The Relationship between Prudential Supervision and Monetary Policy

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Chairman Luetkemeyer, Chairman Barr, Ranking Member Clay, Ranking Member Moore, and distinguished members of the committee, thank you for inviting me to present my views on the relationship between prudential supervision and monetary policy.

The U.S. financial system is far more resilient today than it was a decade ago, and the likelihood of another system-wide crisis is now lower. As a consequence of post-crisis regulatory reforms, banks have more loss-absorbing equity capital than they had in 2007. They also face stringent liquidity requirements. And, the biggest among them must meet rigorous stress tests. This new environment ensures that all financial organizations, especially those that are large and complex, are much less likely to become a burden on the taxpayer.

It is important that we build on this progress. Regulations must remain sufficiently strict and supervisors must interpret and apply them rigorously. We also need appropriate governance. That is, we must organize the *regulatio*n, by which I mean the promulgation of the rules themselves, and the *supervision*, which is the monitoring of compliance with the rules, to ensure that the authorities can and will be able to do their jobs effectively.

Regulation and supervision are intimately connected, so it makes sense to house them in the same agency. Rules will always need refinement. Technological innovation and economic advances mean that the financial system is constantly evolving, and creative people find ways to skirt existing regulations. This all means that rules and their application require frequent adjustment. Who better to gather the information needed to improve the rules—to make them both less burdensome and more effective—than the supervisors enforcing them? This process of continuous improvement, where information from supervisors leads to regulatory enhancements, will be most efficient when the two groups are operating under the same roof.

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My comments today focus on *governance*, framing the discussion in terms of supervision, with the understanding that supervisors should also be regulators. I will address two related questions:

1) Should prudential supervision be an independent function, sheltered from day-to-day political influence with control of its own budget?
2) Should the central bank be a leading supervisor?

My answer to both of these questions is an unqualified yes. To do otherwise would put the financial system at risk of costly disaster.

Some preliminary remarks on monetary policy independence

> *"This administration will always support the political independence of the Federal Reserve Board."* President Ronald Reagan, February 18, 1982.[1]

Before getting to the specifics of my argument, I start with something that is uncontroversial: in adjusting the instruments that Congress authorizes them to use to achieve their statutory goals, central banks should be independent of short-run political pressures. Such *instrument independence* allows monetary policymakers to deliver lower inflation without sacrificing economic growth or employment over the long run.

The reason for this is straightforward: to be credible and successful in achieving their mandated objectives, monetary policymakers must have a long horizon. The impact of today's interest rate decision will not be felt for some time—several years, in many instances. Politicians realized decades ago that their time horizons are not long enough to deliver the best outcomes. The temptation to forsake long-term goals for short-term gains is just too strong. If people expect policymakers to pursue overly accommodative policies to achieve short-run objectives, the long-run goals of price stability and maximum sustainable growth will suffer.

Governments throughout the world solve this dilemma by delegating monetary policy responsibility to a separate, largely apolitical, institution with special expertise. To insulate these policymakers from daily political pressures, central bankers have control of their budgets and the authority to make irreversible operational decisions. By granting central bankers long terms, governments also enhance their credibility.

So, when it comes to monetary policy, there is broad agreement: to deliver price stability and maximum sustainable growth, central bank's operational decisions must be independent of political influence. At the same time, an independent central bank must act with sufficient transparency so that the government can hold policymakers accountable for achieving the legal mandate. In the United States, this is why the Federal Open Market Committee publishes its decisions, explains its actions, and faces public questioning about its efforts to secure price stability and maximum sustainable employment (or economic growth).

[1] Reagan, Ronald (1982). "The President's News Conference," February 18, in John T. Woolley and Gerhard Peters, eds. *The American Presidency Project*, website.

