Reducing Systemic Risk in the Financial Sector

Testimony of

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Mr. Chairman and members of the Committee:

I am happy to be back before this Committee to give my views on reducing systemic risk in financial services. I will focus on changes in our regulatory structure that might prevent another catastrophic financial meltdown and what role the Federal Reserve should play in a new financial regulatory system.

It is hard to overstate the importance of the task facing this Committee. Market capitalism is a powerful system for enhancing human economic wellbeing and allocating savings to their most productive uses. But markets cannot be counted on to police themselves. Irrational herd behavior periodically produces rapid increases in asset values, lax lending and over-borrowing, excessive risk taking, and out-sized profits followed by crashing asset values, rapid deleveraging, risk aversion, and huge loses. Such a crash can dry up normal credit flows and undermine confidence, triggering deep recession and massive unemployment. When the financial system fails on the scale we have experienced recently the losers are not just the wealthy investors and executives of financial firms who took excessive risks. They are average people here and around the world whose jobs, livelihoods, and life savings are destroyed and whose futures are ruined by the effect of financial collapse on the world economy. We owe it to them to ferret out the flaws in the financial system and the failures of regulatory response that allowed this unnecessary crisis to happen and to mend the system so to reduce the chances that financial meltdowns imperil the world's economic wellbeing.

Approaches to Reducing Systemic Risk

The crisis was a financial "perfect storm" with multiple causes. Different explanations of why the system failed—each with some validity--point to at least three different approaches to reducing systemic risk in the future.

- **The highly interconnected system failed because no one was in charge of spotting the risks that could bring it down.**
  This explanation suggests creating a Macro System Stabilizer with broad responsibility for the whole financial system charged with spotting perverse incentives, regulatory gaps and market pressures that might destabilize the system and taking steps to fix them. The Obama Administration would create a Financial Services Oversight Council (an interagency group with its own staff) to perform this function. I think this responsibility should be lodged at the Fed and supported by a Council.
- **The system failed because expansive monetary policy and excessive leverage fueled a housing price bubble and an explosion of risky investments in asset backed securities.**
  While low interest rates contributed to the bubble, monetary policy has multiple objectives. It is often impossible to stabilize the economy and fight asset price bubbles with a single instrument. Hence, this explanation suggests stricter regulation of leverage throughout the financial system. Since monetary policy is an ineffective tool for controlling asset price bubbles, it should be supplemented by the power to change leverage ratios when there is evidence of an asset price bubble whose bursting that could destabilize the financial sector. Giving the Fed control of leverage would enhance the effectiveness of monetary policy. The tool should be exercised in consultation with a Financial Services Oversight Council.
- **The system crashed because large inter-connected financial firms failed as a result of taking excessive risks, and their failure affected other firms and markets.**
  This explanation might lead to policies to restrain the growth of large interconnected financial firms—or even break them up—and to expedited

resolution authority for large financial firms (including non-banks) to lessen the impact of their failure on the rest of the system. Some have argued for the creation of a single consolidated regulator with responsibility for all systemically important financial institutions. The Obama Administration proposes making the Fed the consolidated regulator of all Tier One Financial Institutions. I believe it would be a mistake to identify specific institutions as too big to fail and an even greater mistake to give this responsibility to the Fed. Making the Fed the consolidated prudential regulator of big interconnected institutions would weaken its focus on monetary policy and the overall stability of the financial system and could threaten its independence.

The Case for a Macro System Stabilizer

One reason that regulators failed to head off the recent crisis is that no one was explicitly charged with spotting the regulatory gaps and perverse incentives that had crept into our rapidly changing financial structure in recent decades. In recent years, anti-regulatory ideology kept the United States from modernizing the rules of the capitalist game in a period of intense financial innovation and perverse incentives to creep in.

<u>Perverse incentives.</u> Lax lending standards created the bad mortgages that were securitized into the toxic assets now weighting down the books of financial institutions. Lax lending standards by mortgage originators should have been spotted as a threat to stability by a Macro System Stabilizer—the Fed should have played this role and failed to do so—and corrected by tightening the rules (minimum down payments, documentation, proof that the borrow understands the terms of the loan and other no-brainers). Even more important, a Macro System Stabilizer should have focused on why the lenders had such irresistible incentives to push mortgages on people unlikely to repay. Perverse incentives were inherent in the originate-to-distribute model which left the originator with no incentive to examine the credit worthiness of the borrower. The problem was magnified as mortgage-backed securities were re-securitized into more complex

instruments and sold again and again. The Administration proposes fixing that system design flaw by requiring loan originators and securitizers to retain five percent of the risk of default. This seems to me too low, especially in a market boom, but it is the right idea.

