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A CONVERSATION ON FINANCIAL STABILITY WITH FEDERAL RESERVE GOVERNOR LISA COOK

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David Wessel Good afternoon. Welcome. I'm David Wessel, director of the Hutchins Center on Fiscal and Monetary Policy. Thank you all for coming in person and all the people watching online. We're very pleased to be hosting today's event with Fed Governor Lisa Cook. On the walls of the Federal Reserve Eccles Building, which is now undergoing a massive reconstruction. There's a quote from Carter Glass, the Virginia congressman who was probably better known for the Glass in Glass-Steagall. And he says on there that one of the goals of the Federal Reserve Act of 1913, which he helped craft, was, to quote, correct and cure periodical financial divorces. So I suppose the Fed has been called upon to do just that from time to time, including responding to the global financial crisis. And given the pain of and the cost of that crisis in 2007 and 2008, today we as a society ask the Fed to do more than protect the economy from the fallout of financial crises. We asked the Fed, among others, to reduce the risks of these financial devices, to strive for financial stability while also delivering price stability and maximum employment. Nobody said this was going to be easy. To that end, when Ben Bernanke was chair of the Federal Reserve, he created a Division of Financial Stability at the Federal Reserve Board, which sits alongside the divisions of Monetary Affairs, Research and Statistics and International Finance. And twice a year now, the Federal Reserve publishes a Financial Stability Report, the most recent of which was issued just a couple of weeks ago. So overseeing the Financial Stability Division is a committee of Federal Reserve Board governors, which is chaired by Governor Lisa Cook with us today. A little about Governor Cook. She received a B.A. in philosophy from Spelman College, where I understand she organized a protest every year, and the subjects were divestment from South Africa, repealing the curfews, and more vegetarian options in the cafeteria. So she is someone with a very wide range of interests, even as an undergrad, as a martial scholar, she received a second B.A. in philosophy, politics and economics from Oxford, and then earned her PhD in economics at the University of California, Berkeley. Before joining the Fed board in May 2022, s he spent nearly 19 years on the faculty of Michigan State, where she was a professor of economics and international relations. And you can read on the Fed website all the other things she's done, all her other accomplishments. But I want to mention one, where I actually got to know Governor Cook was when she was director of the American Economics Association summer training program from 2018 to 2021. Following Governor Cook's remarks she will join me on stage with my Hutchins Center colleague, Don Kohn, who's the Robert . You got to help me. How do we pronounce his last name?

Don Kohn Roosa .

David Wessel Robert V Roosa, chair in international economics. Don was a member of the Federal Reserve Board from 2002 to 2010, the last several years of which he was vice chair. He spent ten years as an external member of the Bank of England's Financial Policy Committee, which oversees financial stability issues in the UK. And Don and I and Governor Cook will be joined by Carolyn Wilkins. She happens to be a current member of the Bank of England's Financial Policy committee. She's a veteran of the Bank of Canada, where she was senior deputy governor from 2014 to 2020, and she's now at Princeton's Griswold Center for Economic Policy Studies. And after we have a conversation, I'll welcome questions from the audience. And for that, now, let me turn the podium over to Governor Cook.

Lisa Cook Thank you, David, and thank you, Hutchins Center and the Brookings Institution for hosting me today. I am especially grateful to return to the place where, in my first job as an aspiring economist, I was a research assistant for Alice Rivlin over three decades ago. Today, I would like to talk about the board's work in pursuit of financial

stability, which is critical to the well-being of households, firms, and the broader economy. Following the financial crisis of 2007 to 9, a broad set of reforms has put in place to bolster financial stability to ensure an ongoing focus on that area. The board established its Committee on Financial Stability as a venue for governors to discuss related developments and policy issues. I recently became chair of this committee and will share with you my current views on financial stability and touch on a couple of emerging issues. Enhancing the public's understanding of our work on financial stability is important for transparency and accountability of our efforts. That is why we communicate our financial stability. Work prominently in our Financial Stability Report, which was recently published last month, and provides more detail on some of the developments I will review today. As a U.S. and financial system and global financial system continues to grow and evolve in complexity, the Fed's work on financial stability only becomes more important. A stable and resilient financial system is essential for the Federal Reserve to achieve its dual mandate of maximum employment and price stability. Our financial stability work also informs our approach and priorities to the supervision and regulation of banking organizations. Our coordination with domestic regulatory bodies and our engagement with international bodies such as the Financial Stability Board. When people think about financial stability, they most often recall periods affected by adverse shocks. That is, severe, unexpected events that caused widespread disruptions to the financial markets and in turn, the broader economy. The challenge is that such events are hard to predict. Therefore, the Fed's financial stability framework focuses on understanding what makes the financial system vulnerable to a wide range of potential shocks and how those vulnerabilities might amplify the effects of those shocks, not on predicting specific adverse events. Based on extensive research and experience, we routinely monitor four broad sets of vulnerabilities to the financial system that could amplify shocks, household and business leverage, the use of leverage by financial institutions, the degree of maturity and liquidity transformation in the financial system or, in plain English, funding risk and asset valuations and risk appetite. To lay out how I am currently thinking about each of these vulnerabilities. I will start with household and firm leverage, a simple measure of whether households or firms are borrowing too much is to compare their debt to the level of GDP, as shown in figure one. Based on this measure, household borrowing is lower than it has been in many years. Our analysis then dives deeper, including detailed assessment of mortgage borrowing and consumer credit, and this deeper assessment supports the view of a resilient household sector. Nonetheless, we are also attuned to possible changes in this assessment. For example, I am watching closely the rising delinquency rates associated with auto loans and credit card debt, both of which partially affected normalization from recent lows. This is because they imply increasing household borrower stress, especially among some lower and moderate income households. From the figure. You can also see that looking through the unusual pandemic period, business debt relative to GDP remains above historical norms. Despite this, most firms still have ample earnings to cover their scheduled interest and principal payments. The solid position reflects resilient earnings and the fact that firms with access to bond markets locked in long term funding during the low interest rate environment of 2020 and 2021. As a result, most firms also appear in broad terms, resilient to potential adverse shocks. Let me now turn to the leverage and funding risk in the financial sector. In assessing these vulnerabilities, we tend to place a lot of weight on the capital adequacy and liquidity of the largest and most interconnected financial firms. Currently, these firms appear well positioned to absorb a shock. For instance, figure two shows the ratio of common equity tier one capital to risk weighted assets. A standard regulatory capital measure for three groups of banks. This ratio has been increasing for all types of banks lately, and for the largest banks stands at a multi-decade high. The largest banks also have strong funding profiles, owing in part to the strength of the regulatory regime for these banks. Despite the overall resilience of the

