Reassessing the Role of the Fed: Grappling with the Dual Mandate and More?

Charles W. Calomiris

September 30, 2009

As we contemplate the raft of regulatory reforms currently being proposed, it is important not only to consider the content of regulation, but also its structure. In particular, it is important to ask how the role of the Fed as a regulator should change, and how the targets and the tools of monetary and regulatory policy should adapt to new regulatory mandates. For example, some reform proposals envision a dramatic expansion of Fed regulatory authority, while others do not, and some proposals envision the Fed using monetary policy to prick asset bubbles, while other do not. This position paper considers the desirability of various financial reforms, the proper future role of the Fed, and the proper use of monetary and regulatory policy tools in light of proposed regulatory reforms. What regulatory and overall policy structure would help us best achieve legitimate policy objectives?

The Fed's currently has two jobs: managing monetary policy and regulating bank holding companies and some banks: Monetary policy involves varying the supply of Fed liabilities. The Fed does so during normal times primarily by varying its fed funds target, which results in changes in the amount of purchases or sales of Treasury securities. Recently, however, the Fed has employed new tools to achieve growth in its balance sheet, including aggressive lending to banks and others, varying interest paid on reserves, and setting quantitative objectives for various categories of purchases by the Fed of private securities (especially MBS).

The Fed has a "dual mandate" and is supposed to vary the supply of its liabilities to achieve a balance between two ultimate objectives: maximizing price stability (which many have come to equate with a long-term inflation target of somewhere upwards of 1 percent) and minimizing cyclical fluctuations in unemployment. One way to balance these two objectives is described by the "Taylor Rule," which expresses the warranted fed funds rate as a function of (1) the long-run inflation target, (2) the current level of unemployment, and (3) the current level of inflation. The Fed departed dramatically from the Taylor Rule in 2002-2005 (Figure 1), and today, the Fed's objectives with respect to price stability and unemployment are hard to discern or characterize through any "rule," as all objectives seem to have taken a back seat to the immediate objective of limiting short-term financial sector fallout by setting the fed funds rate to zero and announcing various guarantees or quantitative targets for the purchase or support of various categories of private securities. It is hard to know what sort of Taylor Rule the Fed has in mind for the future, if any. This makes it extremely hard to predict monetary policy, or to hold the Fed accountable to achieving its unannounced and unobservable goals.

The second job the Fed has been given is to regulate some banks and all bank holding companies. As revised under the Gramm-Leach-Bliley Act of 1999, that role now entails decision making authority about what constitute allowable financial activities within financial holding companies that own banks, as well as more longstanding authority to decide which banks should be allowed to merge and on what terms, and the day-to-day supervision and regulation of member banks (other than national banks) and of bank holding companies.

As a regulator, the Fed is also charged with multiple objectives, which sometimes conflict with one another, although there are no Taylor Rules that have been derived to characterize tradeoffs among regulatory objectives. Those objectives include: ensuring the safety and soundness of banks by enforcing existing prudential regulations (including, for example, minimum capital requirements), consumer protection of bank customers, the enforcement of antitrust laws, and the enforcement of a host of other regulatory mandates on banks that include preventing money laundering, identifying potential terrorists, and ensuring that banks cater sufficiently to their local communities.

The expansive role of the Fed as a financial regulator is out of step with the global trend to separate monetary policy from regulatory policy. Virtually all developed economies have separated their monetary authority from their financial regulatory authority. Such a separation is desirable, as it limits the politicization of monetary and regulatory policy; pressures from special interests in the regulatory arena have led to poor regulatory decision making by the Fed (which fears repercussions from Congress) and those pressures similarly have jeopardized the Fed's independence in managing monetary policy (Calomiris 2006).

The most common objection to the proposal to remove the Fed from day-to-day regulatory and supervisory authority is related to the Fed's role as a lender: How can the Fed lend to member banks without having timely information about their condition, and how can it get that timely information without participating in bank examinations and without having the right to examine banks as needed? The answer to this objection is simple: The Fed can and should have a representative attending all regular bank examinations, with full access to all examination meetings and materials, and that official should have the legal right to visit banks at any time to address questions pertaining to bank condition. But this has nothing to do with setting regulatory standards, supervising compliance, approving mergers, or defining what constitutes a financial activity. Fed officials often conflate the need for information with the need for control. The two are separable.

Former Treasury Secretary Henry Paulson advocated disengaging the Fed from day-to-day supervision and regulation. He supported, however, a continuing role for the Fed in "macro" prudential supervision and regulation. Under this vision of the Fed's changing role, which predated the financial crisis, the Fed would set broad, perhaps time-varying prudential standards (for example, minimum capital requirements) based on its knowledge about the condition of the economy and the financial sector, but it would not play an active role in enforcing those standards, or in determining or enforcing other regulatory policies.

