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## ***Real Regulatory Reform***

Jeffrey M. Lacker
President, Federal Reserve Bank of Richmond

Thank you for the opportunity to speak with you this morning. This could not be a more propitious time to bring together senior policy makers and financial industry leaders. As we speak, ambitious changes to the U.S. regulatory and supervisory regime are under consideration in the halls of Congress. My subject this morning will be the reform of the U.S. financial regulatory system, and while much has been written on this vast subject, there is a risk that these laudable efforts get bogged down in less important issues, and we might miss the opportunity for real regulatory reform. So I will devote my remarks this morning to describing what I see as the essential, core issues on the regulatory reform agenda. Before I begin, I should note that I speak only for myself and not for my colleagues on the Federal Open Market Committee.

Given the historic financial market instability of the last two years, the search for improvements and reforms in financial markets and regulation is not surprising. But if the purpose of reform is to achieve greater financial stability, it is essential to inquire first about the nature of the financial instability problem the reforms are aimed at solving. And here it is not enough to simply observe that a crisis has occurred. The considerable downturn in housing market fundamentals alone would have led one to expect substantial movements in financial prices and quantities, with attendant strains for many institutions, even in a very well-functioning financial system.

Many participants in the financial reform debate, however, do not believe that the financial system functioned well in this crisis. Excessive instability, they contend, is caused by inherent deficiencies in financial markets, and governments must stand ready to intervene to remedy those deficiencies, both in the crisis by preventing failures and beforehand by limiting risk taking. What are these deficiencies? Some see externalities at work that lead financial market participants to neglect the spillover effects of one institution's failure on others; one firm's trouble weakens confidence in other similar firms, and encourages the spread of "runs" in which counterparties flee simply because they expect others to flee as well. These externalities are made all the more severe, it is said, by the complex web of interconnections among financial firms.

While such theories have popular appeal, on closer examination they provide a rickety foundation on which to rebuild a regulatory edifice. First, the notion of financial market spillovers stemming from interconnectedness doesn't really fit the standard economists' definition of policy-relevant externalities. Creditors voluntarily chose their counterparties, and they have no inherent reason to neglect the implied exposure to their counterparties' counterparties. Financial asset owners voluntarily agree to a range of potential returns, and they have no inherent reason to neglect any particular possibilities. In short, interconnectedness alone is no market failure.

True, reports that one firm is failing can cause creditors to pull away from other firms. But that intelligence can be genuinely informative about other counterparties' fundamentals, and official intervention will not suppress the news that the institution's condition has turned fatal; that will happen regardless. Moreover, a company's vulnerability to run-like behavior is the result of how they and their creditors have chosen to structure their financial relationships. Firms that engage in maturity transformation – funding holdings of longer term assets with short-term or demandable liabilities – have voluntarily selected a business strategy that leaves them vulnerable to adverse news and financial distress in exchange for the lower cost of short term, highly liquid funding.[1]

These observations should suggest deep skepticism of theories of inherently excessive instability in financial arrangements. More broadly, the usefulness of such theories as a guide to policy action requires a measure of policymaker omniscience regarding economic fundamentals that seems farfetched. Officials, in real time, must be able to confidently detect divergences between observed asset prices and fundamental values, and know when a firm's solvency makes a run unwarranted. Moreover, they must do so in circumstances in which many of their market information sources have a vested interest in official assessments. Out-guessing the outcome of market mechanisms designed to aggregate diverse perspectives is a daunting goal in tranquil times, and may be unattainable in the turbulence of a volatile market.

I do believe there is a spillover channel that *does* add to financial market instability and that regulatory reform can and should address. The federal financial safety net – including both explicit and implicit guarantees – is intended to bolster stability by blunting the incentive of depositors or other short-term creditors to run from otherwise sound institutions. But creditors who are uncertain about whether they will be protected will be hypersensitive to whether a similar institution receives government support. Intervening to prevent losses at one distressed institution will increase the perceived odds of future intervention in like cases, whereas letting that institution file for bankruptcy will diminish those perceived odds. A sudden investor retreat sparked by a collapse in expectations of intervention would just add to financial market volatility in an already volatile situation, which is why the sense of urgency about protecting creditors and counterparties becomes overwhelming during a crisis. Policymakers understandably feel compelled to act in ways they find repugnant, despite how it might exacerbate moral hazard.

