Regulatory Restructuring: Balancing the Independence of the Federal Reserve in Monetary Policy with Systemic Risk Regulation

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[1] The views expressed here are my own and do not necessarily reflect the views of Macroeconomic Advisers, LLC.

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The independence of central banks with respect to monetary policy is absolutely essential. Policies that are focused on financial stability, including intervention at specific financial institutions, on the other hand, require a more cooperative effort, including, in the U.S., the central bank, functional regulators of banks and non-bank subsidiaries, and a clear role for the Treasury. However, there needs to be a bright line between the more cooperative approach to financial stability policy and the independence of the Fed with respect to monetary policy. This distinction is affirmed in a joint statement of the Department of the Treasury and the Board of Governors of the Federal Reserve System on March 23, 2009: "While the Federal Reserve has traditionally collaborated with other agencies in efforts to preserve financial stability, it alone is responsible for monetary policy…The Federal Reserve's independence with respect to monetary policy is critical to ensuring that monetary policy decisions are made only with regard to the long-term economic welfare of the nation." I believe, implicit in this statement and explicit in the Treasury's regulatory reform proposal is the conviction, which I share, that the Fed's joint but collaborative responsibility for financial stability does not conflict with its singular responsibility as independent authority with respect to monetary policy.

<u>The independence of the Fed as monetary policy authority</u>
I do not interpret this hearing as being about or questioning the independence of the Fed with respect to its role as monetary policy authority, but rather focused on how to balance that unquestioned independence with its proposed role as systemic regulator, and indeed whether it would serve the interests of both financial stability and monetary policy to separate these two roles. Nevertheless, I will take a minute to discuss the Fed's independence with respect to monetary policy, because many market participants and some very respectable economists have raised serious concerns about whether the Fed can remain independent in the circumstances that will unfold over the next several years. As a result, these observers are projecting very high rates of inflation over the intermediate term.

This apprehension is based principally on the massive borrowing requirements associated with the deficit today and prospects for very large deficits over the coming years. The question that is asked is whether Congress will intrude on the Fed's independence if this massive borrowing leads to sky-rocketing interest rates, with significant costs to long-run growth prospects as well as to near-term growth and unemployment. Will Congress insist that the Fed help out by maintaining interest rates too low for too long, leading to significantly higher inflation, and thereby inflating away some of the debt and debt service burden? A surprising number of savvy investors and well respected economists share the view that this is either possible or even probable. The best antidote to these fears is to both take disciplined action to lower the deficit and to reaffirm in no uncertain terms your unequivocal commitment to the independence of the Fed.

To what extent if any would the newly proposed role as systemic risk regulator be in conflict with the Fed's traditional role as the independent authority on monetary policy? I don't believe there is a conflict. But, then again, I do not see the Treasury proposal as conferring on the Fed vast new authority as systemic risk regulator to the point where it would become a "super-regulator."

The Fed is already bank holding company (or consolidated) supervisor for all financial institutions that have a bank. Of the systemically important financial institutions today, almost all are already bank holding companies. To be sure, if this were just several months ago, there would have been five systemically important stand-alone investment banks that likely maintained that status to avoid coming under the consolidated supervision of the Fed. These investment banks have failed, been acquired by or merged into bank holding companies, or changed their charter to become a bank holding company. As such, they are already supervised by the Fed. Other institutions that might be designated as systemically important could be a couple of insurance companies, a few systemically important financial firms that are not supervised today and, in principle but initially not likely in practice, large and highly levered hedge funds.

Following up on this theme it should also be recognized that there are functional supervisors of banks and of the investment banking and insurance subsidiaries of bank holding companies. They do much of the heavy lifting of overseeing the risks in their respective parts of the bank holding company. And the Fed, while a functional supervisor of many banks, is not the functional supervisor of many of the largest, systemically important banks. As consolidated supervisor, its responsibility is to ensure that risks emanating from the non-banking subsidiaries do not impose risks to the bank itself, to oversee transactions between the bank, other subsidiaries, and the bank holding company to insure these don't impose risks to the bank, and to ensure that the bank holding company itself has sufficient capital to support the bank if necessary.

The Fed would likely be a more active bank holding supervisor under the Treasury's proposal, no longer limited to the so-called "Fed-lite" approach prescribed by Gramm-Leach-Bliley. It should continue to rely predominantly on the reports of the functional supervisors, but it is now free to join examinations and impose higher capital requirements, after consultation with the functional supervisors.

The Fed also gets explicit regulatory and supervisory authority over the institutions that form the backbone of the payments system. Previously it had to use moral suasion to influence them – but it is pretty good at moral suasion.

Finally, there are two potential roles of a systemic risk regulator. The first is the consolidated supervision of all systemically important financial institutions. This is the role the Fed gets under the Treasury proposal. The second is as monitor of emerging systemic risks, not looking at individual financial institutions, but across markets, sectors, practices, instruments, asset prices, etc. That is a role that has been assigned to the new Financial Services Oversight Council, of which the Fed is a member, but is chaired by and staffed by the Treasury.