banking sector, some regional banks experienced large deposit outflows amid the failures of three banks last spring. Conditions have improved considerably since then. Bank profitability remains solid and deposit flows have stabilized. In addition, as is shown in figure three, most institutions have lowered their reliance on uninsured deposits since the beginning of 2023. We remain attuned to vulnerabilities in this sector. Supervisors are working closely with the set of banks that have experienced outsized fair value losses from higher interest rates and banks that have a high concentration of commercial real estate loans. We have varying levels of visibility into the leverage and funding vulnerabilities of other financial intermediaries. While there are some areas of apparent vulnerability, there's also evidence of resilience. Hedge fund leverage is hard to measure, but available data suggests that these funds leverage is near the high end of its range. Large insurers are well-capitalized, but they have been increasing their use of liability, subject to rollover risk. At the same time as they have raised the portion of their assets invested in riskier corporate debt instruments, money funds have inherent funding vulnerabilities that regulators have been taking steps to address. Reforms adopted by the SEC and coming into force this year will improve funds liquidity positions and address the structural first mover advantage among money fund investors that contributed to some of the runs we have seen in the sector over the years. Let me turn now to asset valuations. I think it is helpful to consider this potential vulnerability in the context of how a sharp change in valuations could interact with the vulnerabilities I have already discussed. I will start with the classic concern for all of us who lived through the Great Recession. A large decline in asset prices against the backdrop of a weak economy. For example, house prices are high relative to historical benchmarks, likely owing partly to a limited supply of homes for sale. What might the implications be if house prices were to weaken at some future date? The house price growth we have seen over the past few years has not been accompanied by increased lending or weakened, weaker credit standards, as was the case in the early 2000. Moreover, the household sector is much more resilient than in 2006. One way to see this is to run the distribution of risks, characteristics we see in the household sector through a constant set of income and house price shocks. The stronger underwriting standards that have prevailed since the post-crisis reforms went into effect, and stronger household balance sheets mean that post stressed delinquency rates should be lower the next time we experience a housing shock. Finally, the financial system is in substantially stronger shape to resist any losses that do occur. The largest banks are subject to stress tests that require them to be able to continue to function through a severe recession, and important structural improvements have been implemented among non-bank entities. Now, a return or return to commercial commercial real estate, or CRE, where the shocks created by the Covid 19 pandemic continue to reverberate. CRE is a broad asset class encompassing multifamily housing, hospitality, retail, warehouses, office buildings and many other business properties. Accounting for this heterogeneity is important in assessing the risks associated with CRE. Properties have been differentially impacted by ways in which many people live, shop and work. For example, occupancy rates of suburban medical offices are very different from those of downtown corporate headquarters. Looking at broader trends, values of office buildings have been most affected by lifestyle changes, and the values of multifamily properties have also dropped over the past year. These trends present challenges for property owners and lenders, who will need to manage those risks and make appropriate adjustments as the outstanding loans come due. As in the fourth quarter of last year, banks accounted for a bit more than half of the $6 trillion in outstanding debt backed by CRE. Figure four shows that much of that exposure is in smaller regional and community banks. On average, CRE loans make up only about 5% of total assets at large banks, but around 30% of assets at smaller banks. This high concentration has caused us to step up our supervisory work with community and regional banks that have significant CRE concentration, and to augment

