Regulatory Restructuring: Balancing the Independence of the Federal Reserve Regarding Monetary Policy with Systemic Risk Regulation
Testimony of Richard Berner, Morgan Stanley, Inc.
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Chairman Watt, Ranking Member Paul, members of the Subcommittee, and members of the Financial Services Committee, my name is Richard Berner. I am Co-Head of Global Economics at Morgan Stanley in New York. Thank you for inviting me to this hearing to address the appropriate role for the Federal Reserve in systemic risk regulation.

The current financial crisis has exposed significant weaknesses in our financial system and in the regulatory structure responsible for its oversight. To assure that we have a strong and stable financial system, there is broad agreement on two needed policy changes. First, we need to strengthen our financial regulatory infrastructure. Second, regulators and supervisors must adopt appropriate regulation and oversight of the system-wide risks across financial instruments, markets and institutions. Such a "macroprudential," systemic focus would monitor and mitigate the common exposures and behavior that threaten financial stability. In addition, I believe that macroeconomic policies, especially monetary policy, should lean against asset and credit booms.

In my view, the Federal Reserve is best equipped to take the lead on systemic risk regulation and oversight. While some may see conflict between this role and the more traditional responsibilities of a central bank, I think such supervision is an essential and natural extension of the Fed's role in the conduct of monetary policy and of its responsibilities as lender of last resort.

Three factors support that claim. First, the Fed is the ultimate guardian of the safety, soundness and integrity of our financial markets, and thus should be the agency primarily responsible for ensuring the safety and soundness of the most important financial institutions within those markets. Second, the conduct of monetary policy in today's complex financial markets requires understanding of the process of intermediation, both through traditional lenders and through the capital markets. Giving the Fed clear supervisory oversight of the institutions involved in that process enhances its ability to make the right monetary policy choices. Finally, the Fed's expertise and understanding of financial markets and institutions makes it the natural choice for this role. The Fed's leadership in the Supervisory Capital Assessment Program (SCAP) demonstrated that expertise.

While it is more controversial, all central banks are rethinking the role of asset prices in conducting monetary policy. Asset booms and busts have destabilized the economy and financial system at great cost, but the Fed's narrow set of traditional monetary policy tools may not be adequate to dampen such booms. What's needed is an expanded set of tools. As I will discuss in a moment, these are the very same tools that are appropriate for systemic risk regulation. Thus, there is substantial overlap between the goals of monetary policy and those of macroprudential regulation and oversight, as well as in the tools needed to achieve them.

It's appealing to argue that separate policy goals require separate agencies and separate policy instruments, at least in the abstract. But as a practical matter, the experience of other countries that separate such responsibilities from the traditional role of the central bank has been no better than our own. For example, the Bank of England has been more narrowly focused on monetary policy, while the Financial Services Authority has had responsibility for all financial regulation and oversight. While the Bank and the FSA clearly have collaborated in the recent crisis, arguably their separation of powers did not enable them to manage the systemic risks arising in the current crisis more successfully than US regulators.

In what follows, I outline some of the shortcomings of the US regulatory system, and remedies needed. I'll conclude by answering the four questions you posed.

**Our regulatory system has three major shortcomings.**

1. *Regulatory structure based on institutional boundaries.* Our antiquated regulatory infrastructure supervises institutions rather than financial activities, which allowed some firms to take on risky activities with inadequate or no oversight. The interconnectedness of global markets and institutions creates vulnerabilities across the banking system, capital markets, and the payments and settlement systems that our current regulatory system is not equipped to recognize or manage.

There is broad agreement that a focus on systemic risk is one remedy. Designating the Fed as the lead systemic regulator will limit the extent to which risky activities and important market information slips through the cracks, and it will promote supervisory accountability to the Congress and the taxpayer.

2. *Regulatory safety net excessively prone to moral hazard, encouraging inappropriate risk-taking.* There is no escaping some moral hazard in any regulatory safety net. In our case, however, concentration in the financial services industry has created complex, systemically important institutions that are "too big to fail," with no appropriate way to shut them down when they run into trouble.

Remedies needed to reduce this weakness include:

More extensive oversight and supervision of large, complex financial institutions.

An explicit regulatory charge on institutions that are deemed too big to fail. If imposed through capital requirements, it is called a *systemic capital charge*. This would help to offset the moral hazard created by an implicit guarantee, which encourages excessive risk taking and discriminates against smaller institutions.

Legislation that provides a resolution process for bank holding companies and non-bank financial institutions. As long as we have institutions that are too big to fail, we need a strong resolution framework that is understood by all before a crisis hits. As the current crisis has demonstrated, an *ad hoc* approach creates uncertainty and reduces the credibility of policy.

3. *Procyclicality.* Our regulatory infrastructure promotes procyclical swings in institutional and investor behavior that magnify financial market volatility rather than dampening it. Our system of capital requirements, collateral and haircuts is tied to credit ratings, and compensation is tied to short-term performance, all reinforcing procyclical behavior. Regulatory capital measures lag well behind market-based measures of capital and risk. Lenders are constrained partly by accounting rules from building up reserves in good times as a cushion against losses, encouraging excessive leverage in good times and excessive deleveraging in periods of stress. Regulators have not insisted that banks cut dividends to conserve capital or to rebuild it amid a crisis. The procyclical nature of collateral requirements and haircuts curtails the risk-dispersion powers of financial innovation when liquidity dries up in the face of financial shocks, and makes the financial system less stable, not more so. And regulators have been too willing to allow the use of new instruments untested for stress that can increase procyclicality.

