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SHOULD THE FEDERAL RESERVE BE A SYSTEMIC STABILITY REGULATOR?

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INTRODUCTION

The current financial crisis has revealed the need for fundamental changes in both the content and structure of regulation. As far as the latter is concerned, it has long been recognized that, for largely historical reasons, the United States has an overly fragmented regulatory structure. Organized along functional lines, the U.S. system has two main market regulators (the SEC and CFTC), at least four banking regulators (the Federal Reserve, OCC, FDIC, and OTS), and insurance regulation conducted entirely at the state level.

This fragmentation has generated overlaps in responsibilities, while at the same time allowing important gaps in regulation to

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arise. Among these gaps is the lack of any agency with overall responsibility for monitoring and addressing systemic risk (a situation that is by no means unique to the United States). This paper considers the need for a systemic stability regulator, what such a regulator should do, and to which agency this responsibility might be assigned. Although many of the observations apply to the specific situation of the United States, much of the argument is of general applicability.

1. WHY IS A SYSTEMIC STABILITY REGULATOR (SSR) NEEDED?

A *first* reason for having an agency with overall stability responsibilities is that consolidation in finance has led to the emergence of a range of institutions that have become so large that their disorderly failure would have major implications for the broader economy. These institutions are not confined to the banking sector, which used to be considered the “core” of the financial system. A half century ago, banks were responsible for 60 percent of the credit extended in the United States. Now, with increased securitization and the larger role of capital markets and institutional investors, that percentage is only about 20 percent. Large non-bank institutions have become of systemic significance.

Second, given the importance of capital markets as a source of funding and vehicle for risk management, the interconnections between financial intermediaries in different sectors have become closer and more complex over time. As we have seen in the current crisis, investment banks, money-market funds, and non-bank institutions such as AIG can generate vulnerabilities that are quickly transmitted to other players including the banking institutions at the center of the system.

Third, in a competitive but regulated environment, new players tend to arise that are largely or wholly outside the regulatory net. In current circumstances, these include money market funds, private pools of capital (hedge funds, private equity), off-balance sheet entities such as structured investment vehicles (SIVs), and so on. Without an agency responsible for overall systemic oversight, there is no structured way in which the need for regulation of these new players can be assessed.

Fourth, there is a category of institutions that may not have significant balance sheets but nevertheless play an important role in the infrastructure of intermediation, through their provision of broking or informational services. These would include mortgage brokers (at the heart of the sub-prime crisis), credit rating agencies, accounting standard setters, and audit firms. All of these played at least some role in the run-up to the crisis, yet they were largely outside the purview of the current network of financial regulation. Payment and settlements systems, too, though generally overseen by central banks, are of vital importance to the stable functioning of the system.

Fifth, without a systemic regulator, the focus of regulation is likely to remain institutional, rather than holistic. The basic philosophy of existing regulation is that by ensuring the sound operation of each individual institution, the health of the overall system will be safeguarded. This pays insufficient attention to market dynamics, and can constitute a fallacy of composition. Apparently prudent behavior by banks or other financial institutions, acting individually, can lead to systemic strains. The most obvious example is when, faced with falling asset prices, a bank attempts to withdraw from risk by liquidating part of its portfolio. This makes sense for a single institution acting in isolation. However, if all follow such a course, the result can be a

vicious spiral, leading to a collapse of asset prices. A systemic regulator should take account of market dynamics leading to systemic fragility.

Sixth, and related to the above, it has become clear that the financial system is subject to *procyclicality*, which can be amplified by an institutional focus in supervision. Measures of risk typically fall during an economic upswing, causing financial intermediaries to economize on capital by increasing leverage. This tends to accentuate a boom. Conversely, measures of risk rise in downturns. This promotes deleveraging, discourages lending, and intensifies the drag on the real economy. Again, no individual supervisory agency is charged with identifying and counteracting this tendency.