The Macro System Stabilizer should also seek other reasons why securitization of asset-backed loans—long thought to be a benign way to spread the risk of individual loans—became a monster that brought the world financial system to its knees. Was it partly because the immediate fees earned by creating and selling more and more complex collateralized debt instruments were so tempting that this market would have exploded even if the originators retained a significant portion of the risk? If so, we need to change the reward structure for this activity so that fees are paid over a long enough period to reflect actual experience with the securities being created.

Other examples, of perverse incentives that contributed to the violence of the recent perfect financial storm include Structured Investment Vehicles (SIV's) that hid risks off balance sheets and had to be either jettisoned or brought back on balance sheet at great cost; incentives of rating agencies to produce excessively high ratings; and compensation structures of corporate executives that incented focus on short-term earnings at the expense the longer run profitability of the company.

The case for creating a new role of Macro System Stabilizer is that gaps in regulation and perverse incentives cannot be permanently corrected. Whatever new rules are adopted will become obsolete as financial innovation progresses and market participants find ways around the rules in the pursuit of profit. The Macro System Stabilizer should be constantly searching for gaps, weak links and perverse incentives serious enough to threaten the system. It should make its views public and work with other regulators and Congress to mitigate the problem.

The Treasury makes the case for a regulator with a broad mandate to collect information from all financial institutions and "identify emerging risks." It proposes putting that responsibility in a Financial Services Oversight Council, chaired by the Treasury, with its own permanent expert staff. The Council seems to me likely to be cumbersome. Interagency councils are usually rife with turf battles and rarely get much done. I think the Fed should have the clear responsibility for spotting emerging risks and trying to head them off before it has to pump trillions into the system to avert disaster. The Fed should make a periodic report to the Congress on the stability of the financial system and possible threats to it. The Fed should consult regularly with the Treasury and other regulators (perhaps in a Financial Services Oversight Council), but should have the lead responsibility. Spotting emerging risks would fit naturally with the Fed's efforts to monitor the state of the economy and the health of the financial sector in order to set and implement monetary policy. Having explicit responsibility for monitoring systemic risk—and more information on which to base judgments would enhance its effectiveness as a central bank.

<u>Controlling Leverage.</u> The biggest challenge to restructuring the incentives is: How to avoid excessive leverage that magnified the upswing and turned the downswing into a rout? The aspect of the recent financial extravaganza that made it truly lethal was the over-leveraged superstructure of complex derivatives erected on the shaky foundation of America's housing prices. By itself, the housing boom and bust would have created distress in the residential construction, real estate, and mortgage lending sectors, as well as consumer durables and other housing related markets, but would not have tanked the economy. What did us in was the credit crunch that followed the collapse of the highly leveraged financial superstructure that pumped money into the housing sector and became a bloated monster.

One approach to controlling serious asset–price bubbles fueled by leverage would be to give the Fed the responsibility for creating a bubble Threat Warning System that would trigger changes in permissible leverage ratios across financial institutions. The warnings would be public like hurricane or terrorist threat warnings. When the threat was high—as demonstrated by rapid price increases in an important class of assets, such as land, housing, equities, and other securities without an underlying economic justification--the Fed would raise the threat level from, say, Three to Four or Yellow to Orange. Investors and financial institutions would be required to put in more of their own money or sell assets to meet the requirements. As the threat moderated, the Fed would reduce the warning level.

The Fed already has the power to set margin requirements—the percentage of his own money that an investor is required to put up to buy a stock if he is borrowing the rest from his broker. Policy makers in the 1930s, seeking to avoid repetition of the stock price bubble that preceded the 1929 crash, perceived that much of the stock market bubble of the late 1920s had been financed with money borrowed on margin from broker dealers and that the Fed needed a tool distinct from monetary policy to control such borrowing in the future.

