Remarks of Richard Berner, Director, Office of Financial Research, U.S. Department of the Treasury
at the Exchequer Club, October 16, 2013, Washington, D.C.

Thank you Chancellor Ryan for that introduction and for your kind invitation. It's an honor to follow the prominent officials and thought leaders who have joined you at lunches like this one. Many of them have discussed the financial crisis and the responses to it, which were designed to strengthen our financial system and our economy.

In that tradition, today I want to tell you about the Office of Financial Research and our role in promoting financial stability.

Financial stability occurs when the financial system functions to provide its basic services, even under stress. Clearly, many threats to financial stability emerged in the crisis.

Out of the crisis has come a widespread appreciation for a different approach to policymaking. Financial stability is now a statutory policy objective for every federal financial regulator, policy analysis is focused on assessing threats to financial stability, and policymakers are creating more tools to combat those threats — developing what we call the macroprudential toolkit. Macroprudential is a fancy word to mean that we now must look across the entire financial system, not just in a few institutions or markets, to assess and mitigate threats to financial stability.

This different perspective is essential because, as we saw in the years preceding 2008, the standard tools and data used to measure risks provided little indication of the vulnerabilities that were growing in the financial system. Market participants and regulators broadly misperceived the extent of leverage and maturity transformation. They did not see the migration of such activities to the so-called shadow banking system, or the economic exposures of supervised firms to these activities. And they collectively underestimated how disruptions could spread across interconnected companies and markets, and impair the functioning of the financial system, with severe consequences for the economy.

The new analytical toolkit needs to assess these fundamental sources of vulnerability, to be more forward-looking, and to test the resilience of the financial system to a wide range of events and incentives.

Likewise, there is no mistaking the need to improve the quality and scope of financial data to monitor activity across the financial system. Available data measuring financial activity and exposures prior to the crisis were too aggregated, too limited in scope, too out of date, or otherwise incomplete. No wonder leverage and maturity transformation, the growth of non-bank activity, and exposures were poorly understood — the data failed to show them.

The Dodd-Frank Act recognized that new institutions were needed to fill these gaps in tools and data. The Act created the Financial Stability Oversight Council and the Office of Financial Research. The Council is charged with assessing and monitoring threats to financial stability, developing remedies for those threats, and restoring market discipline. Our work at the OFR is aimed at supporting the needs of the Council by collecting and improving the quality of financial data and developing tools to evaluate risks to the financial system.

With this institutional framework in place, I want to discuss five critical challenges that we in the OFR face, how we are confronting them, and what we have accomplished so far.

The five challenges are:

1. Improving financial stability analysis and monitoring
2. Prioritizing and meeting data needs for analysis and monitoring
3. Developing standards to improve the quality and utility of financial data
4. Balancing confidentiality with data sharing, and
5. Developing the macroprudential toolkit

1. Improving financial stability analysis and monitoring

Improving financial stability analysis and monitoring requires a strong framework. Our framework begins by looking to the six basic services provided by the financial system:

1. Credit allocation, in which lenders are matched with borrowers, such as companies, households, and governments.
2. Maturity transformation, in which a lender obtains short-term funds to invest or loan at longer duration.
3. Risk transfer, in which intermediaries accept or insure against risks, such as credit or duration risk, at a price, from those who don't want to hold it.
4. Price discovery, in which the interaction of buyers and sellers determines fair market prices for financial assets.
5. Liquidity provision, which facilitates transacting in timely fashion without materially affecting prices.
6. Facilitation of payments, or the services through which transactions and payments are made, cleared, and settled.

Financial stability occurs when these services function smoothly. But each of these functions may be vulnerable to shocks when market participants take them to extremes and markets fail. Such vulnerabilities are threats to financial stability — and the Council and the OFR have complementary mandates to identify them and assess how they might transmit or amplify such shocks across the financial system. To do that, we must understand how vulnerabilities develop.

We know, for example, that the low volatility and cheap funding prevalent in times of market calm can prompt return-seeking market participants to take on leverage, maturity transformation, and credit risk. This increased risk-taking can promote vulnerabilities in short-term funding markets that promote runs and fire sales.

