

# REASSESSING THE FED'S REGULATORY ROLE

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As we contemplate the raft of regulatory reforms currently being proposed, it is important not only to consider the content of regulation, but also its structure. In particular, it is important to ask how the role of the Fed as a regulator should change, and how the targets and the tools of monetary and regulatory policy should adapt to new regulatory mandates. For example, some reform proposals envision a dramatic expansion of Fed regulatory authority, while others do not, and some proposals envision the Fed's using monetary policy to prick asset bubbles, while others do not. This article considers the desirability of various financial reforms, the proper future role of the Fed, and the proper use of monetary and regulatory policy tools in light of proposed regulatory reforms. What regulatory and overall policy structure would help us best achieve legitimate policy objectives?

Reforms of regulatory content and structure should recognize that combining regulatory and monetary policy objectives within the Fed may be undesirable. The risks of adverse consequences from combining monetary policy and regulatory authority within the Fed are real and threaten the effectiveness of both its monetary and regulatory policies. Experience and logic suggest that most regulatory and supervisory tasks should not be placed within the Fed. There are, however, legitimate arguments for charging the Fed with certain responsibilities—particularly, as a setter of time-varying macro

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prudential standards for the minimum capital or liquidity ratios of banks. If the Fed is charged with that role, however, it is important that the Fed exercise its responsibilities in a manner that reduces the risks of adverse consequences. The best means for doing so is for the Fed to adopt clear, transparent, and separate rules that guide its monetary policy targets and the variation over time in macro prudential standards.

## The Problem with Concentrating Regulatory Powers within the Fed

The Federal Reserve currently is charged with two occupations: managing monetary policy and regulating banks (i.e., all bank holding companies and some banks within them). Monetary policy involves varying the supply of Fed liabilities. The Fed does so during normal times primarily by varying its fed funds target, which results in changes in the amount of purchases or sales of Treasury securities. Recently, however, the Fed has employed new tools to achieve growth in its balance sheet, including aggressive lending to banks and others, varying interest paid on reserves, and setting quantitative objectives for various categories of purchases by the Fed of private securities (especially mortgage-backed securities).

With respect to monetary policy, the Fed has a “dual mandate” and is supposed to vary the supply of its liabilities to achieve a balance between two ultimate objectives: maximizing price stability (which many have come to equate with a long-term inflation target of somewhere upwards of 1 percent) and minimizing cyclical fluctuations in unemployment. One way to balance these two objectives is described by the “Taylor Rule,” which expresses the warranted fed funds rate as a function of (1) the long-run inflation target, (2) the current level of unemployment, and (3) the current level of inflation. The Fed departed dramatically from the Taylor Rule in 2002–05, and today, the Fed’s objectives with respect to price stability and unemployment are hard to discern or characterize through any “rule,” as all objectives seem to have taken a back seat to the immediate objective of limiting short-term financial sector fallout by setting the fed funds rate to zero and announcing various guarantees or quantitative targets for the purchase or support of various categories of private securities. It is hard to know what sort of Taylor Rule the Fed has in mind for the future, if any. This makes it extremely hard

to predict monetary policy, or to hold the Fed accountable to achieving its unannounced and unobservable goals.

The second occupation the Fed has been given is to regulate some banks (member banks that are not nationally chartered banks) and all bank holding companies. As revised under the Gramm-Leach-Bliley Act of 1999, that role now entails decisionmaking authority about what constitute allowable financial activities within financial holding companies that own banks, as well as more longstanding authority to decide which banks should be allowed to merge and on what terms, and the day-to-day supervision and regulation of the bank holding companies and the banks that it oversees.

As a regulator, the Fed is also charged with multiple objectives, which sometimes conflict with one another, although there are no Taylor Rules that have been derived to characterize tradeoffs among regulatory objectives. Those objectives include: ensuring the safety and soundness of banks by enforcing existing prudential regulations (including, for example, minimum capital requirements), consumer protection of bank customers, the enforcement of antitrust laws, and the enforcement of a host of other regulatory mandates on banks that include preventing money laundering, identifying potential terrorists, and ensuring that banks cater sufficiently to their local communities.

