STATEMENT OF
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THE ROLE OF THE FEDERAL RESERVE

BEFORE THE
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U.S. HOUSE OF REPRESENTATIVES
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Chairman Watt and Ranking Member Paul and members of the Subcommittee. I am sorry I cannot be with you in person today but I am grateful for the opportunity to present my views on this important topic.

The set of institutions that today provide the architecture for our financial system – the Federal Reserve System, The SEC, the FDIC– all emerged over time in response to events, most often to crises. Those that survive today exist because they turned out to be useful. They contributed to the stability and growth of our financial markets for many decades during which our system was the envy of the world and did much to foster the growth of the U.S. economy. They are survivors. There are many other institutions that did not meet that test, either because they were ill conceived from the beginning or because financial innovation rendered them obsolete.

There is a great desire to reform the institutions that regulate our financial system and there is some urgency to do so because of the huge costs to society caused by their manifest failure in the current financial crisis. Our current system is a patchwork that has evolved from a series of past disruptions to our financial system. The proposals that have been put forth by the Administration and that are now under discussion in Congress contain many valuable and important ingredients and address many of the central problems. One central feature of these proposals, however, is to assign the task of regulating systemic risk to the Federal Reserve. This is not visionary policy making. More importantly it is not the best approach to addressing the problem of systemic regulation.

I suggest that it is not the best path for four reasons: 1. Systemic risk is a form of "market failure" resulting from the size and/or interconnectedness of financial institutions that would be best addressed by means of a new regulatory construct. 2. It changes and broadens the mandate of the Federal Reserve in ways that make it more connected to the Treasury and that threaten its long-standing and fiercely defended independence. 3. It risks diverting the focus of the Federal Reserve from its primary task of conducting monetary policy and insuring the integrity of the payments system. 4. There is an alternative solution to assigning systemic risk control to the Fed that makes more sense and makes better use of the regulatory resources that exist in our financial architecture.

Historical Precedent

The most successful financial institutions to arise out of the financial crisis of the 1930's succeeded because they addressed specific market failures. The most successful policy response to the banking crisis of the 1930s was the creation of the Federal Deposit Insurance Corp., which can be traced to an amendment to the Banking Act of 1933. President Franklin D. Roosevelt opposed the creation of the FDIC, as did many leading bankers in the major US money centers of the time.

Nevertheless, this one institution was responsible for calming the fears of depositors and ending bank runs. Its creation was followed by many decades of relative stability in the financial system. The FDIC has been a successful institution because it solved a well-defined problem--uncertainty about the liquidity and solvency of American banks. More importantly, it did so in a way that acknowledged the contradictions and risks inherent in fractional reserve banking by making those responsible for incurring the risks pay for insuring against them.

Similarly, the Securities and Exchange Commission, created under the Securities Exchange Act of 1934, was successful because it addressed a market failure – the lack of standardized reliable information about firms whose securities were offered for sale to the public. It doubtless contributed to decades of sustained growth in our capital markets.

Regulatory institutions tend to be successful when they address specific market failures in a way that does not stifle the markets and discourage innovation but rather makes them more robust. The Fed itself was founded in response to the panic of 1907 when the need for a lender of last resort for solvent but illiquid institutions and responsive monetary policy become an obvious compelling public policy issue.

This is the reason not to rush into delegating further regulatory responsibilities to the Fed, the FDIC, the SEC and others. Maybe we need to think first about whether these are the institutions we need. And perhaps think again about what regulating systemic risk actually means.

Systemic Risk

Systemic risk is like pollution. It originates because of one activity but affects many. There is no market discipline that works to control it. Financial firms that accumulate risk are similar. They add risk to the system and endanger the entire market. The failure of a firm that is an important counterparty to others has the potential to severely disrupt many other financial institutions, their customers and other markets. Market discipline fails to work to constrain them if creditors and counterparties believe they will not be allowed to fail. The free insurance implied by that notion creates incentives for firms to become excessively large and complex. True, financial collapse will severely punish shareholders, but not various classes of debt-holders likely to get bailed-out, thereby giving such firms an unmatched cost of capital advantage and distorting the financial intermediation process. When combined with corporate governance failures, this can create incentives that in turn lead to severe systemic risk.

The first step is to define and quantify the systemic risk involved. We need measurement first. Note that banks and bank holding companies are not the only candidates for study. Insurance companies and hedge funds can also create systemic risk, as history has shown. The second task is to put a price on the risk that these firms create. This is not a trivial problem, but there are a number of thoughtful proposals circulating about how to do this.

The last step is to make the "polluters" – the institutions that create systemic risk - pay in order to reduce the system's exposure to such risk. In effect an un-priced risk in the financial system should in the future be appropriately priced, and this by itself will create incentives for markets and institutions to respond appropriately without expensive, granular intervention by government in the functioning of financial institutions.

This is what we should mean by systemic risk regulation. The systemic risk that firms create should be priced into a fee for access to the Federal Reserve's lending facilities. It should be priced into the fee the FDIC charges for deposit insurance or any other kind of insurance the firms benefit from. It should be reflected in the capital and liquidity firms are required to hold. And it should be public information. Only then will market discipline begin to discourage the creation of systemic risk. We have the opportunity to improve both the Fed's lender of last resort provisions and our deposit insurance system if we do the regulatory reform right.