our regulatory data for the sector. For instance, data available from SEC form 10-q filings suggests that data suggests that office exposure accounts for a small share of most regional banks CRE loans. All told, I view CRE risks currently as sizable but manageable, and I will be paying close attention to the sector in the short and medium run. Risks related to CRE, are well known to investors and supervisors alike. Another big part of our job is to look for emerging vulnerabilities, and one that has garnered my attention is private debt. Private credit generally refers to direct loans made to businesses, mostly middle market firms, by non-bank entities such as private debt funds and business development companies, and the U.S. private credit funds. Assets under management have grown rapidly in recent years. They were estimated to stand at $1.1 trillion in September 2023, comparable in size to both the high yield bond market and institutional leveraged loan market. History teaches us that rapidly growing lending often involves weak underwriting or excessive risk appetite. The growth in private credit is likely attributable to a confluence of factors. After the financial crisis of 2007 to 2009, private equity investment and leveraged buyouts grew quickly, and demand for credit from middle market and private equity sponsored firms grew along with them. Some borrowers appear to prefer private credit deals to bank lending because of easier deal execution and greater contractual flexibility, particularly during the ups and downs of the economic cycle. In addition, the growth of private credit coincided with a period in which stronger bank regulation and supervision were put in place, suggesting that those actions to make banks safer played a role. Overall, I think the growth of private credit likely has not materially adversely affected their financial systems resilience. Private credit funds appear well-positioned to hold the riskiest parts of corporate lending. These intermediaries generally use little leverage and are organized as closed in funds, which means that investors cannot withdraw the funding supporting the investment. Nonetheless, private credit funds have also growing interconnections with traditional financial intermediaries, including banks. Banks are or are increasingly originating their own private credit deals, such as through business development companies that are operated or minority owned by the banks themselves. As a result, I will be monitoring the contribution of private credit to the overall leverage of the business sector and the evolving interconnectedness between private credit and the rest of the financial system. I will conclude with a few thoughts on cyber risk. I should emphasize at the outset that the Federal Reserve's role in managing cyber vulnerabilities is focused primarily on ensuring the institutions we supervise effectively manage the cyber risks they face, including from key technology service providers to those institutions. It is also focused on safeguarding the resilience of the services provided by the Federal Reserve and the financial system more broadly, in the event of a successful attack. We also work with our partners across the government, including the US Department of Treasury and with the private sector, to understand and address cyber risks. Over the past few years, we have seen an accelerating tempo of cyber attacks from mixed groups associated with criminal enterprises and hostile government. While the news sometimes seems dominated by ransomware attacks, we also continue to observe other types of attacks, such as those that seek to uncover information from governments and firms, or to carry out or plant the seeds for destructive acts, attacks on information systems that could severely disrupt operations. In response to these risks, we are examining cyber incidents carefully to make sure we have a fuller understanding on how attacks can affect the financial system, including through banks, non-bank financial firms, digital service providers and critical infrastructure. In this work, we focus heavily on the operational resilience of the institutions we supervise, the service providers used by the institutions and the financial services provided by the Federal Reserve. We have also begun to incorporate analysis of timely data on firm level or firm level cyber vulnerabilities and interconnections across firms and with service providers to monitor cyber vulnerabilities at the system level. As we contemplate future incident, my view is that financial resilience

can play a crucial role mitigating the adverse effects of cyber attacks. Cyber attacks erode the confidence that investors and institutions have in each other and in the financial sector. While strong capital and liquidity positions will not by themselves prevent an intrusion, they leave the affected institution in a better position to rejoin the system once the attack is resolved and, most importantly, promote confidence among its counterparties. Moreover, the effects of chaotic markets may impact other institutions that suddenly face losses whose magnitudes might be hard to judge. Well-capitalized, highly liquid and well-managed institutions will be best positioned to manage such difficult circumstances. Let me conclude by summarizing how we approach the set of issues I have discussed, including system wide monitoring, CRE and private credit development and cyber risks and our financial stability work. We cannot know the next shock that will test the resilience of the financial system. That is why we focus on the resilience of the financial sector and our regulatory and supervisory work concerning banking organizations and and in our engagement with other regulators. We also continuously monitor the financial system and regularly, regularly report on our assessments in the Financial Stability Report. Such public communication contributes to the transparency and accountability of our efforts. I hope it is also something that will stimulate a public discussion, discussion and vulnerabilities to financial stability. As my colleagues and I value the range of views on these issues held across researchers, financial market participants, and the broader public. For this reason, I look forward to our discussion. Again, thank you to the Hutchins Center and the Brookings Institution for hosting me today. Thank you.

David Wessel Thank you very much for coming. One of the advantages of, having a Federal Reserve governor who was a research assistant at Brookings actually knows to call it the Brookings Institution, which is about 50/50, have two people, including people who work here, call us the Brookings Institute. So I'm glad. I'm glad you remember. And, I'm particularly glad that you, mentioned your work with Alice Rivlin, whose spirit, yeah, pervades this institution, as we all try to live up to the, ideals she set for good, policy analysis and good policy. Carolyn and Don thought I'd start with you. Just ask you a little bit of reaction to Governor Cook's remarks on this financial stability report. Basically, as I read it, the report says, well, the consumer's in pretty good shape. Business is in pretty good shape with a few things to worry about. The, we did a great job shoring up the big banks. We got some worries about the smaller banks, given CRE. There's a lot of known unknowns out there. Cyber, geopolitics, asset prices are elevated. If they fell quickly, that might too, might cause some problems. I'm just wondering whether you see, and I should note that the whole point of a financial stability report is to say, not the things that are we feel good about, but what are the things that we should worry about? So I'm curious what you think we should worry about and where you think Governor Cook and the Fed have hit it, right? Or where they overlooked some things. Do you want to start?