Seventh, a fragmented supervisory structure fails to assign responsibility for crisis management and resolution. As we have seen, a complex financial crisis can affect virtually all institutions. A consistent and coherent strategy is needed to confront such a crisis satisfactorily, which implies the need to task a particular agency with this overall responsibility.

Eighth, and last, the global nature of financial markets, and the global reach of large financial institutions, implies that national solutions to emerging problems need to be adequately coordinated globally. It would facilitate such an approach if a single systemic regulator in each country was the interface with regulation and supervision elsewhere.

2. WHAT TASKS SHOULD BE ASSIGNED TO THE SSR?

The foregoing analysis suggests, in broad terms, the tasks that could be assigned to an SSR. What follows is not intended to

be an exhaustive list, and in places may include responsibilities that could be assigned elsewhere. However, it includes the main functions that could be attributed to such a regulator.

- (i) *Supervision.* There is now general agreement that certain financial institutions, by virtue of their size, or interconnectedness with the rest of the financial sector, are of systemic importance. They have the potential to create significant negative externalities if they get into difficulty and are threatened with disruptive failure. It is important for the SSR to be in a position to continuously monitor the health of these institutions, and to assess how their activities are affecting the rest of the financial system. This does not necessarily mean direct supervisory responsibilities. But it would be necessary for the systemic regulator to be confident that it had access to all the information it needed on a sufficiently timely basis. This would obviously be facilitated if the systemic regulator was at least a leading partner in ongoing supervision. The systemic regulator ought also to be able to define (even if not necessarily to publish) the list of institutions judged to be “systemically important.”
- (ii) *Oversight.* Beyond being able to judge the health of individual key institutions, the SSR should have the responsibility of assessing the significance of developing trends in financial intermediation, and their potential to generate systemic risk. This could include, for example, the role of new players, new instruments, or new business models. (An example from recent experience would be the growth of the “originate

to distribute” model, based on increasingly sophisticated asset structurings, and distributed widely to non-bank institutions.) For reasons given above, this assessment of financial trends need not be confined to financial institutions, strictly defined, but could include, e.g., new means of providing information or financial analysis.

- (iii) *Rule making.* The SSR needs also to have the capacity to make rules to curb systemic risk. If, for example, the SSR concluded that increasing leverage was undermining the strength of financial institutions, it should be in a position to prescribe actions to limit such leverage. Or, if a new category of institutions was judged to have become systemically significant, the SSR should be able to bring them under the regulatory net. Care would of course have to be exercised in deciding how much rule-making authority should be delegated through primary legislation, but such legislation should be designed in such a way as to limit the scope for a rule-making gap to arise and persist.
- (iv) *Enforcement.* Rule making implies enforcement procedures. While these powers need not be given to the SSR, there is some justification for doing so. In the case of systemic financial regulation, it would be important for enforcement powers to be implemented in a timely way. One example is early intervention in cases where a systemically important financial institution faces a significant threat to its viability. Another would be where leverage was increasing across the financial system in a manner judged to be exces-

sive, in which case powers to define and enforce increases in capital requirements might be needed.

- (v) *Monitoring.* Monitoring systemic vulnerabilities springs naturally out of the supervision and oversight role described above. It differs, however, in that it could include specific sources of vulnerability such as the growth of credit concentrations, “crowded trades,” excessive maturity transformation, risk-promoting compensation practices, and so on. It is for consideration whether the SSR should be given the authority (or the requirement?) to publish regularly its assessments of such vulnerabilities, and to take action to address them.
- (vi) *Intervention.* It is natural for a systemic regulator to play a central role in the management and resolution of crises which nevertheless occur. Such intervention could (or should?) include the ability to provide liquidity support to solvent but viable institutions. In addition, it could include solvency support to questionably solvent institutions whose failure would have broader economic consequences of a highly negative kind. And the systemic regulator could also be assigned a role in the winding down of failing institutions, whose disruptive disappearance would pose a threat to systemic stability. This would be simplified if the agency concerned had its own resources, but even if it did not, means could be developed (with suitable safeguards) of accessing the borrowing power of the government, or the balance sheet of the central bank. In any event, putting public funds at risk is arguably a responsibility which

requires wider political involvement, which is one of the reasons why even independent central banks are in general expected to limit themselves to liquidity support.