The expanding role of the Fed as a financial regulator in recent years is out of step with the global trend to separate monetary policy from regulatory policy. Virtually all developed economies have separated their monetary authority from their financial regulatory authority. Such a separation is desirable, as it limits the politicization of monetary and regulatory policy; pressures from special interests in the regulatory arena have led to poor regulatory decisionmaking by the Fed (which fears repercussions from Congress), and those pressures similarly have jeopardized the Fed's independence in managing monetary policy (Calomiris 2006).

The most common objection to the proposal to remove the Fed from day-to-day regulatory and supervisory authority is related to the Fed's role as a lender: How can the Fed lend to member banks without having timely information about their condition, and how can it get that timely information without participating in bank examinations and without having the right to examine banks as needed? The answer to this objection is simple: The Fed can and should have a representative attending all regular bank examinations, with full access to all examination meetings and materials, and that official should have the

legal right to visit banks at any time to address questions pertaining to bank condition. But this has nothing to do with setting regulatory standards, supervising compliance, approving mergers, or defining what constitutes a financial activity. Fed officials often conflate the need for information with the need for control. The two are separable.

Former Treasury Secretary Henry Paulson advocated disengaging the Fed from day-to-day supervision and regulation. He supported, however, a continuing role for the Fed in “macro” prudential supervision and regulation. Under this vision of the Fed’s changing role, which predated the financial crisis, the Fed would set broad, perhaps time-varying prudential standards (for example, minimum capital requirements) based on its knowledge about the condition of the economy and the financial sector, but it would not play an active role in enforcing those standards, or in determining or enforcing other regulatory policies.

## A Macro Prudential Role for the Fed?

The financial crisis has brought a new sense of urgency to proposals like Secretary Paulson’s for creating an explicit mandate for macro prudential supervision and regulation. Most proposals envision that the Fed would play the central role in monitoring indicators of risk in the financial system (e.g., by tracking financial institutions’ leverage, borrowers’ leverage, economy-wide credit growth, and asset price changes), modeling what those indicators collectively imply for system-wide risk, and altering prudential regulatory mandates (like minimum capital requirements, provisioning requirements, and reserve requirements) accordingly as economic circumstances change.

Should the Fed play that macro prudential role? Some observers argue that the Fed has failed in the past to recognize systemic risk problems and is not a credible monitor of systemic risk, partly because of its political vulnerability. Those Fed critics see a need for a “council of regulators” to handle macro prudential regulation. That council might contain representatives from each of the major regulatory authorities, and/or independent members; it would constitute a new regulatory authority with its own budget, staff, and a mandate to develop a framework for monitoring risk, identify moments of elevated systemic risk, and impose prudential regulatory changes accordingly.

Advocates of entrusting the Fed with macro prudential authority argue that because the Fed is already acting as a cyclical manager via

its control of monetary policy, vesting authority over macro prudential regulation elsewhere would reduce overall accountability in the system. It might be harder to hold either party accountable for cyclical disasters if we had two institutions (the new council and the Fed) both managing interrelated aspects of cyclical policy.

I find this accountability argument somewhat persuasive, notwithstanding the valid concerns about the politicization of the Fed and its failures to identify or act upon systemic risks in the past. Of course, reasonable people will disagree about the relative weights to attach to these two points of view. In any case, I believe that there are measures that can be taken to improve the accountability of macro prudential regulation by the Fed. I conclude that there is at least a legitimate argument for charging the Fed with the responsibility of setting time-varying minimal prudential standards for banks, but only if the Fed pursues that new macro prudential authority via a predictable and transparent framework (which would make the setting of standards, and the Fed, largely immune to momentary political pressures).

## Implementing Macro Prudential Regulation

How should macro prudential policy be implemented? How will policymakers identify moments of heightened macro financial risk, and what tools should be used in responding to perceived increases in systemic risk? Should the reactions of the macro prudential regulator to news be entirely discretionary or should the “reaction function” be rules-based? Should the policy reaction to systemic risk entail only a regulatory standards response, only a monetary policy (fed funds rate) response, or both?