Carolyn Wilkins Sure. Thank you. And thanks for the invitation. No, I was I was quite amazed by how similar your assessment of the risk for the U.S. correspond with the Financial Policy Committee's assessments of the risks coming from the global financial system to the UK. So, you know, you're going to read things like CRE, private debt, the big troubles in different areas of non-bank financial intermediation. I think where we're particularly concerned is, is, also with respect to the interaction between those risks and the vulnerabilities that we see on the sovereign debt side. It's hard for a central bank to say those things. But when you think about the LDI incident, which we can get into the leverage deniability and, you.

David Wessel No acronyms here. So what is theLDI incident. By the way, Carolyn is supposed to tell you she's speaking for herself and not the Bank of England, right?

Carolyn Wilkins We can get it. Basically. What? What? You know, the point I'm trying to make is that you can gett, a trigger to these vulnerabilities that were so very well outlined, that come from places that you might not necessarily expect. And in the UK, the trigger for a big, stress in the gilt market came from a budget announcement that uncovered a lot of vulnerability in liability driven investment that's undertaken by pension funds to manage the risks, basically. That usually happen naturally because you've got, your assets and your liabilities interact differently with interest rate and inflation risks. And so that that can that needs to be managed. And so, you know, Governor Cook, when you spoke about thinking through not the individual vulnerabilities, but how they might interact and what kinds of scenarios or shocks could create some unraveling, like we saw, in 2023, I think is the right is the right route.

David Wessel So you mentioned sovereign debt. So you're talking about U.S. Treasury here or what?

Carolyn Wilkins Well, in this case, I was thinking about treasuries. But there's other countries that are indebted in the world. So it's important to understand the nature of this risk and the potential for a trigger. I mean, people go right away to outright default, but it doesn't have to be that. If you're in a Treasury market that's got low liquidity, term spreads are really priced for perfection. You could just have, a rapid change in risk sentiment over a couple of days that can create a spike in interest rates. In the U.K., it was 130 basis points, which was on the on the 30 yield, 30 year gilt yield. It was twice as big as the biggest thing we've ever seen. You're not stress testing for that, but it nonetheless uncovers a vulnerability that's already there. And it usually happens through, unmanaged leverage, margin calls that create, Foresti leveraging for fire sales. And then that just amplifies the interest rate shock and requires some kind of response, either the the place where the trouble started, they've got their natural, writing mechanisms, but it often lands in the lap of the Federal Reserve or another central bank.

David Wessel Right. Don, are they worrying about the right things?

David Wessel Yes. I mean, yes, I think, that was a very comprehensive report. And, all the things that I was worried about mentioned one way or another. And I thought your speech was a really nice exposition of the, of the main points. And I want to add I really like the fact that you're here, but also that you've, you're highlighting this report, and I think we've struggled at the Bank of England. How do we get people to pay attention to our financial stability report? And so I think giving a speech every six months or so with a financial stability report would be contributing to public understanding and, interactions. So that I thought the this event is is a good thing. I think, I agree with Carolyn and I about the sort of the risk of rapid movements in asset prices. And as you pointed out, and as the Financial Stability Report points out, a lot of assets seem to be priced in the upper tail of their historic distribution relative to cash flows and, and risk, very narrow risk spreads. So I think, I think it's an issue of financial stability issue is if those, those things change, that's fine. I mean, asset prices are supposed to fluctuate, people make money, lose money, etc., but there are amplification mechanisms here, right? So what do you see as the main amplification mechanism as with, asset price a sharp movement in asset prices. And then what what should the authorities, broadly speaking, not only the Fed but maybe other authorities be be doing about those amplification mechanisms?

Lisa Cook So certainly, asset prices for various classes, are in the upper range of their historical distributions, as you were saying. So there can be amplifications for any of those,

assets. We equity markets, for corporate, corporate bond spreads for residential real estate. So price declines, for example, a significant price decline, can have, significant effects on other depending on the interconnections on other asset prices, on other, assets. So we worry in terms of, vulnerabilities about these amplifications, no matter where they are and no matter what the asset class. So we're monitoring them, very closely. And this is a part of our supervisory program.

Don Kohn So I think you brought up in the report, limited, capacity of the broker dealers in the treasury market, so are actions being taken to try and enhance the liquidity. The market of Carolyn was obviously this. The sovereign debt market is at the heart of any financial system.

Lisa Cook Right, right. To the, the treasury market is, extremely important to the Federal Reserve. It's a $26 trillion market. And, it's, is, liquid and resilient. Liquidity levels have been somewhat low recently. And, this is something that we're monitoring, closely, but the, Treasury market has still functioned well. We work with, several other agencies, the Treasury Department, the CFTC, the SEC, the New York Fed to monitor developments in the Treasury market. We have our we have our eye on this corner.

David Wessel Governor Cook, you mentioned in the report as well that, looking at the banks that higher for longer could pose a problem for banks. We saw it was played a role in the incidents last year with as SVB and the other banks. And I'm wondering just if we have this combination of rates are higher for longer is small and regional banks have a lot of CRE loans. How how big a risk is this beyond just to the individual banks, but to financial stability in general? And what do we do to minimize those risks?

Lisa Cook CRE specifically?

David Wessel CRE and the losses on their portfolios or home loans.

Lisa Cook Right, right. CREs I was saying in my speech is is a problem for smaller and regional banks, roughly 30% of their assets, are in these, in these loans. So in our supervisory efforts, we are encouraging banks to increase, loan loss provisioning to implement their risk management strategies. So, again, our framework is focused on the vulnerabilities, make sure that the shock absorbers work. And this is, one way in which we would do that, but we're always monitoring this closely.