- (vii) *International cooperation.* If, as seems likely, governments in other jurisdictions establish broadly similar institutional arrangements, in which an official agency is tasked with systemic oversight, the SSR would take the leading role in international cooperation. This is unlikely, for the foreseeable future, to involve ceding national regulatory powers, but it would desirably include the maximum degree of international harmonization in regulating a global industry.

3. WHAT ARE THE OPTIONS FOR A SSR?

There are a number of possible options for assigning systemic oversight responsibilities. The choice will depend to some extent on the range of tasks assigned to a systemic regulator, political considerations, and historical factors. The range of possibilities in the United States seems to be the following:

- *The Fed.* This has had the support of Chairman Barney Frank of the House Financial Services Committee, as well as others. Support for the Fed reflects its historic role in crisis management, as well as the leading role it has taken in the present turbulence. In other jurisdictions, a high-level advisory group headed by Jacques de Larosière has favored a leading role for the European Central Bank in the proposed European Systemic Risk Council.

- *Another existing regulatory authority* (the SEC, U.S. Treasury, FDIC, or other). Although this option cannot be completely excluded, it is hard to see any existing body being appropriate for the regulatory role describe above, or commanding widespread support. (This is not to say that certain specific functions of a systemic regulator, e.g., resolution of failing institutions, might not be carried out by one of these agencies.)
- *A newly created body*. It is conceivable that at least some of the functions of systemic stability regulation could be assigned to a newly created agency. This could be an agency with powers limited to systemic oversight, or one with broader supervisory responsibilities. In those countries that have integrated regulators (e.g., the United Kingdom, Japan, and Germany), the question will arise as to how much systemic oversight, in addition to their current supervisory mandates, they should also be charged with.
- *A “College” of functional regulators*. Another approach would be to create a body that attempted to combine the insights of a variety of regulators with responsibilities for financial sector supervision. In the United States, the membership of such a coordinating group would be similar to that of the President’s Working Group, but it could be created as a separate agency, with Board members drawn from existing regulators, but its own executive authority and a separate staff.

In what follows, the focus is on the advantages and drawbacks of the central bank (the Fed) in the role of SSR. A fuller judgment would have to take into account the pros and cons

of other options as well, but that is beyond the scope of this paper.

In practice, any decision about the assignment of systemic responsibilities will also reflect a variety of political considerations, as well as judgments about how well the Fed is perceived to have performed in the current crisis. While this is inevitable, it is not necessarily the best basis for judgment. A decision in this respect ought primarily to consider the *externalities* (positive and negative) from combining the SSR function with the Fed's other functions, such as monetary policymaking. I try to follow this approach in the next section.

4. PROS AND CONS OF CHOOSING THE FED

A number of powerful arguments can be advanced in favor of choosing the central bank (in this case the Fed) as SSR. Central banks have had an historic responsibility for financial stability. This was, in fact, the reason for the establishment of the Fed in 1913. The Fed has been at the center of financial crisis management throughout its life and is endowed with the balance sheet to provide liquidity support to banks in temporary difficulties. Moreover, the Fed already oversees bank holding companies, and has a well-qualified and respected staff. The New York Fed, in particular, has a long history of mostly successful involvement in tackling financial crises.

These arguments, although powerful, are essentially "legacy" arguments. They imply that the Fed is better placed, at present, to perform the systemic stability and crisis resolution role than any other agency. They do not address the issue of externalities in combining monetary policy making and financial stability responsibilities. Thus, they do not necessarily imply that it would

be the right institution if the regulatory structure could be re-designed more fundamentally. To judge the case for the Fed in this context, it is necessary to look at the case for combining the financial stability role with the Fed's other key responsibility: that of ensuring price stability.