We know that threats can arise in large, complex financial institutions. Supervisors are using so-called stress tests to model losses that such institutions could suffer when exposed to an unpredictable variety of shocks. Test results help to calibrate their needs for capital and liquidity. Our mandate at the OFR is to evaluate the capacity of such tests to assess overall financial stability. This capacity is limited because current stress tests do not focus on the transmission of stress across institutions and markets. The OFR is researching the frontiers of stress testing, evidenced by three recent Working Papers and by an all-day research workshop at the Treasury last year. We also assess and monitor financial stability indicators with exotic names like CoVar, DIP, and SES that may indicate systemwide sources of stress in financial companies.

We know that threats can arise in nonbank financial companies in what has come to be known as the shadow banking system. That system includes activities such as dealer-intermediated finance, securitization, and funding in wholesale markets. It includes companies such as broker-dealers, hedge funds, private equity funds, asset managers, and insurance companies. These firms may engage in activities involving maturity, liquidity, and credit risk through reinvestment of cash collateral in securities lending or providing tail-risk insurance in credit markets.

Our recent report about the asset management industry, produced at the Council's request, examines some of these activities. It identifies ways that asset management activities could create vulnerabilities, including through redemption risk, use of leverage, cash collateral reinvestment, and crowded trades.

Public attention has been understandably focused on what happens next for asset management. That is up to the Council, not the OFR. Having delivered the report to the Council, our focus will be on continuing to support its work with appropriate data and analysis.

2. Prioritizing and meeting data needs for analysis and monitoring

High-quality data are critical for the work of the Council and the OFR. We can't analyze what we can't measure. In order to measure, we need solid, reliable, granular, timely, and comprehensive data. Let me repeat: There are still significant gaps in our financial data. The OFR's job is to fill those gaps by prioritizing and meeting data needs for analysis and monitoring.

Three steps are involved in filling data gaps. First, prioritize critical questions, and decide which data are needed to illuminate and answer them. Second, assess gaps by taking stock of data already available and comparing them with needs. To further that process, we created and maintain the first inventory of the data held by all Council member agencies. Finally, prioritize and decide on how to fill the gaps.

For example, we are working to fill gaps in repo market data. In a repo — or repurchase — agreement, a dealer obtains short-term funding for securities by selling them to an investor with an agreement to buy them back. Because repo markets represent critical sources of funding for securitization, their impairment during the crisis had adverse consequences for the entire financial system. The scarcity of repo data in 2007 and 2008 masked these vulnerabilities and made assessment of possible policy responses problematic. The New York Fed has improved the quality and scope of repo data since the crisis, but significant gaps remain. We at the OFR are collaborating with Fed staff to fill them.

3. Develop and promote standards to improve the quality and utility of financial data

Filling data gaps is critical; it's equally important to have high-quality, easily accessible data. Our third challenge is thus to develop and promote standards to improve the quality and utility of financial data.

Data that are standardized are critical for analysis. Without standards, we cannot aggregate. Without standards, we cannot compare. We need data that can be aggregated and linked with other datasets for analytical comparisons.

Data standards help us collect more and better data, while reducing the reporting burden for industry. They enable us to aggregate and to compare data on an apples-to-apples basis. They provide regulators and policymakers with a more accurate view of the financial system, including the interconnections between companies and markets.

The financial crisis highlighted the need for data standards. When Lehman Brothers collapsed in 2008, many market participants were unaware of their total exposures to Lehman because that name did not appear on all of their contracts.

The global legal entity identifier, or LEI, offers a solution for this problem.

The LEI is like a bar code or unique ID for parties in financial transactions. It is a 20-digit, alpha-numeric code, which connects to basic business card information to identify clearly and uniquely companies participating in global financial markets. It promises to provide major benefits to financial market participants and government regulators worldwide.

Although standards entail up-front implementation costs for industry, the benefits over time promise to dwarf those costs by enabling firms to report the same data to regulators as they use to manage risks and run their management information systems. Standards also reduce industry costs for collecting, cleaning, and aggregating data. So it's hardly surprising that businesses are eager to embrace the LEI.