The need for independent prudential supervision

> *"To be effective, bank regulators and supervisors also require an appropriate degree of independence; in particular, the public must be confident that regulators' decisions about the soundness of specific institutions are not unduly influenced by political pressures or lobbying."*
> Federal Reserve Board Chairman Ben Bernanke, May 25, 2010.[2]

What about prudential supervision? Here the arguments for independence are remarkably similar to those for monetary policy. Strict bank supervision may result in unpopular limits on certain types of loans or even the closure of failing banks. Pressure from both bankers and their borrowers can lead to a delay in corrective action, fostering poor incentives and increasing the risk of larger problems down the road. Again, political interference may very well generate gains today, but the bill will come due tomorrow. Shelter from political influence, complete with budgetary control, allows supervisors to maintain a long-term view, giving them the credibility to enforce rigorous standards, promoting financial resilience and reducing public costs. As is the case with monetary policy, supervisors' actions are constrained by Congressional statute, combined with the appropriate mechanisms to ensure accountability.

While not all banks need a single supervisor, having one agency overseeing the most systemically risky intermediaries is key to avoiding a race to the bottom among multiple supervisors. This is exactly what happened in December 2006, when Countrywide Financial switched regulators from the Fed and Office of the Comptroller of the Currency to the less effective Office of Thrift Supervision.[3]

Experience in the United States and elsewhere shows how costly it can be when financial regulation and supervision are subject to political oversight. Domestically, two cases are instructive: the Federal Home Loan Bank (FHLB) system and the Office of Federal Housing Enterprise Oversight (OFHEO). In the first, as a result of being subjected to the congressional appropriations process, FHLB supervision of the savings and loan (S&L) industry allowed deep problems to fester. The eventual closing of over 1,000 institutions from 1986 to 1995 had a *direct* cost to taxpayers of roughly $250 billion in today's dollars.[4] (This ignores the large indirect costs arising from the failing S&Ls' misallocation of resources.)

Established in 1992, OFHEO supervised the Government-sponsored enterprises (GSEs)—Fannie Mae and Freddie Mac, the two mortgage giants that played key roles in the 2007-09 financial crisis. Their political influence weakened prudential oversight to the point where, for every $100 that they guaranteed, they were required to have only $0.45 in capital; and, for each $100 in mortgages they retained on their balance sheet, the capital requirement was only 2.5%.[5] In September 2008, with their slim capital buffer gone, the Treasury put the two GSEs into receivership, eventually providing $188 billion of taxpayer

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[2] Ben S. Bernanke, "Central Bank Independence, Transparency, and Accountability," speech at the Institute for Monetary and Economic Studies International Conference, Bank of Japan, Tokyo, Japan, May 25, 2010.
[3] See National Commission on the Causes of the Financial and Economic Crisis in the United States, *The Financial Crisis Inquiry Report*, Washington D.C.: U.S. Government Printing Office, January 2011, pg. 173-4.
[4] A description of the impact of the appropriations on supervision is in FDIC, "The Savings and Loan Crisis and its Relationship to Banking," Chapter 4 in *An Examination of the Banking Crises of the 1980s and Early 1990s*. For estimates of the costs, see Curry, Timothy and Lynn Shibut, "The Cost of the Savings and Loan Crisis: Truth and Consequences," FDIC Banking Review, vol. 13, no. 2, 2000.
[5] See Viral V. Acharya, Matthew Richardson, Stijn van Nieuwerburgh and Lawrence J. White. *Guaranteed to Fail: Fannie Mae, Freddie Mac, and the Debacle of Mortgage Finance*. Princeton, N.J.: Princeton University Press, 2011.

support to keep them afloat. (Again, that leaves out the massive costs arising from the misallocation of resources resulting from the GSEs' behavior.)

Elsewhere in the world, examples of how political interference fueled costly financial crises with dire consequences are easy to come by. I mention two. The fact that Korean and Indonesian supervisors lacked independence clearly worsened the Asian Crisis of 1997-98. And, the political sensitivity of supervisors, especially with regard to real-estate related credit, surely exacerbated Japan's decades-long banking problems.[6]

So, logical reasoning, careful research and common sense all lead to the same conclusion: independent prudential supervisors provide the foundation for a resilient financial system. When supervisors are independent of political interference, complete with budgetary autonomy, the financial system is more stable and taxpayer costs are lower. For this reason, the Basel Committee on Banking Supervision's second Core Principle for Effective Banking Supervision is that supervisors possess operational independence and have budgetary processes that do not undermine their autonomy.[7]

Whether a government upholds this core principle (and others) affects the confidence people have in its financial system. With that in mind, the IMF incorporates the principle of supervisory independence into its Financial Sector Assessment Program, which evaluates the resilience of a country's financial system. Today, the vast majority of countries in the world meet this standard.