The resolution of ambiguity about implicit safety net guarantees is thus biased toward intervention, which tends to expand the scope of implied guarantees over time. Each crisis that elicits additional support raises expectations of future support, weakening market discipline and making business strategies built on maturity transformation more attractive relative to protecting against runs. This dynamic is not lost on regulators, of course, who invariably toughen regimes within the scope of their authority to prevent recidivism in the next cycle. This raises the cost of regulated intermediation, however, and increases the demand for liquid, deposit-like investment vehicles that avoid regulation. So in the next expansion, maturity transformation takes root again just outside the regulated zone, where there is a chance of benefiting from the safety net, but full regulatory constraints on risk-taking can be avoided. For example, the trust companies that sparked the Panic of 1907 were outside the purview of the New York Clearinghouse.[2] Money market mutual funds and the tri-party repurchase agreement (repo) market are two modern examples of such “regulatory by-pass” that provide deposit-like liquidity without the regulatory burden associated with bank intermediation. Given the scale and breadth of their customer base, participants in bank-like arrangements might reasonably have anticipated government support in the event of widespread market stresses, a conjecture that ultimately was confirmed.

Aggravating this dynamic is the fact that the incentive distortions will be concentrated in those states of the world in which financial system strains are widespread and the safety net is “in the money.” This encourages firms to discount more heavily exposures to macroeconomic shocks, such as a nationwide downturn in housing prices, or market-wide liquidity shocks, such as we have seen in this past crisis. Firms facing such incentives would overvalue, for example, the senior tranches of mortgage-backed-securities, relative to fundamentals.

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What sort of financial regulatory reform does this diagnosis imply? The events of the last several years certainly have revealed opportunities to improve the regulatory and supervisory regime for large, complex bank holding companies, and as one should expect the Federal Reserve and the other banking agencies are acting aggressively on lessons learned. Tougher capital and liquidity requirements for financial institutions are in order, to more tightly restrain leverage and maturity transformation; the Fed is leading domestic and international efforts to do so. Improvements are needed in understanding and monitoring off-balance sheet exposures of large financial firms and the ways in which they can boomerang back on to their balance sheets; again, the Fed is leading efforts to do so. And the ways in which we account for macroeconomic risk factors in assessing the risks facing individual institutions can be improved; here, the Fed is drawing on its unique multidisciplinary expertise to build new supervisory capabilities. These capabilities were essential to the so-called bank “stress-tests” last year, which assessed future capital needs under adverse but plausible macroeconomic scenarios and dramatically reduced market uncertainty about potential balance sheet risks at those institutions.

But regulatory improvements alone, as essential as they are, won’t be enough. This cycle of crisis, rescue and by-pass is destined to recur, and with ever more force, unless we alter what market participants believe will happen when a financial firm becomes distressed. Recognizing that market discipline requires that creditors expect to bear losses on insolvent counterparties, many financial reform proposals create a new failure resolution process that gives policymakers additional “tools,” besides the existing bankruptcy code, for handling failing firms.

Reformers are right to focus on the dismal options facing policymakers on those climactic Sunday nights when a large firm’s fate hangs in the balance. But I believe it would be wrong to establish a government fund, as many proposals do, that could be used at regulators’ discretion to soften the blow to a failing firm’s creditors. This discretion would work against the goals of resolution reform, particularly the goal of ensuring predictable losses. Expanding policymakers’ toolkit will do nothing to reduce the frequency of financial crises if it does nothing to reduce policymakers’ aversion to the destabilizing effect of undermining expectations of government support for the creditors of other similarly-situated firms.

Real regulatory reform requires eliminating the inherent ambiguity of the implicit component of the financial safety net. But exactly where do we draw a new bright line around the safety net, now that the old line – government-insured depository institutions – has been demolished? Neither economists, lawyers, nor anyone else have been able to define observationally the notion of "systemic importance," which is understandable if their systemic significance stems mainly from ambiguity of the implicit safety net. One is forced instead to fall back on charter type, and here an appealing choice of scope is the set of institutions affiliated with insured depository institutions.

The credibility of definite boundaries for the safety net will require clear commitment. Those inside should have clear expectations about the nature of backstop government liquidity support and a commensurate regulatory regime. Those outside should presume they will receive no support. The credibility of that commitment will require disappointing expectations of creditor-protecting intervention, perhaps in painful ways. But without a willingness to resolve safety net ambiguity in favor of unassisted failure, we will have continual difficult preventing risky maturity-transformation strategies that by-pass the explicit safety net.