There has been some debate about whether the Fed's role in bank and bank holding company supervision today complements or conflicts with its role in monetary policy. The role as a hands-on supervisor of some banks and of all bank holding companies, for example, provides first-hand information about the state of the banking sector, which can be a valuable input into the assessment of the economic outlook, especially in periods of extreme stress in the banking sector. The counter-argument is that the Fed's concern for the health of the banking system, derived from its role as a bank and bank holding company supervisor, can encourage the Fed, at times, to sacrifice its macro objectives in order to help the banking system when it is ailing. When I was on the Board, I never witnessed any conflict in practice between these two roles. I don't see why this debate should change as a result of the increase in supervisory reach under the Treasury proposal.

A basic premise for my view is that a central bank should always have a hands-on role in bank supervision. First, central banks always have at least an informal responsibility for monitoring systemic risk, and the banking system is a major source of such risk. Second, the central bank is always a source of liquidity to banks and must therefore have first-hand knowledge of their credit worthiness, and this is especially true in times of stress. In the current episode, the Fed has had to be especially creative in developing liquidity facilities to meet this need. Finally, the central bank will always be called upon to cooperate with Treasury at times of intervention in particular institutions, where the Fed provides liquidity and Treasury should take any credit risk. A good example of this cooperation is the Term Asset-Backed Securities Loan Facility, where the Fed provides liquidity to various securitization markets and the Treasury provides first loss protection. Given the Fed's role already as consolidated supervisor of most systemically important financial institutions, the choice may really be whether to remove the Fed from its current role as bank holding company supervisor or to expand it to cover all systemically important financial institutions. This seems like an obvious choice to me.

<u>Would it be necessary to insulate the Fed's traditional role in executing monetary policy from its new role as systemic risk regulator, and, if so, how could that be accomplished?</u> These two roles are housed in different divisions as well as shared with Reserve Banks, with the supervision division overseen by a committee of Board members and monetary policy made by the FOMC. I don't see any need to separate them any more than they already are.

If one wanted to totally separate these two functions within the Federal Reserve System, some have suggested two different Boards, one for supervisory policy and one for monetary policy. Alternatively, regulatory reform could be much more far-reaching, either by assigning the role of consolidated supervision to one of the other federal banking regulators, or by creating a unified financial services regulator with supervisory authority for banks, investment bank and insurance subsidiaries of bank holding companies, and stand-alone investment banks and insurance companies to this agency. This has the advantage of promoting consistent prudential supervision of all financial institutions.

However, moving in either direction would be a radical change in the structure of regulation, with uncertain consequences. In any case, the recent experience with extreme stress in the banking system has cast considerable doubt on the wisdom of transferring all banking supervision to another banking supervisor or to a unified financial services agency, and specifically taking the central bank out of the role as a hands-on supervisor of bank holding companies. In periods of stress, it is the central bank that will inevitably be called upon to be the liquidity provider of last resort and, with the Treasury, to intervene when particular institutions are near collapse. In this case, it must have first-hand knowledge of the credit worthiness of institutions it might be called upon to lend to.

<u>What are the public policy considerations for and against making the Fed the systemic risk regulator, given its role as central banker and independent authority on monetary policy?</u>

Let me set out the case for the Fed maintaining both consolidated supervision of systemically important financial institutions and monetary policy. First, the Fed has considerable experience in the role as consolidated supervisor of bank holding companies. Second the two roles are more complementary than conflicting. Third, the central bank will be inevitably called upon to intervene in periods of extreme stress, and the timing and effectiveness of its response can be compromised if it lacks hands-on knowledge about banking organizations. The Fed has already developed a very successful collaborative approach with Treasury and other functional regulators in support of its special role in periods of extreme stress.

The case against could include the following: To the extent that the role of systemic regulator confers upon the Fed vast new authority, there could be some reluctance to augment the power of this already powerful institution. Removing the Fed from its role as systemic supervisor and bank supervisor could allow some consolidation of federal banking supervisors, a worthy goal that the Treasury plan does not accomplish. Separating these two roles would guarantee that any potential conflict between them was eliminated.

<u>Should the Fed relinquish any roles and why?</u>

If the Fed was getting substantial new powers as systemic regulator – and had to devote considerable new resources to this responsibility – then it seems reasonable that it should give up some of its current responsibilities.

One reason for removing some current authority is a political consideration: Congress might be cautious about giving, on net, substantial additional powers to an already very powerful institution. In this case, given my views of the limited degree to which the Fed's current role as bank holding company supervisor is expanded in the Treasury proposal, it is not obvious that the case for giving something else is powerful from this perspective. If something is to be given up, the most obvious choice is consumer protection and community affairs. These are not seen around the world as core responsibilities of central banks. The case for giving up consumer protection and consumer affairs is strengthened by Treasury's proposal to unify these responsibilities in a single agency.

The bottom line is that the Fed is the best choice for consolidated supervision of systemically important financial institutions in its current role, as well as in any expanded role under the Treasury proposal, and this authority is much more complimentary than conflicting with its role as an independent authority on monetary policy. Indeed, there is a natural fit between these two roles.