David Wessel Carolyn, the Fed report and I know the FDIC report as well, talks about something broadly defined as geopolitical risk, of which there seems to be an extra amount at the moment. And I'm wondering how you think about preparing a financial system for something as hard to predict as what's going on in the Middle East, the Red sea, shipping, terrorism, what's going on in Ukraine, and if it spills over to the rest of Europe. I mean, is that a tail risk that we just can't expect the financial system to insure against? And that's why we have central banks? Or is there something you can do as a financial stability monitor to help make the system more resilient?

Carolyn Wilkins Well, I, I think that, it's a bit of both. It's there is there's a role for self-insurance for different kinds of risks,including, some shocks that come from the geopolitical, part of the world. And but then there's always a role for the central bank and governments. And, you know, the way that we're approaching it is with, I must say, with a lot of humility, because no one really knows how it's going to turn out. And so it has to be about different forms that route can take and channels through which can propagate. So

the most obvious one is, you know, the short term risks that come to a positive risk to inflation, that could mean that interest rates either have to rise or they have to be high for longer, which is something that, you know, Governor Cook and others have talked about as being a bit of an issue for financial stability. But it can come through other doors. You can come through the cyber door and not through ransomware, but trying to shut things down. And of course, there's a role for central banks in the area that's in their purview to think about how do we make sure the system's ready for that? And that's not something you do in in a week. It's something that you need to have started before and many central banks have. And that just doesn't include necessarily the, institutions that you oversee directly. But those that are third parties, like cloud, for example, that are really critical to the operations of, of particularly globally systemically important financial institutions. And so there's things you can do. The Bank of England has an operational resilience framework. We just published, we have a third party critical third party, framework that we've published that will that's looking at gaps and trying to fill them in terms of what are our expectations for institutions to do, things themselves. I think the final thing in this, this may not seem to be in line with the geopolitical side, but I think it is because some of these shocks and the realignment of asset prices that can come suddenly, uncover the vulnerabilities, think hard about the banking system, but we don't think as hard about the non-bank financial intermediation. And I think understanding how those would act on an individual hedge fund or an LDI fund or something is one thing, but under understanding how that system interacts is a much bigger and harder thing. That's actually where the problem lies. And so another thing you can do, and it was it's a start. So all humility is a system wide exercise where you try to get we're doing this in the bank on England. And when we've got over 50 non-bank financial institutions, plus the regular banks or regular players, and we're going through a scenario that's a ten day high stress asset price move, to see how individual institutions would react and how those reactions could either amplify the situation, probably amplify the situation and how individual companies need to change their plans. You asked about the central bank. At the end of the day, it also means that maybe for a big enough risk, we have to be there. And it's a question is, are our facilities, following the right principles and set up and pre-position in a way that we can act quickly in a targeted, way that's proportional to what's going on.

Don Kohn So, David, can I comment on Carolyn's thinking? Both Carolyn and Governor Cooke have mentioned the sudden, unexpected changes in rates. And I think perhaps the most important role the Federal Reserve or central bank can play, as be as Carolyn was getting to at the end, a backup source of liquidity for solvent institutions that are under stress because they didn't anticipate this well enough. And that means active use of the discount window. We know the Federal Reserve has faced challenges. There's stigma to using the discount window. It's called the lender of last resort. So whenever anyone comes, there's a suspicion that it's the last resort. But we also know that the Federal Reserve has taken steps to De-stigmatize to make it more useful. As as was intended by the founders of the institution in 1913. Can you explain a little bit on the steps that the Fed has been taking to help with that?

Lisa Cook Certainly. So the discount window, functioned well during the pandemic and during the, banking stress of, last year. And it provided, liquidity when firms and households needed this and it made sure that monetary policy was still being implemented because it was lending to a broad range of, of, counterparties. So, it has been working well, but certainlyefficiency can be improved. That's certainly true. One thing that we're doing is encouraging, banks, our supervisors are encouraging banks to pre-position collateral, for example. And that is going, well, so far in the last year, an additional trillion dollars has been pre-positioned in collateral. So that's, that's progress. But obviously

that's, that's it's not complete. We're not done. So we continue to, push forward on improving the efficiency of the discount window.

Don Kohn Thank you. So, Governor Cook, he taught economics in the classroom for a couple of decades. And now you find yourself at the Federal Reserve talking about financial stability. And I wonder, what have you learned that you didn't know when you were in the classroom, other than the press is your friend? I know that's one of the.

Lisa Cook Everything. No, you know, it's just amazing. There are lessons that I've been teaching that didn't include as much institutional detail. And these institutional details matter how the discount window functions actually matters. And I think I, you know, I just sort of waved my hands about that and a lot of other things, but this actually, matters types of 13, three facilities matters. The type of disruption, matters, and therefore the response, matters. So there I think it has to do mainly with institutional detail. So I have a lot of slides from my classes that I need to update as soon as I think about getting back in the classroom.