During the stock market bubble of the late 1990s, when I was Vice Chair of the Fed's Board of Governors, we talked briefly about raising the margin requirement, but realized that the whole financial system had changed dramatically since the 1920s. Stock market investors in the 1990s had many sources of funds other than borrowing on margin. While raising the margin requirements would have been primarily symbolic, I believe with hindsight that we should have done it anyway in hopes of showing that we were worried about the bubble.

The 1930's legislators were correct: monetary policy is a poor instrument for counteracting asset price bubbles; controlling leverage is likely to be more effective. The Fed has been criticized for not raising interest rates in 1998 and the first half of 1999 to discourage the accelerating tech stock bubble. But it would have had to raise rates dramatically to slow the market's upward momentum—a move that conditions in the general economy did not justify. Productivity growth was increasing, inflation was benign and responding to the Asian financial crisis argued for lowering rates, not raising them. Similarly, the Fed might have raised rates from their extremely low levels in 2003 or raised them earlier and more steeply in 2004-5 to discourage the nascent housing price bubble. But such action would have been regarded as a bizarre attempt to abort the economy's still slow recovery. At the time there was little understanding of the extent to which the highly leveraged financial superstructure was building on the collective delusion that U.S. housing prices could not fall. Even with hindsight, controlling leverage (along with stricter regulation of mortgage lending standards) would have been a more effective response to the housing bubble than raising interest rates. But regulators lacked the tools to control excessive leverage across the financial system.

In the wake of the current crisis, financial system reformers have approached the leverage control problem in pieces, which is appropriate since financial institutions play diverse roles. However the Federal Reserve—as Macro System Stabilizer—could be given the power to tie the system together so that various kinds of leverage ratios move in the same direction simultaneously as the threat changes.

With respect to large commercial banks and other systemically important financial institutions, for example, there is emerging consensus that higher capital ratios would have helped them weather the recent crisis, that capital requirements should be higher for larger, more interconnected institutions than for smaller, less interconnected ones, and that these requirements should rise as the systemic threat level (often associated with asset price bubbles) goes up.

With respect to hedge funds and other private investment funds, there is also emerging consensus that they should be more transparent and that financial derivatives should be traded on regulated exchanges or at least cleared on clearinghouses. But such funds might also be subject to leverage limitations that would move with the perceived threat level and could disappear if the threat were low.

One could also tie asset securitization into this system. The percent of risk that the originator or securitizer was required to retain could vary with the perceived threat of an asset price bubble. This percentage could be low most of the time, but rise automatically if Macro System Stabilizer deemed the threat of a major asset price bubble was high. One might even apply the system to rating agencies. In addition to requiring rating agencies to be more transparent about their methods and assumptions, they might be subjected to extra scrutiny or requirements when the bubble threat level was high.

Designing and coordinating such a leverage control system would not be an easy thing to do. It would require create thinking and care not to introduce new loopholes and perverse incentives. Nevertheless, it holds hope for avoiding the run away asset price exuberance that leads to financial disaster.

Systemically Important Institutions

The Obama Administration has proposed that there should be a consolidated prudential regulator of large interconnected financial institutions (Tier One Financial Holding Companies) and that this responsibility be given to the Federal Reserve. I think this is the wrong way to go.

It is certainly important to reduce the risk that large interconnected institutions fail as a result of engaging in highly risky behavior and that the contagion of their failure brings down others. However, there are at least three reasons for questioning the wisdom of identifying a specific list of such institutions and giving them their own consolidated regulator and set of regulations. First, as the current crisis has amply illustrated, it is very difficult to identify in advance institutions that pose systemic risk. The regulatory system that failed us was based on the premise that commercial banks and thrift institutions that take deposits and make loans should be subject to prudential regulation because their deposits are insured by the federal government and they can borrow from the Federal Reserve if they get into trouble. But in this crisis, not only did the regulators fail to prevent excessive risk-taking by depository institutions, especially thrifts, but systemic threats came from other quarters. Bear Stearns and Lehman Brothers had no insured deposits and no claim on the resources of the Federal Reserve. Yet when they made stupid decisions and were on the edge of failure the authorities realized they were just as much a threat to the system as commercial banks and thrifts. So was the insurance giant, AIG, and, in an earlier decade, the large hedge fund, LTCM. It is hard to identify a systemically important institution until it is on the point of bringing the system down and then it may be too late.

