

Testimony on “Examining the Link Between Fed Bank Supervision and Monetary Policy”

House Financial Services Committee

March 17, 2010

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Chairman Frank, Ranking Member Bachus, members of the committee, thank you for the chance to testify today. My name is Anil Kashyap. I am the Edward Eagle Brown Professor of Economics and Finance at the University of Chicago Booth School of Business. Much of my research and teaching focuses on monetary policy and banking. In the context of today’s hearing you should know that twenty years ago I was on the staff of the Federal Reserve Board of Governors and that I serve as a consultant to the Federal Reserve Banks of Chicago and New York. But I also serve as an advisor/consultant for a number of other organizations, public and private, including the Congressional Budget Office (CBO) and most importantly for my remarks today the Squam Lake Group.²

In my brief time today I will consider whether and how the Fed’s supervisory role should change by considering three specific questions. First, I will ask how the most costly mistakes regarding individual institutions in the United States during last crisis might have differed if the Fed had been stripped of its supervisory powers. Second, I will review the most prominent (and relevant) foreign case where the central bank was not involved in bank supervision, and ask if those outcomes were especially good. Third, I will look at the overall financial system, and ask what might have been done to protect the whole system better. Here my thinking has been strongly influenced by what the Squam Lake Group has proposed.³

¹ These remarks reflect only my own opinions and should not be attributed to any of the organizations with which I am affiliated. I also wish to thank, again without necessarily associating with my conclusions, Richard Berner, Douglas Diamond, Charles Goodhart and Jeremy Stein for helpful conversations on these issues.

² Among these other entities are the Clearinghouse Corporation and the Cabinet Office of Japanese Government, but obviously the views expressed here are mine alone and do not reflect those of any of these organizations.

³ The Squam Lake Group is comprised of 13 leading financial economists who came together to offer guidance on the reform of financial regulation. Members include eight of the nine most recent presidents of the American Finance Association (including the current president and the president-elect), a former Federal Reserve Governor, a former Chief Economist of the International Monetary Fund, and former members of the Council of Economic Advisers under President Bill Clinton and President George W. Bush. See www.squamlakeworkinggroup.org.

Preliminary Observations:

Let me start with a couple of preliminary statements of fact. First, there were many causes of the crisis including poor risk controls at major financial institutions, a regulatory architecture that did not keep up with developments in the financial system, and inadequate supervision. No credible analysis of the crisis suggests that a single fix could have prevented what we saw and making sure that the next crisis can be handled better will require many changes to the system. Today, we are going to focus on supervisory reform but we should not pretend that perfect supervision, if there is such a thing, will be enough to prevent another crisis or keep its costs small—I will come back to this point at the end of my remarks.

Second, I am going to emphasize the intimate connections between supervision and lender of last resort duties. But there are also well-established synergies between bank supervision and other responsibilities of the central bank. This includes the making of monetary policy but also extends to the design of special lending facilities that the Fed set up as a result of the unusual and exigent circumstances that prevailed in this crisis. I do not want to minimize these considerations but given the time constraints for my presentation, and my anticipation of what the Fed's representative will cover, I will not focus on these issues; I welcome questions on these topics and also present a brief summary of these arguments in the Appendix to this testimony.

Finally, the best way to assess potential supervisory reforms is to go through a counterfactual exercise about how things would have been different this time (and in the future) under a different supervisory regime. This kind of exercise is obviously speculative but there some things that historical experience teaches us and I will try to focus on those lessons. Given the short time today I want to focus on three of these thought exercises.

Question #1 Could the Biggest Individual Supervisory Failures Been Avoided By Getting the Fed Out of Supervision?

We now have some sense that as far as the US taxpayer is concerned it is straightforward to rank the costs of the various bailouts for individual institutions. In an ideal world, each of these institutions would have been shut down or sold with no expense to the taxpayer. The debt and equity holders of these institutions should have borne the costs of the mismanagement. But in each case that did not happen and instead taxpayer funds were committed. Here is brief review of the rogue's gallery.