With respect to the proper tools to employ, experience and theory both suggest that adding another objective to macroeconomic policy without adding any new tools (in addition to monetary policy) will complicate monetary policy and make it even harder to hold the Fed accountable to any well-defined set of objectives or actions. Judging Fed monetary policy against an announced Taylor Rule would be an imperfect but reasonably good means of evaluating the Fed's balancing of its dual mandate of inflation targeting and unemployment stabilization; adding a financial stability indicator variable to the list of variables affecting the fed funds rate would make it much harder to write a coherent Taylor Rule, and thus make it much harder to hold the Fed accountable for achieving any well-defined set of objectives

in its monetary policy. Large deviations from fed funds rate targets implied by a Taylor Rule could be too easily defended on the basis of an ill-defined perceived need to maintain financial stability. The Fed's radical departure from the Taylor Rule in 2002–05, which prompted the credit binge that helped set the stage for the subprime crisis, reminds us of the desirability (from the standpoint of both economic and financial stability) of holding the Fed accountable to observable benchmarks (like the Taylor Rule) when judging the performance of monetary policy.

To be clear, when suggesting that the Fed follow a Taylor Rule, I am not suggesting that policy be determined by the Taylor Rule in a mechanical sense, but rather that the Fed announce a Taylor Rule, which would serve as a benchmark for policy. Discretion would still be possible (an announced rule has no legally binding effect), but any discretionary deviation from the announced rule would require explicit and immediate justification from the Fed, which would add discipline and predictability to the monetary policy process.

I conclude that, in the interest of accountability and predictability, monetary policy should stick to the knitting embodied in some form of the Taylor Rule, which should be announced in advance by the Fed. Reactions to concerns about financial fragility should be implemented through a separate framework from the Taylor Rule and should rely on additional tools—increased minimal capital standards, provisioning standards, and reserve requirements—not the fed funds rate or other monetary policy actions by the Fed.

In the interest of promoting accountability, if the Fed is charged with macro prudential authority, it should be required to create and publicize a formal framework for measuring time-varying system-wide financial risk. Unless the Fed (or whoever else is given macro prudential authority) is required to publicly defend its approach to measuring this systemic risk it will be hard to hold it accountable for its policy actions in response to perceived increases in systemic risk. To add to accountability, it may make sense for this disclosed framework to be subject to approval by a council of regulators.

How feasible would it be to model systemic financial risk for purposes of setting time-varying capital and liquidity requirements for banks? This sort of modeling is still in its infancy, but early research is promising. For example, Borio and Drehmann (2008) have developed a simple dual-threshold model that works reasonably well to predict severe financial collapses. They find that whenever both asset

prices and credit supply grow at very high rates, the risk of a costly financial and macroeconomic collapse is high. One could potentially add measures of leveraging by households, businesses, and financial firms to that framework, as suggested by Brunnermeier et al. (2009), if doing so would improve the fit. This sort of model would provide clear signals to trigger the imposition of stricter regulatory standards during booms. Recent experience, especially in Colombia in 2007–08 (Uribe 2008), suggests that timely interventions based on these sorts of signals can be quite effective in slowing down credit-driven asset pricing bubbles before they become too dangerous to the economy.

### Too-Big-to-Fail Regulatory Reforms: More Rules, Not Fed Discretion

Some reform proposals envision the creation of additional regulatory and resolution authority powers, and/or modifications of bankruptcy law, to deal with the special challenges of resolving large financial institutions. Proposals include both *ex ante* and *ex post* policies. *Ex ante*, a regulatory authority would be charged with identifying which banks and nonbank financial institutions are sufficiently large and complex that their failure might pose a systemic risk to the financial system, and then applying special regulatory standards to those institutions (e.g., higher capital, provisioning, and reserve requirements). *Ex post*, reforms to the resolution of these institutions would endeavor to ensure that they would no longer be too big to fail.