The credibility of a clear and well-defined financial safety net could be enhanced by limiting discretion in the deployment of public funds in a resolution process. And this includes the Fed. I and several others have suggested limiting the Fed's ability to engage in extraordinary credit measures.[3] Such limits might include abolishing the so-called 13(3) provisions that allow the Fed to lend to entities outside of banking institutions with regular access to the discount window. Beyond the Fed, the bankruptcy process could perhaps be enhanced in ways that speed up the resolution process for large financial firms, but retain clear legal rules about the distribution of losses and oversight by a bankruptcy court. Many have argued that such enhancements might make resolving financial failures without public funds more attractive to policymakers.

Compared to the real reform of clarifying the scope of the financial safety net, optimizing the number or organization of regulators strikes me as a second- or third-order problem at best. And proposals to materially alter the Federal Reserve's supervisory responsibilities strike me as misguided. First, under every reform proposal I am aware of, the Federal Reserve Banks retain the authority to provide liquidity assistance to banks via their discount windows. This "lender of last resort" function requires making discriminating judgments about the viability of illiquid institutions on very short notice at the end of the day. In my experience, the capacity to make such judgments relies heavily on the expertise derived from ongoing supervisory activities, which give Reserve Bank staff a wealth of knowledge about both local banking markets and the likelihood of a bank failing given its current financial condition. And this is true for both the large institutions that garner all the headlines, and the hundreds of community banks that are still an essential segment of our banking system. As long as the Federal Reserve is responsible for discount window lending, it makes no sense to diminish the Fed's robust role in the supervision of a range of banking institutions, from large to small.[4]

More broadly, I spoke earlier about why moral hazard is likely to be particularly acute regarding macroeconomic risks. Such risks could affect a broad range of institutions, and thus there will be some economies of scale in supervisory assessments of those risks. More to the point, however, macroeconomic analytics is a core competency that is essential to the conduct of monetary policy and that no other federal banking agency can match. Indeed, the Fed's macroeconomic expertise was vital to the "stress-tests" that did so much to improve market confidence last spring, and that are likely to feature prominently in future capital assessment regimes. Severing the organizational link to those competencies is not a wise way to structure bank regulation.

In contrast to the attention devoted to rearranging bank regulatory agencies, it is striking that most reform proposals ignore the two failed government-sponsored enterprises that are now in U.S. Treasury conservatorship. For the better part of two decades, the GSEs that securitize and guarantee the bulk of U.S. mortgage debt grew their businesses under an ambiguous regime that led most market participants to view them as implicitly guaranteed. Housing finance cannot achieve a sustainable configuration without a final determination of the status of these companies and of whether and how we deliver government subsidies to mortgage finance. I have said elsewhere that it would be a mistake to try to build this expansion on another housing boom and that over time we should wean our economy off dependence on housing subsidies. Too many houses were built over the last decade, and what we've been through the last three years should teach us that subsidizing household mortgage debt was a dangerous policy that was carried too far. But whatever society decides about the bias toward housing, real regulatory reform would be incomplete without addressing the fate of the government-sponsored housing finance enterprises.

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To summarize, a healthy, well-functioning financial system requires a restoration of market discipline, and that will be impossible without clear boundaries on the federal financial safety net. True, regulation and supervision needs strengthening, and that process is well underway at the Federal Reserve and elsewhere. But merely expanding the scope of regulation to chase those firms that extract implicit guarantees by engaging in maturity transformation would be an interminable journey with yet more financial instability in its wake. Arresting the continual expansion of the implicit safety net will in turn require changing what people believe about the likelihood of government support in the event of a future crisis. Having experienced two years of dramatic safety net expansion, reconditioning beliefs will be a difficult process. It will require writing clear rules that constrain the use of public funds. But it also will require that the rules be confirmed by future behavior, and this will be the greatest challenge to achieving real financial reform.

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[1] Jeffrey M. Lacker (2008), "Financial Stability and Central Banks," a speech delivered to the European Economics and Financial Centre, London, England, June 5.
[2] Robert F. Brunner and Sean D. Carr (2007), The Panic of 1907: Lessons Learned from the Market's Perfect Storm, Hoboken, N.J.: John Wiley & Sons.
[3] Jeffrey M. Lacker (2009), "Government Lending and Monetary Policy," a speech delivered to the National Association of Business Economists, Alexandria, Va., March 2. Charles Plosser (2010), "The Federal Reserve System: Balancing Independence and Accountability," a speech delivered to the World Affairs Council of Philadelphia, Philadelphia, Pa., Feb. 17.
[4] Narayana Kocherlakota (2010), "The Economy and Why the Federal Reserve Needs to Supervise Banks," a speech delivered to the Minnesota Bankers Association, St. Paul, Minn., Feb. 16.