7-23-2009

Regulatory Reform and the Federal Reserve

Allan H. Meltzer
Carnegie Mellon University, am05@andrew.cmu.edu

Regulatory Reform and the Federal Reserve

By Allan H. Meltzer

The Allan H. Meltzer University Professor of Political Economy and Visiting Scholar at the American Enterprise Institute

Testimony, July 23, 2009 Senate Committee on Banking

Thank you for the opportunity to present my appraisal of the administration's proposal for regulatory changes. I will confine most of my comments to the role of the Federal Reserve as a systemic regulator and will offer an alternative proposal. I share the belief that change is needed and long delayed, but appropriate change must protect the public, not bankers. And I believe that effective regulation should await evidence and conclusions about the causes of the recent crisis. There are many assertions about causes. The Congress should want to avoid a rush to regulate before the relevant facts are established. If we are to avoid repeating this crisis, make sure you know what caused it.

During much of the past 15 years, I have written three volumes entitled A History of the Federal Reserve. Working with two assistants we have read virtually all of the minutes of the Board of Governors, the Federal Open Market Committee, and the Directors of the Federal Reserve Bank of New York. We have also read many of the staff papers and internal memos supporting decisions. I speak from that perspective. I speak also from experience in Japan. During the 1990s, the years of the Japanese banking and financial crisis, I served as Honorary Adviser to the Bank. Their policies included preventing bank failures. This did not restore lending and economic growth.

Two findings are very relevant to the role of the Federal Reserve. First, I do not know of any clear examples in which the Federal Reserve acted in advance to head off a crisis or a series of banking or financial failures. We know that the Federal Reserve did nothing about thrift industry failures in the 1980s. Thrift failures cost taxpayers $ 150 billion. AIG, Fannie and Freddie will be much more costly. Of course, the Fed did not have responsibility for the thrift industry, but many thrift failures posed a threat to the financial system that the Fed should have tried to mitigate. The disastrous outcome was not a mystery that appeared without warning. Peter Wallison, Alan Greenspan, Bill Poole, Senator Shelby and others warned about the excessive risks taken by Fannie and Freddie, but Congress failed to legislate. Why should anyone expect a systemic risk regulator to get requisite Congressional action under similar circumstances? Can you expect the Federal Reserve as systemic risk regulator to close Fannie and Freddie after Congress declines to act?

Conflicts of this kind, and others, suggest that that the administration's proposal is incomplete. Defining "systemic risk" is an essential, but missing part of the proposal. Trying to define the authority of the regulatory authority when Congress has expressed an interest points up a major conflict.

During the Latin American debt crisis, the Federal Reserve acted to hide the failures and losses at money center banks by arranging with the IMF to pay the interest on Latin debt to those banks. This served to increase the debt that the governments owed, but it kept the banks from reporting portfolio losses and prolonged the debt crisis. The crisis ended after one of the New York banks decided to write off the debt and take the loss. Others followed. Later, the Treasury offered the Brady plans. The Federal Reserve did nothing.

In the dot-com crisis of the late 1990s, we know the Federal Reserve was aware of the growing problem, but it did not act until after the crisis occurred. Later, Chairman Greenspan recognized that it was difficult to detect systemic failures in advance. He explained that the Federal Reserve believed it should act after the crisis, not before. Intervention to control soaring asset prices would impose large social costs of unemployment, so the Federal Reserve, as systemic risk regulator would be unwise to act.

The dot com problem brings out that there are crises for which the Federal Reserve cannot be effective. Asset market exuberance and supply shocks, like oil price increases, are non-monetary so cannot be prevented by even the most astute, far-seeing central bank.

We all know that the Federal Reserve did nothing to prevent the current credit crisis. Before the crisis it kept interest rates low during part of the period and did not police the use that financial markets made of the reserves it supplied. The Board has admitted that it did not do enough to prevent the crisis. It has not recognized that its actions promoted moral hazard and encouraged incentives to take risk. Many bankers talked openly about a “Greenspan put,” their belief that the Federal Reserve would prevent or absorb major losses.