Thanks to officials and businesses globally, the LEI system is beginning to take hold. Organizations in several countries are issuing "pre-LEIs," which are designed to be compatible with the final LEI system. To date, almost 100,000 pre-LEIs are in use. Registration authorities called local operating units are in place in six countries; they constitute the bottom tier of governance. The middle tier is a foundation in Switzerland whose board is being assembled by authorities around the globe to ensure that all parties implementing the LEI adhere to governing principles and standards, including reliability, quality, and uniqueness. And a Regulatory Oversight Committee provides overall oversight.

We are proud to have contributed to that effort, to have helped shape the LEI governing structure, and that OFR's Chief Counsel chairs the LEI Regulatory Oversight Committee.

But using the LEI is still largely voluntary. And like it or not, standards work best when they are universal, like the bar code system. Thus, in my view, the time has come for regulators around the world to require companies to use the LEI in reporting financial data. True, in the U.S. and Europe, regulators require that the LEI be used for swap reporting. To be effective, however, the LEI should be ubiquitous.

The LEI is the cornerstone of the OFR's data standards efforts. But the Office is also pursuing other critical standards initiatives in partnership with the Council and our global counterparts. These initiatives include ownership hierarchies to define the relationships among entities in corporate structures, protocols for data sharing, and standards for collection and aggregation of data in the new swap data repositories.

4. The need to balance confidentiality with data sharing.

The Dodd-Frank Act prohibits the OFR from publishing confidential data, but also requires the Office to make data appropriately available to the public to promote both market transparency and research on the financial system. That requires *balancing confidentiality with the need to share data*.

We can envision data sharing as three levels of concentric circles. The innermost circle entails data sharing between the OFR and Council member agencies. We are collaborating through the Council and its committees on data sharing agreements, protocols, and safeguards.

The middle circle represents data sharing with academic researchers under protocols that balance the need for access with heightened safeguards to protect confidential data.

The third, outermost circle involves sharing data with the public, again with the most stringent safeguards, for transparency, accountability, and communication about our work.

At the OFR, we are exploring how best to share data at each of these three levels and striking the appropriate balance. For example, our latest research Working Paper discusses balancing transparency and confidentiality by using new technologies, such as cryptography.

5. Developing the macroprudential toolkit.

Ultimately, our objective is to strengthen the financial system so it can reliably provide the fundamental financial services I highlighted earlier. The final challenge, then, is to develop the macroprudential toolkit to promote financial stability.

The macroprudential toolkit is the collection of policy instruments available to financial policymakers and supervisors. It should help them address systemwide vulnerabilities early to decrease the odds of another financial crisis, and respond to threats to lessen the impact of any crisis that occurs.

We are beginning an important transition, turning from a bank-centric discussion of prudential tools to one that is truly macroprudential. The framework to guide our efforts is outlined in recent research papers, underscored in the OFR's inaugural research conference in December 2011, and discussed in our first Annual Report. We must focus simultaneously on the specific channels — across institutions, activities, and markets — through which threats to financial stability typically surface, such as default, runs, and fire sales. And we must seek a like number of policy instruments with the potential to reduce or neutralize these threats, such as capital requirements, liquidity requirements, and minimum haircuts. In that regard, I am heartened by recent global support for further exploring how to construct and implement this potentially important policy tool.

The macroprudential toolkit should have a distinct tool to address each threat or channel of transmission. We must select the right financial stability tool for the job, while being mindful of the interplay among them and with other policy tools.

The OFR is not empowered to make policy, but the Dodd-Frank Act directs the Office to conduct studies and provide advice on the impact of policies related to threats to financial stability. Helping to construct and evaluate the macroprudential toolkit is part of that mandate.

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Fundamental uncertainties are the hallmark of threats to financial stability, and the financial system is vast, complex, and evolving. The goal of fully capturing every threat with our analysis will always elude us. But we will keep on trying. Better data, research, and analysis can help us improve market discipline, regulation, and the shock absorbers and guardrails needed to make the financial system more resilient.

The list of challenges I discussed today is daunting. However, the OFR team relishes challenges and rises to them. Each of our 180-plus employees — and counting — can take pride in what we have accomplished so far. And we benefit from strong collaboration. Yet all of us — together — are only at the beginning of this venture. There is much more to come, and I look forward to the next opportunity to give you an update on our progress and success.

Thank you again for having me here today. I would be happy to respond to your questions.