This leads to the inescapable conclusion: prudential supervision should be an independent function, housed in an entity with control of its own budget, insulated from day-to-day political influence, but acting transparently to ensure accountability.

Why the central bank should be a leading supervisor

> *"Monetary policy and concerns about the structure and condition of banks and the financial system more generally are inextricably intertwined. Other agencies, certainly including the Treasury, have legitimate interests in regulatory policy. But I do insist that neither monetary policy nor the financial system will be well served if our central bank is deprived from interest in, and influence over, the structure and performance of the financial system."*
> Paul A. Volcker, March 17, 2010.[8]

Should central banks be a leading supervisor, including supervising systemically important institutions? The answer is clearly yes. As the lender of last resort, as the monetary policy authority, and as the organization responsible for overseeing the health and stability of the overall financial system—what we could call a *systemic regulator*—the central bank needs to be a supervisor.[9]

[6] For a discussion of these episodes, and others, see Marc Quintyn and Michael W. Taylor, "Should Financial Sector Regulators Be Independent?" IMF Economic Issues No. 32, 2004.
[7] Basel Committee on Banking Supervision, "Core Principles for Effective Banking Supervision," September 2012.
[8] Paul A. Volcker, "Testimony before the House Financial Services Committee," March 17, 2010.
[9] The Squam Lake Group advocates that the central bank should serve as the systemic regulator, making clear what that does and does not entail. See Squam Lake Group, "A Systemic Regulator for Financial Markets," in *Squam Lake Report*, Princeton, N.J.: Princeton University Press, 2010, Chapter 2.

The lender of last resort and prudential supervision

Recall that Congress created the Federal Reserve in 1913 in response to a series of banking panics. Financial instability after the Civil War resulted from the absence of a central bank to provide emergency loans to solvent institutions facing sudden deposit outflows. When depositors ran on a few banks, panic frequently spread. To promote stability, Congress authorized the Fed to serve as the lender of last resort—lending against good collateral to solvent institutions at a penalty rate.

Operating as the lender of last resort requires two pieces of information: (1) a determination of an institution's solvency, and; (2) a valuation of the collateral that is being posted to back the loan. Supervisors, with their intimate knowledge of the bank's operations, are the officials expected to have both of these.[10]

On the importance of solvency, there are three reasons that it is imperative a central bank *never* lend to bankrupt institutions. First, since the central bank will always require collateral, its loans further subordinate the bank's long-term creditors. It does this both by allowing short-term depositors to run and by inserting itself ahead of others in the queue for claiming repayment when failure inevitably comes. Second, lending to an insolvent bank does not put an end to that institution's fragility. Ultimately, it must be liquidated or re-capitalized. Postponing the day of reckoning is usually costly both for the institution in question and, as a consequence of a misallocation of resources, for the economy as a whole. Third, when people find out that the central bank is willing to lend to insolvent banks—and they will find out—any bank that borrows will be suspected of being bankrupt. The resulting *stigma* will impair the useful function of the lender of last resort as a lender to *solvent, but illiquid* banks. If only those that are bankrupt borrow, the central bank's lending facility will become worse than useless.

Even with a solvent borrower, protecting public finances means that the central bank must obtain sufficient collateral. Again, this requires intimate knowledge of the quality of a bank's assets, something that supervisors routinely assess.