Three remedies are needed here:

First, we need a stronger system of capital regulation that builds reserves and limits leverage in good times. Such a regime should improve financial stability and help monetary policy lean against the wind of asset booms. For example, regulators widely agree that banks should hold more capital. But the composition of that capital is also important to mitigate systemic risk. One proposal ties capital to incentives for management by mandating capital increases in the form of debt convertible to equity. Such contingent capital might provide an equity cushion in periods of stress, and it might reduce the temptation for managers to boost returns through excessive leverage.

Second, securities must be more transparent and homogeneous, and thus less complex. Opacity, heterogeneity and complexity in time of stress have resulted in reduced liquidity, higher volatility and demands for collateral, and forced deleveraging. These factors also promoted excessive reliance on credit ratings, which in turn increased acceptance of opaque, complex securities. Perhaps new securities should be stress tested using prescribed methods before they are adopted.

Third, to reduce settlement and payments-system risk, we need greater use of central counterparties (CCPs) or exchanges for over-the-counter derivatives. Regulators have made great strides here, especially for credit default swaps, but more is needed.

**Four Questions**

Given those regulatory shortcomings and remedies for them, your four questions appropriately focus on the benefits and risks in giving the Fed new powers. I want to conclude by answering them.

1. *Conflict with traditional role.* I agree that this new role may conflict with the Fed's traditional role as the independent central bank. In a crisis, decisions about particular firms may determine whether a stressed institution will survive. Such decisions would involve the Fed in inherently political considerations and the use of taxpayer funds that could compromise its independence.

2. *The Fed's independence.* I believe that it is necessary to insulate the Fed's independence from that part of the systemic risk regulatory role. Two firewalls are needed:

First, while the Fed should be supervisor, the resolution of troubled financial institutions — including the new authority that is needed to wind down bank holding companies and nonbanks — should fall to another agency. In my view, the appropriate agency would be the FDIC, which is properly part of the US Treasury.

Second, our regulatory architecture, not just in the US but globally, must be changed such that institutions now too big to fail will become instead too strong to fail. Remedies will include new approaches to capital regulation, credit risk and liquidity management; restructuring management incentives; stronger oversight across all business lines and geographies; and regulations that increase the cost of participation in certain activities in direct proportion to their potential to increase systemic risk.

Both firewalls should actually strengthen the Fed's role as lender of last resort by reducing moral hazard — especially by reducing the chance that such lending is required to keep afloat nonviable institutions simply because they threaten the stability of the financial system.

3. *Public policy pros and cons.* The public policy considerations for making the Fed the systemic risk regulator outweigh the negatives when you examine our regulatory challenges and who is best equipped to provide the remedies.

As noted above, the crisis made it clear that a micro-regulatory focus on one set of institutions or markets misses important systemic spillovers and vulnerabilities from one part of the financial system to others. In the current crisis, our fragmented regulatory system made coordination among regulators difficult, allowed important information to fall between the cracks, and diluted accountability for supervisory failures. The interconnectedness of markets and institutions means that supervision must look horizontally across instruments, markets, institutions, and regions, rather than in vertical silos. In my view, only the Fed has the expertise and reach, in concert with other central banks, to provide that systemic monitoring, oversight and risk mitigation.

In my view, the Fed's oversight of the process of intermediation and capital markets puts it in the ideal position to prescribe and enforce remedies to the procyclicality in our financial and regulatory system. The Fed is also best equipped to build financial shock absorbers that will reduce the impact of shocks on the system as a whole.

I hasten to state the obvious: The Fed is not perfect. As the guardian of our financial system, the Fed in the past has come up short in ways that others have documented better than I can. I would only say that while we consider making the Fed the lead systemic risk regulator, it's worth examining whether and how the Fed can improve its functioning to better meet these new duties.

Turning to the public policy arguments against giving the Fed such responsibilities, I find one most compelling. The responsibility to regulate systemic risk is not a narrow, technical exercise. Whoever has it will find the task complex, daunting, global in scope and fraught with political conflicts. It will require enormous experience and judgment and support from both the Congress and other regulators. Those considerations suggest that systemic risk regulation may be too big a job for just one regulator. Indeed, assuming that regulatory reform leaves our regulatory institutions largely intact, even if the Fed takes the lead, coordination with other regulators will be essential for success. In that regard, the President's plans for a Financial Services Oversight Council are laudable.

When it comes to overseeing and monitoring systemic risk, coordination with other regulators and central banks abroad may be even more critical than being in sync with regulators at home. Our financial markets are clearly global in scope, and many of our financial institutions, especially those at the core of the financial system, have long had global business models. Yet our regulatory structure, our regulations and our capacity to resolve troubled institutions are largely local. In that context, the President's recommendations for international cooperation and coordination are especially commendable.

4. *Reassigning some Fed responsibilities to other agencies.* Whether the Fed should relinquish any roles in order to accept these new responsibilities in my view depends on the principle of assigning appropriate roles to regulators to do what they do best, as well as on the resources that are available. For example, giving another agency the oversight of regulations aimed at protecting consumers and promoting financial literacy might well be appropriate to allow the Fed to focus on systemic risk issues, although the Fed might still play a useful supporting role in these areas.

Mr. Chairman, thank you for your attention. I will be happy to answer your questions.