the G20 nations, develops these standards.

But we need to keep in mind that these rules were originally designed to level the playing field for internationally active banks across the globe. And to prevent a regulatory race to the bottom among jurisdictions.

Naturally, they have therefore been fitted to the organisational structures, the business models, of such large international banks. Since the adoption of the international Basel II framework in 2005, the complexity of these rules has mushroomed.

The Basel III reforms launched in response to the last financial crisis – including the final elements of the Basel III package that we are currently negotiating in Basel – have made the rules even more detailed and complicated.

We have the guiding principle of the reforms to thank for this: risk-oriented governance and regulation are there to help banks allocate capital resources as efficiently as possible. But in order to prevent undercapitalisation, this approach needs very specific rules. This increases the compliance workload – that is, the effort associated with meeting the requirements as well as demonstrating that they’ve been met.

The Basel rules were made for large, internationally active banks – they were not designed with small banks in mind.

Yet, in Europe, we adopted these rules for all European credit institutions alike – including the thousands of small and medium-sized banks with simple business models and regional focus.

The motivation for this one-size-fits-all-regulation was to have a single set of rules for the single market. The EU’s primary goal of a common, single market meant that one single set of rules was preferred over differentiated sets of rules. Proportionality – the principle that rules must be proportionate to the issue they address – played only a secondary role.

While this makes good political sense, it has had serious side effects – as it favours large, internationally active banks over smaller institutions.

Particularly for credit institutions that are able to strongly optimise their employment of capital in order to benefit from higher returns, this is worth all the effort. And it’s worth it for especially large credit institutions because they can profit from economies of scale where fixed costs per product fall as the volume of business increases. This then also makes it easier to finance a larger compliance department.

Smaller, regionally based institutions, however, cannot normally rely on these economies of scale or a strong risk appetite as a source of income. Seen from a single-entity perspective, the cost of regulation is similar or even higher for these banks, but their ability to take advantage of these complex strategies is somewhat weaker.

In other words, the complicated risk-oriented approach favours banks with a large organisation, whose activities are more complex and which take on greater risks.

The reason we should be giving this more thought is that the vast majority of European banks – around 7,000 in all – are smaller institutions.

The lack of proportionality is a serious concern. In my eyes, it entails at least three issues.

First of all, small banks simply do not have the resources to cope with the sheer volume of regulation. Employing another eighty employees for compliance is quite manageable for a large international bank. But to a small institution with only fifteen or twenty FTEs, another two administrative staff members might well no longer be affordable. Thus rules create distortions in banking business.

New regulation typically need not worry about such business distortions if it serves the greater good. Anti-smoking regulation, for instance, is actually intended to interfere with the tobacco market. But in the case of banking regulation, the situation is different. Some requirements developed for large international banks have proved ineffective for small credit institutions, simply because these enterprises are less complex, do not engage in comparable business fields and are thus exposed to fewer risks. Ineffective regulatory burdens are the second issue for smaller institutions.

The third concern is about potential financial stability issues. Due to their local focus, small institutions perform an essential function in funding small and medium-sized enterprises. And during the crisis years, small institutions have proven to be more robust – not least due to their simple and less risky business models. Thus one-size-fits-all-regulation threatens the healthy diversity of the European banking landscape.

3. Sometimes small is beautiful, and less is more: The Small Banking Box

This has spurred the European Commission to take action. In November 2016, it put forward its proposals for strengthening proportionality as part of the general overhaul of EU banking regulation. These proposals include important changes to the small print, and I am certain that we will be able to roll out a number of meaningful initial improvements.

That said, the proposals don’t go far enough. Therefore, I strongly support more graduated regulation, including a simple set of rules for small and non-complex banks. I call this more fundamental solution the Small Banking Box.

The blueprint for this idea was drafted in a German Expert Working Group. The aim of this group was to develop specific proposals on how to fundamentally alleviate the burden of regulation on small institutions with simple business models. And it delivered on that aim. The outcome is a “non-paper” which the Federal Ministry of Finance put before the competent expert group of the European Commission in June this year. Let me briefly walk you through the approach.