By far the most expensive rescue was for Fannie Mae and Freddie Mac. The CBO's latest estimates put the cost to the taxpayer at over \$200 billion dollars.⁴ The problems at these

⁴ See "CBO's Budgetary Treatment of Fannie Mae and Freddie Mac" Background paper (January 2010), for the methodology, with updated estimates in the CBO's "The Budget and Economic Outlook: Fiscal Years 2010 to 2020" (January 2010).

institutions were well known and the Chairman of the Federal Reserve testified as early as 2004 about the risks that they posed.⁵ Thus, it seems hard to put the blame for these two on the Fed.

The next most expensive rescue was for AIG. The cost of this intervention is estimated to be at least \$30 billion. The Federal Reserve wrote the check for this rescue and the Fed actions, particularly regarding the transparency around the transaction, have been legitimately (and heavily) criticized. AIG's primary regulator, the Office of Thrift Supervision, had no expertise in understanding what was happening inside AIG Financial Products and so when the decisions had to be made the Fed was flying blind.

Chairman Bernanke has said that the AIG case troubles him more than anything else in this crisis. It also provides the best example of why stripping the central bank of supervisory authority would likely make problems such as what happened with AIG more probable in the future.

No one thinks that it is possible, let alone responsible, to have a modern economy without a lender of last resort for financial firms. Likewise, a lender of last resort has to be able to provide liquidity on demand, and hence the central bank is the only credible lender of last resort.

Below, I will outline some other suggestions for improving options regarding impaired firms, but it would be irresponsible to assume that we will not need the lender of last resort to act again. So the question is whether we want a lender of last resort that is guaranteed to be ignorant about the firms it is deciding whether to assist or whether it will have some first-hand familiarity with the institution.

One of my friends has a nice analogy. As the lender of last resort, you are never sure who is going to come through the door and ask for a date. When you meet your date on a Friday night and your date is AIG, the question at hand is whether you'd like to know something about them before you have to pay \$85 billion to buy them dinner. If we mandate that the Fed is not involved in supervision then we make hasty, uninformed decisions inevitable when it is called upon as a lender of last resort.

The third most expensive rescue will likely turn out to be Bear Stearns. Here again the primary regulator, the SEC in this case, was clueless about what was going on as Bear's demise approached. The Fed crossed the Rubicon in arranging this rescue, but as with AIG, it was forced to act on short notice, with very imperfect information about Bear's condition, and with

⁵ See for example, Alan Greenspan, "Proposals for Improving the Regulation of the Housing Government Sponsored Enterprises" (testimony, Committee on Banking, Housing and Urban Affairs, U.S. Senate, 108th Cong., 1st sess., February 24, 2004), available at www.federalreserve.gov/boarddocs/testimony/2004/20040224/default.htm

no supervisory authority to shape the outcome. Whatever criticisms one wants to make about the Fed's actions regarding Bear Stearns, the problems did not come because of incompetent Fed supervision of Bear.

In the question period we can discuss Citigroup, if that is of interest to the committee. Citi was the biggest rescue that the Fed had to arrange where it had some direct supervisory responsibility.

My point in reviewing these cases is not to absolve the Fed; as we say in this town plenty of "mistakes were made." But I think this quick summary shows that if another supervisor had taken over the Fed's responsibilities the U.S. taxpayer would still be on the hook for billions of dollars.

Question #2: Were outcomes in other countries where the Central Bank was not a bank supervisor turn out much better?

One obvious objection to the previous analysis is that I took the rest of the environment as given in contemplating a supervisory system without the central bank. Perhaps if the Fed had been out of the picture the other supervisors would have stepped up and built a better system.

Here the experience of the United Kingdom is particularly informative. The UK has deep financial markets, with many large financial institutions, and London is a financial center. The UK separated the central bank from supervision in the 1990s and set up a separate organization, the Financial Services Agency (FSA), to focus on bank supervision. The agreement that was reached required the Treasury, the Central Bank and the FSA to agree on any rescues. The first real test of this system came when Northern Rock got into trouble.⁶ The management of Northern Rock notified the FSA of its problems on August 13, 2007 and the Bank of England was notified the next day. It took over a month of haggling between the Bank of England, the Treasury and FSA about what to do before the Bank of England eventually announced its support for Northern Rock. Even that support was not enough to prevent a run on Northern Rock, the first in the UK since 1866. While the distribution of the blame is debated, there is complete agreement that the situation was mismanaged and the lack of coordination was important.

