The U.S. Financial System and Macroeconomic Performance

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Any opinions expressed here are mine and do not necessarily reflect those of other Federal Open Market Committeee members.

The clamor for regulatory reform

- Historically important crises have resulted in regulatory reform.
  - The Panic of 1907 led to the founding of the Federal Reserve.
  - The Depression led to the enactment of Glass-Steagall in 1933, creating the FDIC, and separating commercial from investment banking.
  - The Thrift Crisis in the late 1980s led to the enactment of FDICIA and "prompt corrective action."
  - The collapse of Enron and Worldcom led to the enactment of Sarbanes-Oxley.

Reform legislation likely

- This look at history tells a clear story:
- The current crisis is likely to lead to new, reform-oriented legislation.
- But ...
- ... what should the new legislation do?

Organizing a reform agenda

- We are clearly in the middle of the largest financial crisis in a generation.
- First ask: Which aspects of the current regulatory system are working well?
- *Learn from these.*
- Then ask: Which aspects are working poorly?
  - There are many suspects here!
- Then: Design reform based on successful parts of the regulatory system.
- Keep in mind: Where can unintended consequences intrude?
  - ... and there will always be unintended consequences.

PLAN FOR THIS TALK

1. The nature of the crisis.
    1. A failure of financial engineering.
    2. "Bank runs" on non-bank financial institutions.
2. Parts of the regulatory system work well.
3. Parts of the regulatory system work poorly, especially with respect to large financial institutions.
4. How can we apply the lessons from the parts that work well?
5. The role of the Federal Reserve.

A failure of financial engineering

- Securitization markets are in principle a good financial innovation.
- The initial success of mortgage-backed securities (MBS) masked underlying problems.
- By the time of failure, large quantities of MBS and related assets were held globally.
- Few major players escaped unscathed, suggesting few knew the dangers.
- Some parallels with other types of engineering failures.

More on failed financial engineering

- The resulting shock to the global macroeconomy is large and real.
- There is no escaping the adjustment that must occur.
- Government intervention cannot offset this large shock completely, only mitigate some of the effects.
- The design of the securities was the core problem: They did not perform well in some states of the world.
- Most reforms being discussed would do little to address this.

"Bank runs" on non-banks

- Bank runs have been a macroeconomic hazard for hundreds of years.
- Conceptualized as simultaneous withdrawal of deposits from a depository institution.
- Policy intervention:
  - Deposit insurance ...
  - ... plus prudential regulation.

More on "bank runs"

- This crisis has instead produced "runs" on non-bank, non-depository institutions.
- There was no regulation in place for this hazard, because it was not generally viewed as a hazard.
- Bear-Stearns, for instance, borrowed short-term, but against collateral.
- Deposit insurance does not solve this problem.
- What to do?
- *Most reform suggestions do not address this problem either.*
- "Keep a closer eye on these guys" does not work.

Portions of the regulatory system work well

- Bank regulation outside the largest financial institutions has worked well during the crisis.
- We do not see the small bank panic that characterized the Depression, even though this is a big crisis.
- The system of deposit insurance plus prudential regulation solves that problem.

More on successful regulation

- There are bank failures in the system, but they have not caused market disruption.
- Why the success?
- The first component is good monitoring.
- A fairly clear rating system is in place.
- The monitoring system means that the regulator is aware of which banks may fail and can prepare accordingly.

More on successful regulation

- The second component is a clear and credible resolution regime.
- Credibility means that all parties understand what will happen in the event of bank failure.
- The U.S. has a system for closing banks in a way that does not damage others in the industry.
- Conclude: Good regulation is good monitoring plus a clear, credible resolution regime.
- We can learn from the success of this system.

What the successful regulatory structure does

- The system is not designed to "keep banks in business at all costs."
- Nor is the system designed to tell owners how to run their business.
- The system in fact allows some failure to occur.
- What it is designed to do is to turn potentially disorderly failures into orderly failures.
- The system succeeds here.

LESS-SUCCESSFUL REGULATION

- The key problem areas in this crisis have been with large banks and large non-bank financial firms.
- These are often global enterprises.
- The monitoring problem for these institutions is more difficult.
- The bank component of the firm may be only a smaller piece of a large conglomerate.
- As a result, it was difficult to discern how these firms were coping with the financial engineering failure.
- Firms near failure might alert authorities only days before the event.
- So the first part of good regulation was missing: monitoring was poor.

No clear resolution regime

- In addition, the resolution regime is unclear.
- So the second part of good regulation, a clear, credible resolution regime, was also missing.
- These firms are often considered "too big to fail" because of the market disruption that might be caused.
- The correct phrase is "too big to fail ... quickly."
- No firm is literally too big to fail.
- Regulators may encounter fraud—for instance, as with Enron.
- Some plan has to be in place to shut down the failed institution in that case.