David Wessel And, both Carolyn and the lesser extent, Don, talked about financial institutions outside the banks, the non-bank first institutions. You mentioned in your remarks concerns about private credit. You said, I think the party line is it doesn't seem to be a problem, but it's growing awfully fast. And that's a red flag sometimes. You mentioned that life insurance companies are getting more creative, both from the liability and the asset side more, taking more risk on one side and having liquidity risks on the other. Do you think that you, the, the Federal Reserve and the Financial Stability Oversight Council in general have enough data and information on the non-bank financial institutions?

Lisa Cook Certainly there is opacity there. We don't have as much information as we'd like, but we have some. And we do know, for example, that life insurers hold 15% of CRE loans. So, given that, we, can keep monitoring what we know and, with our counterparts, these other agencies, gather as much information as we can. But we, we keep our eye on not just the, entities themselves, but the interconnections, and the, the layers of leverage that might, exist, in this more opaque sector. So we're we're monitoring that closely.

David Wessel And before I turn to the audience, I just want to I don't want to neglect the consumer in the household. You pointed out in your chart showed very well that in general, the American household seems to be in pretty good shape. That's for sure. But you mentioned a couple of concerns about delinquency rates on auto loans, credit card debt. And I wonder, what are you thinking about that? What's your worry? Is it in the danger zone or is it just heading in a direction that's worrisome? Where are you? How are you thinking about that?

Lisa Cook Yes. The, delinquency rates, among low credit scores. Households with low credit scores, are rising. So for credit cards, for auto loans, and, you know, we're we're monitoring this. And we, we obviously wonder whether, other types of credit, that they may be using, let's say buy now, pay later, may under estimate the official data may underestimate actually how much, how much, delinquency there actually is in the system. But we're we're monitoring this, closely, and we certainly don't want to, discount it because, you can say the same thing about subprime loans that. Yeah, it was certain sector had them, but, they, they're, they're an important part of the system.

David Wessel So buy now, pay later. That doesn't show up right in the consumer credit.

Lisa Cook That's right. That's right. Exactly. Not reported to credit.

David Wessel So let's turn to the audience and here's the deal. I'm gonna ask for 2 or 3 questions and then, we'll answer whichever ones we like. Don't give a speech. Ask a question. Do you want to start with Pedro on the back?

Pedro de Costa Thank you. David. Thank you, Governor Cook. You mentioned.

David Wessel And introduce yourself

Pedro de Costa Sure. So Pedro de Costa with MNI. Thank you. You mentioned the importance of institution of detail. Could you tell us a little bit more about the Committee on for Financial Stability Works within the board, who's on it and how you guys might interact with the monetary policy settings side of the of the Fed system, especially as it relates to considerations about, winding down the balance sheet.

David Wessel Thanks. So you'll hard to hear, Pedro, but I think what you're asking to talk a little more about what the Committee on Financial Stability, who's on it and what it does. And there's a guy here left there.

Aaron Caddell Hi. Hi. I'm, Aaron Caddell from Global Counsel here in Washington, DC. We're a policy advocacy firm for companies and banks. And my question for Governor Cook, as well as the others is what were the let. We're about a year away from a year out from the the incidents of last spring with the the sale of First Republic to J.P. Morgan, the collapse of Silicon Valley. There was, a lot of debate around all kinds of things, the moral hazard that that may have led to and the actions by the Fed. Should there be a universal deposit insurance and so forth. So my question to you is, what were the lessons learned from, from that, set of incidents of last spring? Now with a year of reflection since the, since the instance of, spring of 2023, Silicon Valley and so forth.

David Wessel Thank you. In the front here, you stand up.

Audience member Thank you from the Africa Bazaar magazine. My question relates to the sovereign debt that you mention on the global financial system. How concerned are you about the high debt distress in emerging and low income country and the impacts that we have on the U.S. economy? I know the U.S. economy is doing great right now, but our concern about the impacts of what is going on in these countries. Thank you.

David Wessel So Lisa, why don't you start with the first one? What does what is the Financial Stability Committee who was on episode you and what do you do anyways?

Lisa Cook I think I can say who's on it because I think that's on.

David Wessel That's public.

Lisa Cook Yeah. Yeah, I think so. Okay. So, I never know. I'm still learning this stuff, David. So thank you. Thank you, David, thank you very much. So, Adriana Kugler, my, my classmate from Berkeley, and, Chris Waller, I'm sorry, not Chris Waller, vice chair for supervision Barr, I just came from a meeting with, Chris. While I know the committee, we largely oversee the production of the Financial Stability report. So we're the ones getting the updates and deciding what should be highlighted in the report, what we should convey, what is consistent with, transparency and accountability. That's largely what we do.

Don Kohn There are quarterly reports from the financial stability people of the FOMC. Or you invovled in that as well.

Lisa Cook That that's right. That's right. They they coincide. But the the other one is more frequent. Yeah. That's right. Yeah.

David Wessel Yeah. So Don and Carolyn, I wonder if you could help with the question about what are 1 or 2 lessons you think we learned from the March 2023 episode that Governor Cook should keep in mind and her colleagues?

Don Kohn I think there are a couple from the 2023 episode. One is that uninsured deposits can run very, very quickly, particularly in this age of social media. Word spread very, very quickly. So whatever liquidity requirements are, there need to be altered to, to take account of the changing environment. I think another one is the importance of knowing what the mark to market value is of the institutions, because it was the announcement that Silicon Valley Bank needed to raise capital because of their mark to market losses that triggered the run. And I think the third one is, how much change needed to happen in the Federal Reserve supervision of these banks that, and this was in the Barr report. Exactly. And and other reports on the thing that, the supervisors moved too slowly. They were too deferential in terms of giving folks time. The so the need to escalate, concerns to a higher level, more forcefully sooner. And the supervisory thing, supervisory aspect, and I suspect that's been implemented, at the Federal Reserve.