Beyond, Northern Rock, several other large British banks (including Lloyds Banking Group and Royal Bank of Scotland) have required government assistance. The total taxpayer burden from these interventions is uncertain since the UK intends to score the cost based on the final recovery

⁶ See Hyun Song Shin, "Reflections on Northern Rock: The Bank Run That Heralded the Global Financial Crisis." *Journal of Economic Perspectives*, 2009, 23(1): 101–19.

on all the securities that have been acquired. But at this point the UK Treasury estimates the cost as likely lying between £20 billion and £50 billion.⁷

I expect that if we formed a council to oversee the U.S. financial system we would arrive at the same arrangement where we need consensus and that information sharing amongst the different agencies would be poor. The events in the UK suggest that when this system was actually adopted, it did NOT perform very well and I see no reason to expect it to work better here.

Counterfactual #3 “What supervisory steps could have been taken to better protect the financial system?”

Even my cursory review of the biggest meltdowns in this crisis point to problems with the existing regulatory structure that go far beyond the question of which organizations do the supervision of individual institutions. The gaps in supervisory coverage were critical. The fact that institutions could change regulators if the regulator became too tough is appalling and let the risks in the system grow for no good reason.⁸

But the crisis has taught us that instability does not only come from the actions of deposit-taking institutions.⁹ The buildup in leverage throughout the financial system in non-banks was critical in amplifying the initial losses associated with subprime mortgages.¹⁰ Yet, no regulator was charged with looking across the whole financial system, and when individual regulators did see problems they were often powerless to do anything about them. Thus, a critical step in reforming regulation must be the creation of a systemic risk regulator that is charged with monitoring the whole financial system and has the authority and tools to intervene to preserve the stability of the financial system.

I know Mr Watt’s subcommittee held hearings in July on exactly this issue and that Richard Berner and Frederic Mishkin already laid out the logic for why the central bank should be the

⁷ See HM Treasury “Pre-Budget Report 2009,” December 6, 2009, particularly Box B4 on page 199. http://www.hm-treasury.gov.uk/prebud_pbr09_index.htm

⁸ For example Countrywide Home Loans changed its charter when the Fed finally moved to crack down on subprime lending. See the testimony by Patricia McCoy before a subcommittee of this committee in July 2009. http://www.house.gov/apps/list/hearing/financialsvcs_dem/mccoy_house_testimony--hearing--july_16_2009.pdf

⁹ See Paul Tucker, “Shadow Banking, Financing Markets, and Financial Stability,” January 21, 2010 for a summary of the many sources of instability coming from the “shadow banking system.” <http://www.bankofengland.co.uk/publications/speeches/2010/speech420.pdf>

¹⁰ See David Greenlaw, Jan Hatzius, Anil Kashyap, and Hyun Song Shin, “Leveraged Losses: Lessons from the Mortgage Market Meltdown,” 2008, *U.S. Monetary Policy Forum Report No. 2*, Rosenberg Institute, Brandeis International Business School and Initiative on Global Markets, University of Chicago Graduate School of Business.

systemic regulator.¹¹ So I will not repeat the arguments that they have already made for you. I would like to add one additional consideration emphasized by Charles Goodhart: if the central bank were not the systemic regulator, but still operated as the lender of last resort, then the central bank might not be able to control its own balance sheet if the systemic regulator was making independent decisions during a crisis.¹²

But even with a vigilant systemic risk regulator it seems likely most of the problems in this crisis would have appeared. The Squam Lake Group argues that the cost of the AIG rescue could have been substantially reduced by a package of reforms that includes (1) designating the Fed as the systemic risk regulator, (2) increasing the use of centralized clearing of derivatives, (3) creating mandatory living wills for financial institutions and bolstering resolution authority, (4) changing capital rules for systemically important institutions, (5) improving the disclosure of trading positions, and (6) holding back pay at systemically relevant institutions.¹³

I would be glad to discuss the basis for this conjecture, but we will never know whether this might have been possible. I do think I am on safe ground saying that without this type of comprehensive reform the financial system will not be appreciably safer in the future. Moreover, stripping the Fed of its role in bank supervision would be a step in the wrong direction.