I am sympathetic to the view that minimum prudential standards could and should be set on the basis of the externalities that institutions potentially impose on the system. Doing so would help to internalize the externalities of systemic risk created by large, complex financial institutions that are sources of liquidity risk to the financial system.<sup>1</sup>

<sup>1</sup>Not all large, complex financial institutions should be the subject of prudential regulation, only those that pose significant potential systemic risk through their management of liquidity risk. Banks and investment banks that finance themselves with large amounts of short-term debt are inherently sources of potential systemic risk, but hedge funds, insurance companies, mutual funds, and private equity investors should be able to avoid intrusive prudential regulation, if they can demonstrate that they are not sources of systemic risk. Financial institutions other than banks who wish to avoid intrusive prudential regulation should be permitted safe harbor from prudential regulation if they can demonstrate an adequate management of liquidity risks.

But it is counterproductive to make “largeness” and “complexity” matters of discretionary regulatory judgment and, therefore, sources of abuse of authority, lack of accountability, and increased regulatory risk. Moreover, there is no reason to do so—regulators can clearly delineate criteria that do a reasonable job of measuring largeness and complexity. It is possible to propose and publicly defend reasonable ways to set capital standards as a function of bank size, the number and size of its international subsidiaries, and the number of countries in which it operates. Clearly, the Fed, in particular, should not be charged with any discretionary determination of the criteria that define large, complex institutions, as such a role would further politicize the Fed.

Furthermore, there is no reason to have only two categories of institutions (small and simple, vs. large and complex) as some proposals envision; doing so would invite undesirable regulatory arbitrage around whatever threshold is established. Size and complexity should be recognized and measured as continua, and regulatory standards can and should envision multiple gradations of both size and complexity.

I also support the idea of creating better resolution mechanisms for banks and nonbanks that would resolve problems associated with allowing them to fail. But the devil is in the details. Some approaches to designing this new resolution mechanism—specifically, those that would vest discretionary resolution authority in the Fed or any other government authority—would likely make the too-big-to-fail problem worse because those government authorities would be correctly perceived as more inclined and able to use public funds to bail out large complex institutions (Wallison 2009). Furthermore, it would be especially unwise to ask the Fed to manage resolution policy; making the Fed into a discretionary bankruptcy court would further compromise its independence.

The right approach to reforming the resolution of large financial institutions has two parts. First, amend the bankruptcy code to cure any technical deficiencies that make it hard to apply bankruptcy to financial institutions.<sup>2</sup> The bankruptcy court, rather than a regula-

<sup>2</sup>Potential reforms include: (1) clarifying the jurisdiction over assets (deciding which countries’ courts have control over which assets); (2) expanding the range of instruments that are exempted from bankruptcy stays to include commercial paper and other maturing money market obligations, which would limit damage from gridlock in the payments system during a bankruptcy; and (3) avoiding the gaming of bankruptcy negotiations by creditors who have laid off their default risk using credit default swaps (CDS) by using net creditor exposures (debts less CDS hedges) to determine creditors’ voting rights in bankruptcy.

tory authority, is the right place to handle resolution. It is also important that the resolution rules be strict and not subject to too much judicial discretion. The law should require that shareholders in a failed institution face a complete loss, that long-term debtholders face losses commensurate with the negative net worth of the failing institution, and that any government assistance for the sake of incentivizing a merger should be defensible on the basis of a "least cost resolution" test, meaning that no government resources would be used unless doing so produces concrete and demonstrable savings on the transaction to taxpayers. Placing the responsibility for enforcing these strict standards in a court would increase the chance that resolution would be handled properly by applying the rule of law to a preexisting code, and would minimize the chance that political expediency would create an abuse of discretionary regulatory authority.