4. The “Who”

First, let me address the “Who?", namely the intended addressees of the relief measures. The proposal follows a three-tier approach.

At the very top are the systemically important and potentially systemically risky institutions – the smallest group in terms of numbers but extremely important in terms of risk. Nothing will change for these institutions. They remain subject to the full Basel III requirements, additional capital buffers, total loss absorbing capacity, and so on.

The second group includes institutions which are neither large and systemically important nor small and low-risk, which is why it is not possible to make extensive simplifications for them. Nonetheless, some targeted relief measures should be taken by making specific amendments to the current regulations.

Finally, the third group is made up of small and non-complex institutions – the banks that are most affected by the fixed costs of regulation. This group – the largest in number – would see its cost burden alleviated radically by means of a separate regulatory device: the Small Banking Box.

The burning question now, of course, is which institutions belong in which group – and particularly, which banks could be included in the Small Banking Box. These classifications have to be balanced carefully, and this should be part of a European-level discussion.

Importantly, size wouldn't be the only criterion. I've already said that not only do institutions in the Small Banking Box have to be relatively small, they also must not be too complex. This is why we will need additional criteria that prevent institutions with riskier business models from being part of the simplified regime.

Experience has taught us, however, that there will almost never be a perfect list of criteria that covers every eventuality. This is why the final decision should always rest with supervisors. Should they have serious misgivings, they can opt not to subject an institution to the simplified rules. They can also take into account the systemic risks arising from the connectedness of several small institutions – that is to say, small banks which are "too many to fail".

This set of options should not be a one-way street. I believe that institutions that would be considered eligible for the Small Banking Box should also nevertheless have the option of being supervised under the more complex rules.

5. The "What"

That leaves the second key question: what exactly might the box look like? Here we must aim right at the heart of the problem, namely, the paperwork which the complex requirements create in various areas.

Some of these requirements could be completely eliminated for institutions in the Small Banking Box. I could, for instance, imagine largely exempting small banks from disclosure requirements and abolishing remuneration rules for them. In addition, they could be absolved from recovery and resolution planning.

Full exemption from other requirements would be a step too far. But that should not prevent us from trying to make life easier for small banks. For example, reporting could be reduced to a core reporting process – a standardised reporting approach, if you will.

When designing the Small Banking Box we must weigh up the benefits for supervisors, i.e. ensuring financial stability, against the burden it creates for banks. As a rule of thumb, we can say that any rules that are dispensable for effective supervision are up for negotiation.

Conversely, however, that also means that a lot of rules are not up for de-bate. And that brings me to the limits of the Small Banking Box. Importantly, there can be no concessions regarding risk-based capital ratios, the leverage ratio or the short-term liquidity ratio. And the list goes on. Small banks' business models are neither per se simple nor automatically low-risk – and that is particularly true when looking at them as a whole. The new regime must therefore be simple yet robust. Whatever happens, financial stability must be guaranteed.

6. Conclusion

Ladies and gentlemen

Europe's banking sector is still struggling with the legacy of the financial crisis. Regulatory reform has made sure that this is done in line with clear, strong rules.

But: In 20 years, do we want Europe's economy to be served by 50 banks – all of them much too big to fail – and not interested in financing rural development? Or do we want a robust sector with several thousand institutions – with very different business models, serving the different needs of different customers? This future banking sector is what I imagine for a robust European economy – it is agile and it is resilient!

I am deeply convinced that it is worth to change regulations toward this end.

We need to strike a better balance between setting standards for internationally active banks and allowing for different business models of the thousands of small and medium-sized banks in Europe.

Clearly, we can only meet this task at European level. That's why we need to move forward with proportionality within the current review process of CRR and CRD IV. But we must also push for a more fundamental solution.

Therefore, I am calling on the Commission Expert Group on Banking, Payment and Insurance to give priority to the work on proportionality – the Small Banking Box is the most effective and efficient strategy to enhance proportionality.

More debate is needed on this topic. And that's why I am pleased to see that we have gathered such a diverse group of experts and stakeholders here today. I am now looking forward to hearing your views and discussing them with you.

Fonte: Bank For International Settlements (BIS)

http://www.bis.org/review/r171020e.pdf