The financial crisis has brought a new sense of urgency to proposals like Secretary Paulson's for creating an explicit mandate for macro prudential supervision and regulation. Most proposals envision that the Fed would play the central role in monitoring indicators of risk in the financial system (e.g., by tracking financial institutions' leverage, borrowers' leverage, economy-wide credit growth, and asset price changes), modeling what those indicators collectively imply for system-wide risk, and altering prudential regulatory mandates (like minimum capital requirements, provisioning requirements, and reserve requirements) accordingly.

Should the Fed play that macro prudential role? Some observers argue that the Fed has failed in the past to recognize systemic risk problems and is not a credible monitor of systemic risk, partly because of its political vulnerability; Fed critics see a need for a "council of regulators" to handle macro prudential regulation. That council might contain representatives from each of the major regulatory authorities, and/or independent members; it would constitute a new regulatory authority with its own budget, staff, and a mandate to develop a framework for monitoring risk, identify moments of elevated systemic risk, and impose prudential regulatory changes accordingly.

Advocates of entrusting the Fed with macro prudential authority argue that because the Fed is already acting as a cyclical policy maker through its control of monetary policy, vesting authority over macro prudential regulation elsewhere would reduce overall accountability in the system. It would be hard to hold either party accountable for cyclical disasters if we had two institutions (the new council and the Fed) both managing interrelated aspects of cyclical policy; how can one hold a ship's captain accountable for his steering if he controls only one of two wheels on the ship? I find this accountability argument persuasive, notwithstanding the valid concerns about the politicization of the Fed and its failures to identify or act upon systemic risks in the past; I believe that there are measures that can be taken to improve accountability of macro prudential regulation by the Fed (which I discuss below).

Another question concerns the proper tools to use in responding to perceived increases in systemic risk. Should the policy reaction to systemic risk entail a regulatory standards response, a monetary policy (fed funds rate) response, or both? Experience and theory both suggest that adding another objective to macroeconomic policy without adding any new tools (in addition to monetary policy) will complicate monetary policy and make it even harder to hold the Fed accountable to any well-defined set of objectives or actions. Judging Fed policy against an announced Taylor Rule would be an imperfect but reasonably good means of evaluating the Fed's balancing of its dual mandate of inflation targeting and unemployment stabilization; adding a financial stability indicator variable to the list of variables affecting the fed funds rate would make it much harder to write a coherent Taylor Rule, and thus make it much harder to hold the Fed accountable for achieving any well-defined set of objectives in its monetary policy. Large deviations from fed funds rate targets implied by a Taylor Rule could be defended on the basis of a perceived need to maintain financial stability. The Fed's radical departure from the Taylor Rule in 2002-2005 (see Figure 1), which prompted the credit binge that helped set the stage for the subprime crisis, reminds us of the desirability (from the standpoint of both economic and financial stability) of holding the Fed accountable to observable benchmarks (like the Taylor Rule) when judging the performance of monetary policy.

I conclude, therefore, that monetary policy should stick to the knitting embodied in some form of the Taylor Rule, which should be announced in advance by the Fed. Reactions to concerns about financial fragility should be implemented through a separate framework from the Taylor Rule and should rely on additional tools – increased minimal capital standards, provisioning standards, and reserve requirements – not the fed funds rate or other monetary policy actions by the Fed.

In the interest of promoting accountability, the Fed should be required to create and publicize a formal framework for measuring systemic risk. Unless the Fed is required to publicly defend its approach to measuring systemic risk it will be hard to hold it accountable for its policy actions in response to perceived increases in systemic risk. It may even make sense for this disclosed framework to be subject to approval by a council of regulators.

Modeling systemic risk is still in its infancy, but early research is promising. For example, Borio and Drehmann (2008) have developed a simple dual-threshold model of systemic risk which works well to predict severe financial collapses. They find that whenever both asset prices and credit supply are growing at very high rates, systemic risk is high. One could potentially add measures of leveraging by households, businesses and financial firms to that framework, as suggested by Brunnermeier et al. (2009), if doing so would improve the fit. This sort of model would provide clear signals to trigger the imposition of stricter regulatory standards. Recent experience, especially in Colombia in 2007-2008 (Uribe 2008), suggests that timely interventions based on these sorts of signals can be quite effective in slowing down credit-driven asset pricing bubbles before they become too dangerous.

Some reform proposals envision the creation of additional regulatory and resolution authority powers, and/or modifications of bankruptcy law, to deal with the special challenges of resolving large financial institutions. Proposals include both ex ante and ex post policies. Ex ante, a regulatory authority would be charged with identifying which banks and nonbank financial institutions are sufficiently large and complex that their failure might pose a systemic risk to the financial system, and then applying special regulatory standards to those institutions (e.g., higher capital, provisioning, and reserve requirements). Ex post, reforms to the resolution of these institutions would endeavor to ensure that they would no longer be too big to fail.