David Wessel What are you, Carolyn? What did you learn?

Carolyn Wilkins Well, just comparing different jurisdictions and the regulations there in the first place. Clearly interest capitalizing against interest rate risk on the banking book under pillar two is a good idea. Not only because it helps against that kind of risk. I don't think in this case that could ever have enough capital given the run, but it's still it creates the incentives to think about how the asset side of your balance sheet is constructed. And so, that would be the first lesson. The second is there's a the liquidity covered ratio wasn't, you know, wasn't followed by SVB. But even if it hadn't been, I think there's a question about how do you how do you calibrate those and think about the flight risk on operational deposits. Because know it sounds really technical, but it matters a lot. And.

David Wessel Operational deposits, like business transactions?

Carolyn Wilkins Uninsured deposits, and so.

David Wessel Someone's payroll account.

Carolyn Wilkins Yeah. And so, yeah, because those are probably sticker than other kinds of deposits that are uninsured. And so and so, you know, to me, that's kind of a practical implications for how you apply regulations. I think that. So regulation really matters. You know, one of the things that that doesn't get talked about enough is just governance. And it's not in its governance of financial institutions to begin with. I'm on the board of directors of an insurance company and, PNC not it lives in Canada. And, you know, I'm on the risk committee, and I just can't fathom how a board of governors could. I'm sorry. A board of directors could think through. Yes, we want to grow this fast, but we're not going to think of the risks that are accumulating with that such rapid growth and that structure of a balance sheet that we have. And so I think that the governance, it starts with governance of the

financial institution to begin with. And that should be a priority not only of the institution but of of regulation and supervisors. And then the last the last one is just about central bank liquidity facilities. There's been a lot of work afterwards by the bank, Bank of England and others thinking about, well, how can we be ready with, say, preprinted position collateral with facilities that think through all the risks, whether it's moral hazard, whether it is risk to monetary policy stance, whatever it is? Having those at the ready and tailored to different, types of issues, we could have, I think would, would have been helpful to stabilize the system, maybe with less, less potential risks, to the taxpayer, central banks and come up things with quickly and thank goodness they can. But having thought through some of the principles and pre-positioning things in advance can also be helpful.

David Wessel Governor Cook, you're welcome to comment on those, but I wanted to give you a chance to respond to the question about whether you worry about the spillovers of emerging market debt. Is that, like, on your radar?

Lisa Cook Certainly our mandate relates to the US economy. So, we take all, conditions from the models we use and, make monetary policy decisions for the American people, we're moderating those, conditions, abroad. But I just wanted to add one more thing to the lessons that came up during, the, the review of SVB of the, failure of SVB and that's concentration of depositors. And I think that that's something clearly it said, we hadn't paid as much, supervisory attention to and I think it's certainly, something we are paying more attention to going forward.

David Wessel Yeah. We're always ready for the last war. Here, there's a question here. And then and then, you know, I can you come over here to the people in the aisle there?

Alex Graff Hi. My name is Alex Graff. I'm a banking reporter at S&P global. I wanted to ask, you know, you laid out some some of the areas that you're looking at for financial stability, but I wanted to ask what you see as maybe the biggest area for or, area of risk for potential bank failures, additional bank failures down the line. Yeah.

David Wessel Okay. Thank you.

Talia Bradshaw Hi. Good afternoon. My name is Talia Bradshaw. My question is, are you guys all concerned about Reg II effect on limited community access to banking and how that will affect programs such as Bank on?

David Wessel Greg, I.

Talia Bradshaw Read I, the debit card interchange fee cap. Thank you.

Kyle Fitzgerald Hi. Kyle Fitzgerald with the National. Thank you for taking my question. Another question about banking. Last week, Fed Chair Powell said that no decision was made on Basel three. So I just wanted to see if, Governor Cook, you could give us an update on the conversations you've been having with your colleagues on this and what the status is today.

David Wessel Please. We got three for you. Basel three, Reg II. And what's going to be the cause of the next bank failure?

Lisa Cook Okay. Okay.

David Wessel At least two out of three questions you should answer.

Lisa Cook Okay. Two on Basel three. I'll say what Jay said. Certainly there are conversations that are happening, but, he he would be the first one to, reveal that. But we received a lot of a lot of comments, and we're taking those, comments seriously. And, we look forward to the, the, the ongoing conversation, with respect to, additional, stress in the banking system. So in general, the banking system is sound and resilient, and there are high levels of, capital, particularly in the largest banks. As I said earlier, CRE is, more of a problem and, and, smaller banks and smaller and community banks. But the, the framework that we have with respect to financial stability would address, any, any, should address, any additional, problem like this. So we're monitoring how resilient, these banks will be, and that's through our supervisory efforts, encouraging to them to place collateral at the discount window, to increase, loan loss provisioning and and so on. So we're thinking about it broadly, but, the the key is to check the shock absorbers on the car, make sure that it can it can drive over here.

David Wessel Right. Okay. It was a guy who was not looking at his phone who had a question.