An example illustrates the challenge that a central bank lender faces in maintaining financial stability. On November 21, 1985, a computer software error prevented the Bank of New York from keeping track of its U.S. Treasury securities clearing operations. In line with normal practice, orders poured in and the bank made payments without having received the funds. But when it came time to deliver the bonds and collect from the buyers, the order information had been erased from the system. By the end of the day, the Bank of New York had bought and failed to deliver so many securities that it was committed to paying out nearly $23 billion that it did not have. The Federal Reserve, knowing from its up-to-date supervisory records that the bank was solvent, made an emergency $23-billion loan, taking the entire bank (complete with its furnished building) as collateral and averting a systemic financial crisis. The amount of the loan exceeded the aggregate reserves in the entire U.S. banking system at the time. Importantly, only a direct and effective supervisor was in a position to know that the Bank of New York was solvent, that it had the necessary collateral, and that its need to borrow was legitimate.[11]

[10] For a discussion of the role of the lender of last resort, see Paul Tucker, "The Lender of Last Resort and Modern Central Banking: Principles and Reconstruction," in BIS Papers No. 79, September 2014, pg. 10-43.
[11] See the Gerald E. Corrigan, "Testimony before the Subcommittee on Domestic Monetary Policy of the Committee on Banking, Finance and Urban Affairs of the House of Representatives," December 12, 1985, Serial No.

So, in order to operate responsibly and effectively as a lender of last resort, protecting the public interest, the central bank needs to have close access to confidential supervisory assessments, knowledge about an institution's business practices, and the skills to evaluate the collateral a bank is posting to secure a loan. Importantly, this information has to be available to high-ranking central bank officials on very short notice. In some cases, decisions must be made in a matter of minutes, so the quality of the data must be without question and it cannot be in the hands of people across town who may or may not choose to share it.

It is difficult to overstate the importance of liquidity provision in the prevention and management of financial crises. The Federal Reserve has a variety of methods for injecting liquidity into the banking system on short notice, including the direct purchase of securities through open market operations and the provision of intra-day credit through the payments system. But direct lending to banks, usually on the order of several hundred million dollars, is sometimes the most important means to avert panic and contain a crisis. For example, in the aftermath of the terrorist attacks of September 11, 2001, to head off what would have been a financial system collapse, the Fed lent roughly $37 billion that day (and subsequently provided an additional $100 billion through a variety of means). In the aftermath of the Lehman bankruptcy, Federal Reserve lending peaked at $441 billion. Without supervisory information, the Fed would have been flying blind, not knowing if it was lending to insolvent institutions or whether it was accepting good collateral. Not only would this have been bad policy, it would have put taxpayers at risk.

As a practical matter, liquidity provision is also the mechanism central banks use to achieve their traditional interest rate objective. During normal times, when reserves are scarce, the Federal Reserve influences the federal funds rate by adding or draining liquidity from the banking system. This means that there is no operational difference between monetary policy actions and lending operations. In fact, in terms of their impact on the Fed's balance sheet, the purchase of a security and a loan are identical.

Returning to the issue of governance, operations in the midst of a financial crisis are akin to maneuvers during a war. In the heat of battle, the military relies on a clear chain of command to ensure a consolidated view of the battle and effective coordination of resources. Separation of supervision from the central bank would be like having multiple generals with potentially differing objectives simultaneously giving orders to the same army. It is hard to see how this could possibly work. Successful crisis management requires timely and effective coordination.

Monetary policy and prudential supervision

The intimate relationship between monetary policy and prudential supervision is another important rationale for giving the central bank a major supervisory role. As a practical matter, the two are inseparable. The Federal Reserve is set up as a matrix organization, so it is nearly impossible to say where one function stops and another starts. This is particularly true of the Federal Reserve Banks, who bear the day-to-day responsibility of examining and supervising banks. Monetary policy and prudential supervision are not in siloes, but operate in tandem, sharing knowledge, staff and expertise. And, because they work together, they are both more effective.

99-65; and Huberto M. Ennis and David A. Price, "Discount Window Lending: Policy Trade-offs and the 1985 BoNY Computer Failure," *Economic Brief*, Federal Reserve Bank of Richmond, May 2015.