Finally, just to make it clear that I hardly think the Fed has a role (or comparative advantage) at all types of financial regulation, I want to reiterate the Squam Lake Group's recommendation to get the Fed get out of the business of consumer protection regulation. This is a case where I see few synergies between the staffing requirements of consumer protection and the other essential central bank duties. I think the Fed would be far better handing off these duties to another regulator.

¹¹ The written remarks are available at http://www.house.gov/apps/list/hearing/financialsvcs_dem/hrdmp_070909.shtml

¹² See Charles A.E. Goodhart, "The Role of Macro Prudential Regulation," 2009, mimeo, London School of Economics.

¹³ See the The Squam Lake Report: Fixing the Financial System, Princeton University Press, forthcoming.

Appendix: Rehashing the Convention (and Correction) Wisdom about Synergies between Bank Supervision and Central Bank Activities

The body of my testimony concentrates on the implications of excluding the lender of last resort from the supervisory process. But the central bank does many things besides act as lender of last resort and there are at least three important ways that involvement in supervision can improve central bank performance.

First, having direct information on the condition of the banking system can improve the conduct of monetary policy and the central bank's information on the condition of the economy can improve the supervisory process. A pair of papers by Peek, Rosengren and Tootell (1999, 2009) establishes these two-way synergies.¹⁴ Their first paper shows that confidential bank supervisory information could improve the forecasts of inflation and unemployment that are presented at FOMC meetings and are the starting point for many policy discussions. The more recent paper demonstrates that bank supervisory models based on banking data alone can be improved by including the macroeconomic forecasts that are presented to the FOMC in their monetary policy deliberations. The recent stress tests are the kind of example where this could apply.

In addition, there is a long running debate whether the central bank can spot asset price bubbles and what it should try to do if it believes it has identified one. As Rosengren (2010) points out, as long as the central bank has authority over setting both interest rates and supervisory standards the policy options are much better than are often portrayed.¹⁵ In particular, rather than having only the blunt tool of raising short-term rates, the central bank if charged with mandate to deliver financial stability, can adjust prudential policy to prevent the financial system from feeding and amplifying booms. Conversely, as noted by Carney (2009), if some other institution was in charge of macro-prudential regulation and was using its tools to try slow credit creation, the central bank would need to take that into account in making monetary policy decisions.¹⁶

Finally, there are cases where the supervisory experience was useful to the Fed in designing special lending facilities that were created in the midst of the crisis. For example, the Asset Backed Commercial Paper, Money Market Mutual Fund Liquidity Facility (AMLF) was set up

¹⁴ See Joe Peek, Eric Rosengren, and Geoffrey Tootell "Is Bank Supervision Central to Central Banking?" *Quarterly Journal of Economics*, May 1999, Vol. 114, No. 2: 629–653 and "Is Financial Stability Central to Central Banking?" mimeo, 2009, Federal Reserve Bank of Boston.

¹⁵ See Eric Rosengren, Remarks at The Global Interdependence Center's Conference on "Financial Interdependence in the World's Post-Crisis Capital Markets" Philadelphia March 3, 2010 <http://www.bos.frb.org/news/speeches/rosengren/2010/030310/index.htm>

¹⁶ See Remarks by Mark Carney to a symposium sponsored by the Federal Reserve Bank of Kansas City Jackson Hole, Wyoming, 22 August 2009, "Some Considerations on Using Monetary Policy to Stabilize Economic Activity", <http://www.bankofengland.co.uk/publications/speeches/2010/speech420.pdf>

in a matter of days following the Lehman bankruptcy. The facility was heavily tapped from its initiation and helped restore confidence and slow the redemptions that been surging at money market mutual funds. The design of this facility was only possible because of the legal and accounting expertise on the Fed's staff and the Fed's familiarity and expertise regarding the workings of clearing banks, money market mutual funds and the structure of financial markets. If the Fed were out of the supervision business, it is not clear whether something like this would be possible.