Audience member Thank you. My name is [name] from U.S. customs, and my question is related to the buy now, pay later after been growing very much more common, a lot of these apps owners are issuing securities bonds in the financial markets. What happens? And consumers start taking on too much of that. That and they default on it. How will you, what steps can the Federal take to shore up resiliency on the financial markets side for these lenders?

Lisa Cook Are you asking about? I'm sorry. Are you asking about the lenders of the consumers?

Audience member I know that you know, the institutions themselves.

David Wessel The lender.

Lisa Cook The lenders. Right. Okay.

David Wessel Maybe one more.

Michael Redmond Hi. Michael Redmond from Medley Advisors, and I just had a question on, you know, the life insurance risks. Could you just detail the possible scenarios that you have in mind for how those could generate financial stability? You know, in a way that's a little bit more concrete for us to understand.

Audience member I'm [name] from Bloomberg News. Governor Cooke, I wonder if you could say more about how the Fed potentially holding rates higher for longer could impact some of these vulnerabilities that you've identified, particularly on non-bank lending and consumer stress, barring stress.

David Wessel Okay. Are. You folks are all on the lender side of the pay now. Buy now, pay later side and Governor Cook.

Lisa Cook Okay, so so I mentioned that just because there was an article about it today, I don't think I should have brought that up. I'm just saying that there are places where there

are potential vulnerabilities and we're and we're paying attention to those. We are, collecting more data. We're trying to get a line of sight into these, data series that we typically don't have much insight into. So that's, that's just one more of them. So I would treat, buy now, pay later lenders, just like any, non-bank lenders, even though they may, you know, they they may be they may have connections to, banking institutions. But our vulnerabilities framework, should operate similarly. In terms of, the vulnerabilities that might arise there and the amplification that might arise there.

David Wessel So in the report, you say that life insurers are taking on liquidity and credit risk by allocating an increasing percentage of their assets to risky and less liquid instruments. You mentioned private credit is one of them, right. Leveraged loans. And on the other hand, their liabilities are getting more, unusual, like guaranteed returns and stuff. So is this something that you are spending a lot of time thinking about what this vulnerability could be? Or is this just sort of a like, the long list of things we ought to watch?

Lisa Cook And. Yeah, but that to, to be more concrete, if I can think of a concrete example. Again, 15% of CRE loans belong to life insurers. That's a place where there is potentially a vulnerability. So we have to watch this really closely, and make sure that they are doing the same kinds of things, taking the same kinds of measures that the banks we supervise are. So I think that's, that's a concrete example. I think to me, that's the most concrete example.

David Wessel But you also mentioned the question on private credit about interconnectedness. Yes. And a lot of the private equity funds that are doing private credit are buying insurance companies, because that's where the money is.

Lisa Cook That's right. That's right. That's right.

David Wessel That's Amara's question was,. Was it basically how worried are you about banks not being ready for hire for longer or what.

Audience member Yeah. How [inaudible]

David Wessel How does that. What is the concern about rates being higher for longer on the banks? What's the issue for the banks and what do you do about it?

Lisa Cook What we do about it is to make sure that we are, achieving both sides of our dual mandate. So price stability is financial stability. So the best we can do with respect and the best monetary policy can do is to promote stable prices. So that's the fight we've been engaged on. Inflation was at its peak 7% and now it's below 3%. So our focus is on meeting the dual mandate. And, and I think that, that that's, that's largely where we're focused and what we're, what we're monitoring. And we'll keep at that.

David Wessel And, Dan and Carolyn, I just want is there anything you think we should hit? We should not leave the audience without, mentioning.

Don Kohn I think it's been quite comprehensive. I.

David Wessel I got all the risks and nothing else. No other risks that we didn't mention.

Carolyn Wilkins I didn't mention China.

David Wessel China. Okay. Carolyn noted China is also right. So that's really more of a problem for the UK than for the U.S. but what do you what do you have in mind when you say that?

Carolyn Wilkins Well, I, I thought about it in terms of just their, the, their growth path. And in fact, the question that was asked about emerging market debt and interdependency between China and some emerging markets that may have debt that's not denominated in their own currency, and they're relying on China for exports and and of their economic well-being. And if China isn't, that source has a, you know, has a hiccup, then that could be the trigger that that creates some, some stress in that area. And we know from history, we know in the 90s there were one emerging market, different reasons, but one emerging market, thing after another, that did spill over into global financial markets and affected different economies, for sure, less the U.S. and others. But but, I don't think we should underestimate that.

David Wessel So when you think of the financial stability risks to the UK, is China up there on your list?

Carolyn Wilkins China is something that we mentioned in the financial policy report that we gave set out in March. Part of that was working through, emerging markets. The other part is just direct exposures for.

David Wessel A couple of banks. Yeah. Yeah.

Carolyn Wilkins And I think and I think just in general, the macro risks there, China has been there as a lowering price. It's it's been there to be the counterbalance, to bring global growth up at times when because their economies aren't necessarily synchronized with the U.S. and just that structural, you know, change that's coming from them. Demographic change being the biggest driver re kind of changes the pattern, the macro economic cycle patterns that we need to better understand as we we do scenario analysis about how things could play out, how bad can it get. I think that's big enough to make a change.

David Wessel All right. Thank you. Thank you all for coming. Please join me in thanking Governor Cook.