Second, if we visibly cordon off the systemically important institutions and set stricter rules for them than for other financial institutions, we will drive risky behavior outside the strictly regulated cordon. The next systemic crisis will then likely come from outside the ring, as it came this time from outside the cordon of commercial banks.

Third, identifying systemically important institutions and giving them their own consolidated regulator tends to institutionalize ‘Too Big to Fail’ and create a new set of GSE-like institutions. There is a risk that the consolidated regulator will see its job as not allowing any of its charges to go down the tubes and is prepared to put taxpayer money at risk to prevent such failures.

Higher capital requirements and stricter regulations for large interconnected institutions make sense, but I would favor a continuum rather than a defined list of institutions with its own special regulator. Since there is no obvious place to put such a responsibility, I think we should seriously consider creating a new financial regulator. This new institution could be similar to the UK’s FSA, but structured to be more effective than the FSA proved in the current crisis. In the US one might start by creating a new consolidated regulator of all financial holding companies. It should be an independent agency but might report to a board composed of other regulators, similar to the Treasury proposal for a Council for Financial Oversight. As the system evolves the consolidated regulator might also subsume the functional regulation of nationally chartered banks, the prudential regulation of broker-dealers and nationally chartered insurance companies.

I don’t pretend to have a definitive answer to how the regulatory boxes should best be arranged, but it seems to me a mistake to give the Federal Reserve responsibility for consolidated prudential regulation of Tier One Financial Holding Companies, as proposed by the Obama Administration. I believe the skills needed by an effective central bank are quite different from those needed to be an effective financial institution regulator. Moreover, the regulatory responsibility would likely grow with time, distract the Fed from its central banking functions, and invite political interference that would eventually threaten the independence of monetary policy.

Especially in recent decades, the Federal Reserve has been a successful and widely respected central bank. It has been led by a series of strong macro economists—Paul Volcker, Alan Greenspan, Ben Bernanke—who have been skillful at reading the ups and downs of the economy and steering a monetary policy course that contained inflation and fostered sustainable economic growth. It has played its role as banker to the banks and lender of last resort—including aggressive action with little used tools in the crisis of 2008-9. It has kept the payments system functioning even in crises such as 9/11, and worked effectively with other central banks to coordinate responses to credit crunches, especially the current one. Populist resentment of the Fed's control of monetary policy has faded as understanding of the importance of having an independent institution to contain inflation has grown—and the Fed has been more transparent about its objectives. Although respect for the Fed's monetary policy has grown in recent years, its regulatory role has diminished. As regulator of Bank Holding Companies, it did not distinguish itself in the run up to the current crisis (nor did other regulators). It missed the threat posed by the deterioration of mortgage lending standards and the growth of complex derivatives.

If the Fed were to take on the role of consolidated prudential regulator of Tier One Financial Holding Companies, it would need strong, committed leadership with regulatory skills—lawyers, not economists. This is not a job for which you would look to a Volcker, Greenspan or Bernanke. Moreover, the regulatory responsibility would likely grow as it became clear that the number and type of systemically important institutions was increasing. My fear is that a bifurcated Fed would be less effective and less respected in monetary policy. Moreover, the concentration of that much power in an institution would rightly make the Congress nervous unless it exercised more oversight and accountability. The Congress would understandably seek to appropriate the Fed's budget and require more reporting and accounting. This is not necessarily bad, but it could result in more Congressional interference with monetary policy, which could threaten the Fed's effectiveness and credibility in containing inflation.

In summary, Mr. Chairman: I believe that we need an agency with specific responsibility for spotting regulatory gaps, perverse incentives, and building market pressures that could pose serious threats to the stability of the financial system. I would give the Federal Reserve clear responsibility for Macro System Stability, reporting periodically to Congress and coordinating with a Financial System Oversight Council. I would also give the Fed new powers to control leverage across the system—again in coordination with the Council. I would not create a special regulator for Tier One Financial Holding Companies, and I would certainly not give that responsibility to the Fed, lest it become a less effective and less independent central bank.

Thank you, Mr. Chairman and members of the Committee.