It was the Reconstruction Finance Corporation, not the Fed, that restructured banks in the 1930s. The Fed did not act promptly to prevent market failure during the 1970 Penn Central failure, the Lockheed and Chrysler problems or on other occasions. In 2008, the Fed assisted in salvaging Bear Stearns. This continued the too-big-to-fail (TBTF) policy and increased moral hazard. Then without warning, the Fed departed from the course it had followed for at least 30 years and allowed Lehman to fail in the midst of widespread financial uncertainty. This was a major error. It deepened and lengthened the current deep recession. Much of the recent improvement results from the unwinding of this terrible mistake.

In 1990-91, the Fed kept the spread between short- and long-term interest rates large enough to assist many banks to rebuild their capital and surplus. This is a rare possible exception, a case in which Federal Reserve action to delay an increase in the short-term rate may have prevented banking failures.

Second, in its 96-year history, the Federal Reserve has never announced a lender-of-last-resort policy. It has discussed internally the content of such policy several times, but it rarely announced what it would do. And the appropriate announcements it made, as in 1987, were limited to the circumstances of the time. Announcing and following a policy would alert financial institutions to the Fed’s expected actions and might reduce pressures on Congress to aid failing entities. Following the rule in a crisis would change bankers’ incentives and reduce moral hazard. A crisis policy rule is long overdue. The administration proposal recognizes this need.

A lender-of-last-resort rule is the right way to implement policy in a crisis. We know from monetary history that in the 19th century the Bank of England followed Bagehot’s rule for a half-century or more. The rule committed the Bank to lend on “good” collateral at a penalty rate during periods of market disturbance. Prudent bankers borrowed from the Bank of England and held collateral to be used in a panic. Banks that lacked collateral failed.

Financial panics occurred. The result of following Bagehot’s rule in crises was that the crises did not spread and did not last long. There were bank failures, but no systemic failures. Prudent bankers borrowed and paid depositors cash or gold. Bank deposits were not insured until much later, so bank runs could cause systemic failures. Knowing the Bank's policy rule made most bankers prudent, they held more capital and reserves in relation to their size than banks currently do, and they held more collateral to use in a crisis also.

These experiences suggest three main lessons. First, we cannot avoid banking failures but we can keep them from spreading and creating crises. Second, neither the Federal Reserve nor any other agency has succeeded in predicting crises or anticipating systemic failure. It is hard to do, in part because systemic risk is not well defined. Reasonable people will differ, and since much is often at stake, some will fight hard to deny that there is a systemic risk.

One of the main reasons that Congress in 1991 passed FDICIA (Federal Deposit Insurance Corporation Improvement Act) was to prevent the Federal Reserve from delaying closure of failing banks, increasing losses and weakening the FDIC fund. The Federal Reserve and the FDIC have not used FDICIA against large banks in this crisis. That should change.

The third lesson is that a successful policy will alter bankers' incentives and avoid moral hazard. Bankers must know that risk-taking brings both rewards and costs, including failure, loss of managerial position and equity followed by sale of continuing operations.

An Alternative Proposal

Several reforms are needed to reduce or eliminate the cost of financial failure to the taxpayers. Members of Congress should ask themselves and each other: Is the banker or the regulator more likely to know about the risks on a bank's balance sheet?   Of course it is the banker, and especially so if the banker is taking large risks that he wants to hide. To me that means that reform should start by increasing a banker's responsibility for losses. The administration's proposal does the opposite by making the Federal Reserve responsible for systemic risk.

Systemic risk is a term of art. I doubt that it can be defined in a way that satisfies the many parties involved in regulation. Members of Congress will properly urge that any large failure in their district or state is systemic. Administrations and regulators will have other objectives. Without a clear definition, the proposal will bring frequent controversy. And without a clear definition, the proposal is incomplete and open to abuse.