Second, it is crucial that regulatory authorities in the United States work with those in the United Kingdom, and eventually with those in other countries, to establish effective, pre-specified rules for allocating an institution's assets and liabilities across borders. In the Lehman bankruptcy, significant disputes arose among different countries' regulatory authorities and courts over which country's affiliate had the better claim to certain assets within the institution. The difficulty of resolving those cross-border conflicts makes it harder to apply credible market discipline to failed institutions; when bankruptcy is a mess, policymakers want to find an alternative. Regulators and financial institutions should have clearly specified and publicly disclosed plans in place that describe how ownership interests by affiliates will be treated by all regulators so that there is no opportunity for disagreement among the regulatory authorities of the various countries in which affiliates are located. The bankruptcy codes and regulatory rules of the various countries should explicitly recognize and respect those arrangements.

## Conclusion

In the interest of monetary policy independence, effective regulation and supervision of financial institutions, accountability of both monetary policy and regulatory policy, transparency, the alignment of market participants' incentives toward risk, and the avoidance of

inefficient risk management, the following reforms would be desirable:

1. The Fed should be removed from the day-to-day activities of supervision and regulation, including the defining of financial activities, the approval of mergers, and the supervision and regulation of member banks and bank holding companies.
2. There are legitimate arguments for having the Fed take the lead in establishing a publicly disclosed framework for collecting information relevant to measuring systemic risk and implementing a new regime of macro prudential regulation. In the interest of accountability, the Fed may be the appropriate entity to take the lead in macro prudential regulation because it is already charged with responsibility for managing monetary policy.
3. Whoever takes on the role of macro prudential regulator (whether the Fed or a council of regulators), it should develop a formal modeling framework for measuring the extent of systemic financial risk, which it would have to defend publicly. That model would describe how time-varying system-wide financial risk is measured, and how moments of high systemic risk are identified. The macro prudential framework would delineate how minimum capital requirements, provisioning requirements, and reserve requirements would respond to significant perceived increases in system-wide risk.
4. Monetary policy should be rules-based; the Fed should formally adopt as a benchmark some specific announced inflation target and a Taylor Rule associated with that target. That would permit the public to predict monetary policy better and better hold the Fed accountable for monetary policy. The Fed would still be free to deviate from its announced targeting policy, but it would be forced to explain such deviations immediately because both the rule and policy actions would be observable.
5. It would be unnecessary and counterproductive for the Fed to try to use the fed funds rate as a tool to deal with systemic financial risk, as doing so would weaken the accountability of both monetary policy and macro prudential policy. Macro prudential policy should be implemented through time-varying minimum capital and liquidity standards for banks.
6. There is a legitimate argument for imposing higher prudential regulatory standards on large, complex financial institutions. Those standards should be transparent and should reflect the

- fact that complexity is a continuum, not an either/or phenomenon. It would further politicize the Fed to give it discretionary authority over the setting of prudential standards for size and complexity; those standards should be set by the prudential supervisor and regulator on the basis of clear formulae.
7. It makes sense to reform the rules governing the resolution of large failed financial institutions to make it easier for large institutions to fail, and thus prevent abuse associated with too-big-to-fail bailouts and the moral-hazard problems they engender.
  8. It is inappropriate to create a new discretionary resolution authority over nonbank financial institutions that would be placed in the hands of the Fed or any other regulatory agency. Doing so would encourage rather than avoid too-big-to-fail bailouts.
  9. The proper approach to reforming resolution policy for large banks and nonbank financial institutions has two parts: (1) reform of the U.S. bankruptcy code to make it more effective in managing nonbank financial institutions' failures and more credible in imposing losses on stockholders and long-term debtholders of failed financial institutions, and (2) the establishment of legally binding agreements among regulators—starting with an agreement between the United States and the United Kingdom—that would clarify cross-border claims on failed institutions' assets by subsidiaries located in different countries.
  10. The desirability of these reform proposals is mutually dependent. For example, the requirement that the Fed clearly specify and publicly disclose its model of time-varying system-wide financial risk is a crucial precondition for vesting authority over macro prudential regulation in the Fed; otherwise, adding macro prudential regulation to the Fed's mandate would likely worsen the politicization of the Fed and lead to inadequate execution of macro prudential regulation.

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