I am sympathetic to the view that minimum prudential standards could and should be set on the basis of the externalities that institutions potentially impose on the system. Doing so would help to internalize the externalities of systemic risk created by large, complex financial institutions that are sources of liquidity risk to the financial system.[1] It should be possible to propose and publicly defend reasonable ways to set capital standards as a function of bank size, the number and size of its international subsidiaries, and the number of countries in which it operates. But it is counterproductive to make "complexity" a matter of discretionary judgment by regulators (and therefore, a source of potential abuse of authority, lack of accountability, and increased regulatory risk) and there is no reason to do so; regulators can clearly delineate criteria that do a reasonable job of measuring complexity. Furthermore, there is no reason to have only two categories of complexity (simple and complex) as some proposals envision; doing so would invite undesirable regulatory arbitrage around whatever threshold is established. Complexity should be recognized as a continuum, and regulatory standards can and should envision multiple gradations of complexity.

[1] Not all large, complex financial institutions should be the subject of prudential regulation, only those that pose significant potential systemic risk through their management of liquidity risk. Banks and investment banks that finance themselves with large amounts of short-term debt are inherently sources of potential systemic risk, but hedge funds, insurance companies, mutual funds and private equity investors should be able to avoid intrusive prudential regulation, if they can demonstrate that they are not sources of systemic risk. AIG's failure was a special case of an institution that, because of its AAA status, was able to avoid collateralization of its OTC positions, which became a source of systemic risk when AIG was downgraded, but if AIG had collateralized those positions in advance of its downgrade, it would not have been a source of systemic risk. Financial institutions other than banks who wish to avoid intrusive prudential regulation should be permitted safe harbor from prudential regulation if they can demonstrate an adequate management of liquidity risks.

I also support the idea of creating better resolution mechanisms for banks and nonbanks that would resolve problems associated with allowing them to fail. But the devil is in the details. Some approaches to designing this new resolution mechanism – specifically, those that would vest discretionary resolution authority in the Fed or any other government authority – would likely make the too-big-to-fail problem worse because those government authorities would be correctly perceived as more inclined and able to use public funds to bail out large complex institutions (Wallison 2009). Furthermore, it would be extremely unwise to ask the Fed to manage resolution policy; making the Fed into a discretionary bankruptcy court would further compromise its independence.

The right approach to reforming the resolution of large financial institutions has two parts. First, amend the bankruptcy code to cure any technical deficiencies that make it hard to apply bankruptcy to financial institutions (e.g., the treatment of derivatives contracts). The bankruptcy court, rather than a regulatory authority, is the right place to handle resolution. It is also important that the resolution rules be strict and not subject to too much judicial discretion. The law should require that shareholders in a failed institution face a complete loss, that long-term debtholders face losses commensurate with the negative net worth of the failing institution, and that any government assistance for the sake of incentivizing a merger should be defensible on the basis of a "least cost resolution" test, meaning that no government resources would be used unless doing so produces concrete and demonstrable savings on the transaction to taxpayers. Placing the responsibility for enforcing these strict standards in a court would increase the chance that resolution would be handled properly by applying the rule of law to a preexisting code, and would minimize the chance that political expediency would create an abuse of discretionary regulatory authority.

Second, it is crucial that regulatory authorities in the U.S. work with those in the U.K., and eventually with those in other countries, to establish effective, pre-specified rules for allocating losses across borders. In the Lehman bankruptcy, significant disputes arose among different countries' regulatory authorities and courts over which country's affiliate had the better claim to certain assets within the institution. The difficulty of resolving those cross-border conflicts makes it harder to apply credible market discipline to failed institutions; when bankruptcy is a mess, policy makers want to find an alternative. Regulators and financial institutions should have clearly specified and publicly disclosed plans in place that describe how ownership interests by affiliates will be treated by all regulators so that there is no opportunity for disagreement among the regulatory authorities of the various countries in which affiliates are located. The bankruptcy codes and regulatory rules of the various countries should explicitly recognize and respect those arrangements.

In summary, in the interest of monetary policy independence, effective regulation and supervision of financial institutions, accountability of both monetary policy and regulatory policy, transparency, the alignment of incentives toward risk, and the avoidance of inefficient risk management, the following reforms would be desirable:

1. The Fed should be removed from the day-to-day activities of supervision and regulation, including the defining of financial activities, the approval of mergers, and the supervision and regulation of member banks and bank holding companies.

2. The Fed should take the lead in establishing a publicly disclosed framework for collecting information relevant to measuring systemic risk and implementing a new regime of macro prudential regulation. In the interest of accountability, the Fed is the appropriate entity to take the lead in macro prudential regulation because it is already charged with responsibility for managing cyclical policy.