A process to allow the orderly failure or restructuring of systemically important but insolvent firms should accompany systemic risk regulation. The Administration's proposals anticipate the need for these elements but have responsibility scattered among a variety of existing institutions.

Capabilities of the Federal Reserve

There is and always will be a critical role for the Fed in insuring the integrity of the financial system. That the Fed itself should be the systemic risk regulator is much less obvious.

Many of the approaches the Federal Reserve and the Treasury have taken to date have clearly added to future systemic risk . The very fact that some of the institutions that have been bailed-out are systemic (or have been encouraged to merge into financial Goliaths by acquiring other firms) creates a bias towards greater consolidation and financial firms that are arguably too large, too interconnected, too complex, and with too much counterparty exposure.

More directly to the point, while the Federal Reserve has the ability to monitor financial markets and the condition of the firms it regulates, it has no particular expertise in the critical elements of systemic regulation outlined above – pricing and insuring systemic risk and orderly resolution and liquidation of financial institutions.

Monetary Policy and Federal Reserve Independence

History shows that we need the Fed to be independent for the conduct of monetary policy and to serve as a lender of last resort. And it is a reasonable and experienced candidate for assuring the stability and security of the payments system.

An independent central bank can focus on monetary policies for the long term - that is, policies targeting low and stable inflation and a monetary climate that promotes long term economic growth. Political cycles, alas, are considerably shorter. Without independence the political cycle will subject the central bank to pressures that in turn would impart an inflationary bias to monetary policy. On this view politicians in a democratic society are shortsighted because they are driven by the need to win their next election. There is plenty of evidence for this in countries around the world that spans decades in time – and indeed the US has traditionally advocated central bank independence in other countries as part of economic policy reforms designed to promote sustainable growth. In short, a politically insulated central bank is more likely to be concerned with long-run objectives.

The dramatic expansion of the balance sheet of the Fed in the last two years, together with its close involvement in the bailout of financial institutions like AIG and Merrill Lynch, have put this respected institution firmly in the spotlight. It is a problem precisely because, when Fed programs target particular asset classes, or industries or firms (which they do), the Fed has put itself in the business of allocating credit. Its actions can also distort prices for these assets. This they should not do as a matter of principle. Buying Treasury securities is completely neutral with respect to the allocation of credit. Buying securities backed by, say auto loans, is not.

The presence of these assets on the balance sheet in such quantities creates yet another problem for the Fed, one that exposes it to intervention. First, these huge un-borrowed reserves make some observers nervous about future inflation, even though there is no evidence of it right now. Somehow, this overhang will have to be dealt with going forward. But if the Fed has to reduce the assets on its balance sheet to forestall an inflation threat, that could be very disruptive to credit markets. Complicated positions could be hard to unwind. If these assets were already liquid, the Fed wouldn't have had to buy them in the first place. This means it may be difficult to get the cash out of the economy before it is too late.

A Different Solution

The institution with the most experience at facilitating the orderly failure/restructuring of financial institutions today remains the FDIC. It also has –

at least in principle – experience with insuring financial firms. But, the FDIC in its present form is not the right institution to regulate systemic risk. It is too vulnerable to capture by the banks and to political pressure.

Banks have lobbied hard to limit FDIC's ability to behave like a true insurance fund. They have won limits on the size of insurance fund – set currently at between 1.15 and 1.5% of insured deposits. It wasn't until passage of the Federal Deposit Insurance Reform Act in 2005 that insurance rates could be tied to risk assessments of the institutions. During the crisis the FDIC may also have added to systemic risk through the Temporary Liquidity Guarantee Program. It guaranteed newly issued senior unsecured debt of banks for a fee of 75 basis points, the same rate for all banks regardless of their risk profile. This remarkable intervention was justified by invoking the FDIC's statutory authority to prevent systemic risk.

Perhaps what we need is an institution like the FDIC, one that incorporates and expands its role but is more independent. Its purview could extend to other systemic institutions (hedge funds, insurance companies). The systemic risk that firms create should be priced into the fee for deposit insurance and into a fee for access to the Federal Reserve's lending facilities.

Whatever direction regulatory reform takes it is really important to think about institutional designs that are less subject to capture by politics or by the financial institutions themselves.

Biographical Summary

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Thomas F. Cooley is the Richard R. West Dean and the Paganelli-Bull Professor of Economics at the New York University Stern School of Business, as well as a Professor of Economics in the NYU Faculty of Arts and Science. The former President of the Society for Economic Dynamics and a Fellow of the Econometric Society, Professor Cooley is a widely published scholar in the areas of macroeconomic theory, monetary theory and policy and the financial behavior of firms, and is recognized as a national leader in both macroeconomic theory and business education. Dean Cooley is a member of the Council of Foreign Relations and numerous advisory boards. He also writes a weekly column for FORBES.com. He is an organizer of and contributor to the volume *Restoring Financial Stability: How to Repair a Failed System*, published by Wiley, March 2009.

Before joining NYU Stern, Dean Cooley was a Professor of Economics at the University of Rochester, University of Pennsylvania, and UC Santa Barbara. Prior to his academic career, Dean Cooley was a systems engineer for IBM Corporation. Dean Cooley received his BS from Rensselaer Polytechnic Institute, and his MA and PhD from the University of Pennsylvania. He also holds a doctorem honoris causa from the Stockholm School of Economics.