Prudential supervision provides important inputs into the monetary policy process. The Federal Reserve supervises those parts of the banking system that account for nearly all of its assets. This includes oversight of more than 5,000 holding companies and over 200 foreign banking operations. Through its access to these financial firms, supervisors naturally learn about the health of the borrowers as well as that of the lenders. Put differently, the Federal Reserve knows a great deal about what banks are doing, to whom they are lending, as well as the size and the terms of the loans.

This nonpublic information can be vital for monetary policy.[12] A deep and complete understanding of the state of the financial markets and institutions, including the terms and conditions under which borrowers can obtain financing, is critical for the determination of the appropriate monetary policy stance. That is, the level of the interest rate set by the Federal Open Market Committee depends on supervisory information.

The events of mid-2008 provide a clear instance when the use of banking system information was critically important. Inflation was running a quarter of a percentage point above the Fed's 2-percent objective. A mechanical rule based solely on inflation and unemployment would have dictated that monetary policymakers raise interest rates to a level exceeding 5 percent. Fortunately, with their understanding of financial fragilities—gleaned in part from access to supervisory information about the deteriorating state of the banking sector—the Federal Open Market Committee judged interest rates at 2 percent consistent with inflation and growth prospects.[13] Needless to say, the next few months provided disastrous, dictating further policy *easing*, not *tightening*.

Information and skills also flow from monetary policymakers to prudential supervisors. An assessment of the safety and soundness of banking institutions requires an understanding of economic prospects—something that is integral to the formulation of monetary policy. In practice, this means that the economic and financial outlook is an input into supervisory evaluations. Nowhere is this more apparent than in the case of stress testing. Stress tests today are the most powerful prudential tool we have for safeguarding the resilience of the financial system. They take seriously the fact that when a large common shock hits, there may be no one who will purchase a bank's assets or provide equity capital. Ensuring that each systemic intermediary can withstand significant stress raises the likelihood that the system can survive. And, importantly, by adjusting the scenarios to reflect changing conditions, prudential authorities ensure that the system remains resilient. Formulating stress scenarios requires both knowledge about how the entire economy operates and a sense of the financial risks that are not adequately compensated. This is true both for domestic developments, like real estate booms, as well as those that could come from other parts of the world, like the cyclical downturns of major trading partners.

In sum, monetary policy and prudential supervision are complementary. Each requires information from the other. As Paul Volcker put it, the two are inextricably intertwined.

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[12] See, for example, Joe Peek, Eric S. Rosengren and Geoffrey M.B. Tootell, "Is Bank Supervision Central to Central Banking?" *Quarterly Journal of Economics*, vol. 114, no.2, May 1999, pg. 629-653.

[13] See the comments of William Dudley on pages 4 to 8 of the transcript of the June 24-25 FOMC meeting.

Financial stability and prudential supervision

Finally, there is the relationship between prudential supervision and the maintenance of systemic stability. The second of these is prudential supervision for the financial system as whole. It is clear that the central bank is the locus of that responsibility. The Federal Reserve does not have an explicit financial stability mandate. But it has a powerful, implicit one: without a modicum of financial stability, it would fail to achieve the statutory objectives of maximum employment, stable prices and moderate long-term interest rates.

With that in mind, building on the skills of its staff, its day-to-day access to and knowledge of financial markets, and its supervisory information, the Federal Reserve has created the capacity to monitor the financial system in order to ensure that both monetary and prudential policy are set in a way that enhances resilience.

Concluding remarks

I began by asking two questions: should prudential supervisors be operationally independent and should the central bank be a leading supervisor? My answer to both questions is yes. When supervisors are independent of political interference, complete with budgetary autonomy, the financial system is more stable and taxpayer costs are lower. Furthermore, a supervisory function is essential for effective and efficient execution of core central bank functions. As lender of last resort, the monetary policy authority, and the guardian of the health and stability of the overall financial system, it is essential that the Federal Reserve be a leading supervisor, including for systemically important institutions. The American public would be ill served if any of this were to change.