Resolving the conflicting interests is unlikely to protect the general public. More likely, regulators will claim that they protect the public by protecting the banks. That's what they do now.

The administration's proposal sacrifices much of the remaining independence of the Federal Reserve. Congress, the administration, and failing banks or firms will want to influence decisions about what is to be bailed out. I believe that is a mistake. If we use our capital to avoid failures instead of promoting growth we not only reduce growth in living standards we also sacrifice a socially valuable arrangement—central bank independence. We encourage excessive risk-taking and moral hazard.

I believe there are better alternatives than the administration's proposal.

First step: End TBTF. Require all financial institutions to increase capital more than in proportion to their increase in size of assets. TBTF gives perverse incentives. It allows banks to profit in good times and shifts the losses to the taxpayers when crises or failures occur.

My proposal reduces the profits from giant size, increases incentives for prudent banker behavior by putting losses back to managements and stockholders where they belong. Benefits of size come from economies of scale and scope. These benefits to society are more than offset by the losses society takes in periods of crisis. Congress should find it hard to defend a system that distributes profits and losses as TBTF does. I believe that the public will not choose to maintain that system forever. Permitting losses does not eliminate services; failure means that management loses its position and stockholders take the losses. Profitable operations continue and are sold at the earliest opportunity.

Second step: Require the Federal Reserve to announce a rule for lender-of-last- resort. Congress should adopt the rule that they are willing to sustain. The rule should give banks an incentive to hold collateral to be used in a crisis period. Bagehot's rule is a great place to start.

Third step: Recognize that regulation is an ineffective way to change behavior. My first rule of regulation states that lawyers regulate but markets circumvent burdensome regulation. The Basel Accord is an example. Banks everywhere had to increase capital when they increased balance sheet risk. The banks responded by creating entities that were not on their balance sheet.

Later, banks had to absorb the losses, but that was after the crisis. There are many other examples of circumvention from Federal Reserve history. The reason we have money market funds was that Fed regulation Q restricted the interest that the public could earn. Money market funds bought unregulated, large certificates of deposit. For a small fee they shared the higher interest rate with the public. Much later Congress agreed to end interest rate regulation. The money funds remained.

Fourth step: Recognize that regulators do not allow for the incentives induced by their regulations. In the dynamic, financial markets it is difficult, perhaps impossible, to anticipate how clever market participants will circumvent the rules without violating them. The lesson is to focus on incentives, not prohibitions. Shifting losses back to the bankers is the most powerful incentive because it changes the risk-return tradeoff that bankers and stockholders see.

Fifth step: Either extend FDICIA to include holding companies or subject financial holding companies to bankruptcy law. Make the holding company subject to early intervention either under FDICIA or under bankruptcy law. That not only reduces or eliminates taxpayer losses, but it also encourages prudential behavior.

Other important changes should be made. Congress should close Fannie Mae and Freddie Mac and put any subsidy for low-income housing on the budget. The same should be done to other credit market subsidies. The budget is the proper place for subsidies.

Congress, the regulators, and the administration should encourage financial firms to change their compensation systems to tie compensation to sustained average earnings. Compensation decisions are too complex for regulation and too easy to circumvent. Decisions should be management's responsibility. Part of the change should reward due diligence by traders. We know that rating agencies contributed to failures. The rating problem would be lessened if users practiced diligence of their own.

Three principles should be borne in mind. First, banks borrow short and lend long. Unanticipated large changes can and will cause failures. Our problem is to minimize the cost of failures to society. Second, remember that capitalism without failure is like religion without sin. It removes incentives for prudent behavior. Third, those that rely on regulation to reduce risk should recall that this is the age of Madoff and Stanford. The Fed, too, lacks a record of success in managing large risks to the financial system, the economy and the public. Incentives for fraud, evasion, and circumvention of regulation often have been far more powerful than incentives to enforce regulation that protects the public.