3. The Fed as macro prudential regulator should develop a formal modeling framework for measuring the extent of systemic financial risk, which it would have to defend publicly. That model would describe how systemic risk is measured, and how moments of high systemic risk are identified. The macro prudential framework would delineate how minimum capital requirements, provisioning requirements, and reserve requirements would respond to significant perceived increases in systemic risk.

4. Monetary policy (including the setting of the fed funds rate or any quantitative growth objectives relating to Fed actions) should be rules-based; the Fed should formally adopt as a benchmark some specific announced inflation target and a Taylor Rule associated with that target that would permit the public to hold the Fed accountable for monetary policy. The Fed would still be free to deviate from its announced targeting policy, but it would be forced to explain such deviations, and consequently it would be more easily held accountable for them.

5. It would be unnecessary and counterproductive for the Fed to try to use the fed funds rate as a tool to deal with systemic financial risk, as doing so would weaken the accountability of both monetary policy and macro prudential policy.

6. There is a legitimate argument for imposing higher prudential regulatory standards on large, complex financial institutions, but those standards should be transparent and should reflect the fact that complexity is a continuum, not an either/or phenomenon.

7. It makes sense to reform the rules governing the resolution of large failed financial institutions to make it easier for large institutions to fail and thus prevent abuse associated with too-big-to-fail bailouts and the moral-hazard problems they engender.

8. It is inappropriate to create new discretionary resolution authority over nonbank financial institutions that would be placed in the hands of the Fed or any other regulatory agency. Doing so would encourage rather than avoid too-big-to-fail bailouts.

9. The proper approach to reforming resolution policy for large bank and nonbank financial institutions has two parts: (1) reform of the U.S. bankruptcy code to make it more effective in managing nonbank financial institutions' failures and more credible in imposing losses on stockholders and long-term debtholders of failed financial institutions, and (2) the establishment of legally binding agreements among regulators – starting with an agreement between the U.S. and the U.K. – that would

clarify cross-border claims on failed institutions' assets by subsidiaries located in different countries.

10. The desirability of these reform proposals is mutually dependent. For example, the requirement that the Fed clearly specify and publicly disclosed its model of systemic risk is a crucial precondition for vesting authority over macro prudential regulation in the Fed; otherwise, adding macro prudential regulation to the Fed's mandate would likely worsen the politicization of the Fed and lead to inadequate execution of macro prudential regulation.

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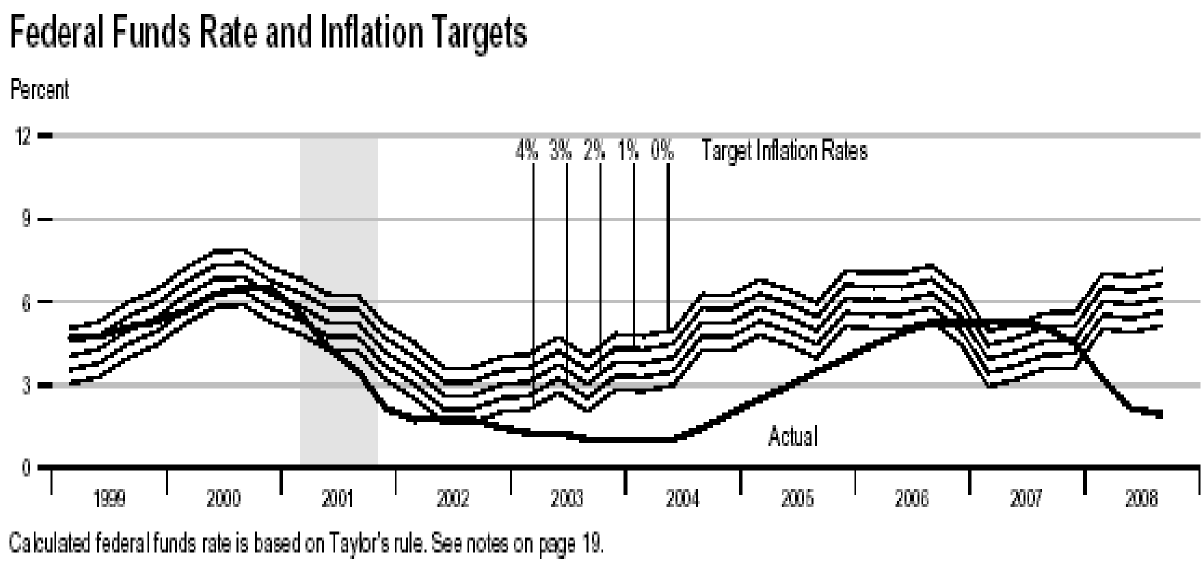
Figure 1



Source: Federal Reserve Bank of St. Louis.