Here, it can be argued that there are important positive externalities from combining the monetary policy and SSR stability roles. As the implementer of monetary policy, the Fed has a continuous interaction with market participants that gives it a window into emerging vulnerabilities, an important attribute for a stability regulator. Conversely, having responsibility for oversight of (at present) bank holding companies, may help the Fed better understand the transmission of monetary policy actions into the real economy.

It is hard for an outsider to judge how strong these external benefits are. They certainly should not be dismissed out of hand. But they did not prevent the build up of vulnerabilities prior to the present crisis. In other jurisdictions where supervision is outside the banking system (e.g., the United Kingdom, Canada, Germany, and others), there is little evidence that the central banks have felt unduly handicapped in their execution of monetary policy by not having a direct supervisory role.

Let us now turn to the case that can be made against giving additional financial system oversight responsibilities to the Fed. Some of these are also "legacy" arguments that should not necessarily be considered conclusive. For example, it can be argued that the Fed is not at present the primary supervisor of a number of systemically significant institutions. This is less true than it was before the failures of Fannie Mae, Freddie Mac, and AIG, and the disappearance of the independent investment bank model. But even if it were an important consideration, it could

easily be dealt with by extending the reach of the Fed's direct supervisory role.

Much more important are the possible negative externalities of combining the roles of monetary policy and financial stability, which need to be set against the advantages described above. The two roles, though involving some overlap, can be argued to be rather different. There could therefore be a dilution of focus. Most management theory tends to emphasize the advantages of limited mandate organizations, and central banks cannot automatically be excluded from this generalization.

A slightly different objection is that the combination of the two roles, each of which is by itself of great importance, would concentrate too much power in a single organization. This would have to be justified by a strong presumption of improved efficiency. Even if the concentration of power were accepted, it would invite closer involvement by the political process. Exercise of systemic regulatory powers would be a subject of intense political scrutiny, both in good times, where the authority might be trying to restrain financial innovation, and in crises, when it would be providing discretionary support to particular threatened institutions.

Political scrutiny, in itself, is no bad thing. But there are two risks. One is that it could lead to the politicization of the Fed's monetary policy role, with potential adverse consequences for price stability. The other is that it could undermine the Fed's credibility, by associating it with decisions that were almost bound to be controversial (unwelcome restraint in good times, unpopular "bailing out" in bad times).

Finally, there is risk of a conflict of interest between the two roles the Fed would be assuming. Although it may seem far-

fetched, it cannot be completely excluded that the monetary policy needed to preserve price stability runs counter to the desire to help out a particular institution that faces difficulty, and where the supervisor would face criticism of a failure occurred. One does not have to believe the Fed would succumb to this temptation to be concerned about the risks of a public perception that it had.

5. CONCLUDING COMMENT

Although the foregoing discussion has cast some doubt on the case for the Fed as a systemic stability regulator, it is not intended to be a firm conclusion. As already noted, the case for the Fed has to be judged against the alternatives, and this paper has not considered these in sufficient detail. In particular, it is important to know whether a fundamental redesign of the regulatory structure is possible, or if it will be necessary to assign the SSR role to an existing institution. Three other considerations argue against a “rush to judgment.”

First, it is highly desirable that the arrangements for an SSR fit in with other reforms being made to the content and structure of regulation. *Second*, though it may seem counter-intuitive, there is no immediate need to hasten the establishment of a new structure. Doing so will not have a material impact on how the present crisis is resolved, and after recent experience, it is highly unlikely that excessive risk-taking will again become a problem in the next several years. (There is of course a case for “not letting a good crisis go to waste,” but it seems unlikely that the passage of time for reflection will cause the severity of the crisis to be forgotten.) *Third*, it would be very beneficial if

the arrangements under consideration in numerous jurisdictions were as consistent as possible, and not adopted without regard for what is done elsewhere. To paraphrase Einstein, decisions in this area should be made as quickly as possible, but not quicker.