Defining too big to fail

- What is meant by "too big to fail quickly"?
- We want an *orderly* resolution regime that will close down the failed firm without creating problems for the remaining firms in the industry.
- Ronald Feldman and my colleague Gary Stern emphasize that this resolution regime must be credible.
- Credible means that all parties understand what the regime is and that it will indeed be employed in the event of failure.
- The resolution regime then affects the entire equilibrium pricing structure.

Core problems

- What are the core problems relative to the successful part of the regulatory structure?
- Monitoring of large banks and non-bank financial firms is difficult.
- This has led to sometimes sudden revelation of problems at major institutions.
- Very disruptive.
- Lack of a clear resolution regime has kept all parties guessing what will happen next.
- In the face of the financial engineering failure, the Fed has been forced to improvise to try to work around these deficiencies.

Existing resolution regimes

- Given the discussion, you may be surprised to learn that the U.S. actually has a resolution regime for large non-bank financial firms.
- It is called "bankruptcy court."
- It often means reorganization instead of liquidation.
- This has been considered inadequate for certain types of large non-bank financial firms.
- A simple reform would be to rewrite the bankruptcy code to allow for special considerations that apply to financial firms.
- This would not help us with the monitoring question: the filing may still be "sudden."

Size limitations

- One simple approach that has been suggested might be to limit the size of firms.
- This would bring large financial institutions within a regulatory framework which is robust and is known to work well, even in a crisis.
- Still, it is questionable whether size restrictions could be adequately enforced.
- The global aspect of these firms might also make this idea difficult to implement.
- A version of this would be to place a tax on firm size.
    - A tax does not seem to help either with monitoring or with resolution.

Monitoring without a resolution regime

- The most common response to the situation has been that we need more monitoring of large financial firms.
- It is unclear what monitoring by itself can accomplish. We need the resolution regime.
- Monitoring can help authorities track which firms are likely to fail.
- It cannot do very much about poor business decisions.
- Regulators are not going to have a better idea than business leaders themselves as to which direction the firm should go in order to be profitable.

The lender of last resort

- The Fed is the nation's lender of last resort.
- If the Fed may be lending to institutions, it will need to have a role in regulating those institutions.
- Otherwise, the Fed will be unable to make a judgement on whether to lend and under what terms.
- The role of Fed lending in mitigating the current crisis has been substantial.

The nation's monetary authority

- The Fed also runs the monetary policy of the nation.
- To perform this function effectively, the Fed needs to know the condition of the financial system.
- This also argues for a substantial Fed role in the regulation of these firms.
- The need to know the status of financial markets has been underscored by recent events.

Systemic risk regulation

- Should the U.S. have a systemic risk regulator?
- Widely discussed in the wake of financial market turmoil.
- The Fed has been the *de facto* systemic risk regulator.
- Many financial market problems, whether under the official Fed purview or not, have come to the Fed during this crisis.

A poorly defined debate

- The debate on systemic risk regulation needs to be sharpened substantially.
- The definition of systemic risk regulation is far from clear.
- A macro-prudential view: does the Fed already do this?
- A narrower, institutional view: what new powers to assign?

A macro-prudential view

- A macro-prudential view often emphasizes a regulator that "takes everything into account."
- Coupled with monetary policy, it means taking everything into account when setting interest rates.
- I think the Fed already does this.
- Certainly, policy debates in the last twenty years have discussed bubbles in technology stocks and in housing prices.

The Fed and Systemic Risk

- Three important systemic calls by the Fed:
  - William Poole on GSEs.*
  - Gary Stern on "Too Big to Fail."**
  - Ned Gramlich on subprime.***

*"Financial Stability," 2002; "Housing in the Macroeconomy," 2003; and "Reputation and the Non-Prime Mortgage Market," 2007.

**Gary H. Stern, Ron J. Feldman, Too Big To Fail: The Hazards of Bank Bailouts, Brookings Institution Press, 2004.

***Edward M. Gramlich, Subprime Mortgages: America's Latest Boom and Bust, Urban Institute Press, 2007.

A narrower view

- A narrower view would contain the idea that certain market practices may need to be curtailed.
- Alternatively, business practices at certain firms might need to be discouraged, should they be viewed as systemically risky.
- What is unclear is what powers a new regulator would need to carry out these tasks.
- How would firms operate, knowing that a particular practice might be found "too risky" at some point in the future?
- I do not think the answers are clear at this point.
- The debate needs a much sharper focus.

Conclusions

- For smaller banks, the U.S. regulatory system works well and is robust during a crisis.
- That system includes deposit insurance, high-quality monitoring of banks, and a clear, credible resolution regime.
- For large banks and non-bank financial firms, monitoring is more difficult and the resolution regime is unclear.
- Key improvements would be to develop a credible resolution regime for large financial institutions, and to upgrade monitoring.
- The Fed's lender of last resort and monetary policy functions mean that it will have to remain closely involved in the regulatory structure.
- Systemic risk regulation has been widely discussed, but the debate strikes me as too broad and unfocused at this point.