ECOMENTARY™

MAS042010

The Central Issue: Wall Street versus Main Street

Charles Plosser, President of the Philadelphia Fed, has stepped out onto the treacherous ice of political policy-making. He is to be commended for the risks he takes and for the correct policy analysis he has provided.. The Plosser Letter of April 20, 2010 published on the Federal Reserve Bank of Philadelphia website: www.philadelphiafed.org is appended to this note.

1. A proper analysis of the 2007/2008 financial panic shows that the proximate source of the panic was too much risk piled on too little capital in large financial institutions. The real issue is what was the cause of this inappropriate risk-taking managerial behavior? The answer is that very large financial institutions had their survival inappropriately guaranteed. They recognized they were too big to be allowed to fail. (TBTF). Witness the Fanny and Freddy debacle.

2. The Fed and the Treasury feared systemic failure and this fear created a TBTF financial environment with incentives for the very risk taking we wish these institutions would avoid.

    a. Once the fear of systemic failure takes over, any institution of size can be characterized as TBTF.

    b. To avoid being left to a bankruptcy process, financial institutions will want to grow into a TBTF status---that is to indulge in moral hazard.

    c. Policy authority fears of systemic risk actually create incentives for inappropriate risk taking by these financial institutions. Heads these institutions "win" but tails, the taxpayer loses.

    d. This sets up a bail-out scenario for the policy authorities and as a result pits Wall Street against Main Street. It does so because it makes beneficiaries out of risk-indulgent financial institutions (Wall Street) and makes the tax-payer (Main Street) into an involuntary payee for the Moral Hazard that this risk behavior produces

3. Legislators understandably respond to this implied taxpayer entrapment, They demand a political say in determining who will have the authority to bail-out a failing institution and under what conditions such bail-outs can occur. This is the wrong road to financial reform. This approach is bound to lead to a policy failure in which private economic agents respond to inappropriate incentives created by the policy authorities themselves. That outcome will then be incorrectly titled a "market failure."

4. Unfortunately, current legislative efforts stem from a misdiagnosis of the Credit Crisis. Many policy makers have concluded that many large financial institutions used inappropriate leverage and thereby caused systemic risk. Rather than focusing on the moral hazard created by a TBTF mentality, legislators are now focused on writing a menu of do's and don'ts for the balance sheets of regulated financial institutions. This enshrines a TBTF policy in the public domain. Those that fall under these proscriptions will be protected.

5. The proper solution to this problem is to get rid of the notion of TBTF, and instead to implement a suitable resolution authority that will be uniformly applied to a failing financial institution. Bankruptcy with predictable consequences will yield a far superior result.

6. Getting rid of TBTF will make the market into an ally of regulators. If markets deem a financial institution to be too risky, they will drive down its share prices precisely because it will be known

beforehand that bankruptcy is likely and will be allowed. Managers will therefore manage their leverage and their risk more appropriately in order to avoid an (orderly) bankruptcy process. Losing one's highly paid job in a bankruptcy will deter some managers from inappropriate risk decisions.

Once the financial problem is posed correctly, it becomes much easier to resolve the issues of which government institution should supervise large financial firms. The logical candidate is the Fed who deals with these institutions on a daily basis in any case. Subsidiary issues now being written into the various financial regulation bills such as the scope of the Fed's authority, the appointment process governing certain Federal Reserve governors and the latitude allowed the Fed through its lending authority become much easier to define and solve. Once the market is made into an ally of the financial regulators, market disciplinary measures and methods to recapitalize weakened financial institutions will become much easier.

Plosser advocates eliminating the Fed's 13(3) lending authority; contingent capital requirements for financial firms in which debt converts automatically into equity in times of stress; a requirement that the Fed deliver a semi-annual Financial Stability Report to the Congress; and, finally restricting the Fed's conduct of monetary policy to a portfolio that contains only Treasury securities. The "dodgy assets" now on the Fed's balance sheet would have to go and could not reappear again! The Fed can then return to its monetary policy obligations and let the Treasury make its fiscal choices.

Plosser's letter has cut to the chase much of the current cant surrounding financial reform. It is a simple and elegant plea based on focused objectives and modest goals. Focused objectives and modest goals will also be the main drawbacks to the politicians now involved. It would substantially reduce the scope of their various legislative proposals that are now under consideration. A better idea is now available.

Sadly, the public is likely to be the loser when the final shape of financial reform legislation is revealed in spite of the better alternative Plosser has now offered. Politics does indeed make strange bedfellows.

April 20, 2010

As the United States Senate resumes debate on financial regulatory reform, I want to share some of my concerns with several aspects of the bill passed by the Senate Banking Committee. The financial crisis has clearly demonstrated the need for reform. It is important, however, that reform does not mistake symptoms for root causes or overreach in ways that could lead to unintended consequences. If we don't enact the right reform, we may end up sowing the seeds of another, unintended crisis.

I believe that the most important challenge that reform must address is the too-big-to-fail problem (TBTF). If equity investors and creditors do not seriously believe that their money is at risk and that any financial firm can fail, regardless of size, then they will remain inclined to take on too much risk. More importantly, creditors, if they perceive any possibility of a government backstop, will have less incentive to monitor the risk-taking of the owners. Under the current system, when stock and bondholders of TBTF firms win, they profit, but when they lose, they become eligible for a government bailout. Such an arrangement clearly leads to moral hazard. We only need to look at Fannie and Freddie for the outcome. Reform must end the belief that some firms are TBTF.

In order to end TBTF, we must have a way that credibly convinces large financial firms and the markets that firms on the verge of failure will, in fact, be allowed to fail. If the resolution mechanism is either too vague or allows for too much discretion by regulators or Congress to rescue firms through subsidies or bailouts, then troubled firms will surely argue that the risks of failure are so severe and systemic that they must be bailed out. This is what we saw in the recent crisis. A credible commitment by government not to intervene or bail out firms must be the centerpiece of the resolution mechanism.

I believe the best approach to making such a credible commitment and thus ending TBTF is amending the bankruptcy code for nonbank financial firms and bank holding companies, rather than expanding the bank resolution process under the

FDIC Improvement Act (FDICIA). While the Senate bill has tightened up the proposal with a stronger bias toward liquidating a troubled firm, the bill would still give a great deal of discretion to policymakers to avoid the discipline of a bankruptcy court. I recognize that the current bankruptcy code does not adequately address the inherent challenges in liquidating large financial institutions without risks to the market, but I believe a modified bankruptcy process would eliminate discretion and strengthen market discipline, by permitting creditors as well as regulators to place the firm into bankruptcy when it is unable to meet its financial obligations.

The Senate bill's proposal to restrict the Federal Reserve's supervisory authority to about 35 of the largest financial firms with $50 billion or more in assets further undermines the effort to end TBTF. The markets will likely interpret this provision as signaling that these firms are unique and will continue to be treated as TBTF. Many would assume that the language in the resolution section that emphasizes bankruptcy would not apply to these firms. This provision would, de facto, make the Federal Reserve supervisor of the firms deemed TBTF.

In addition, restricting the Federal Reserve's supervisory authority to these large firms would focus the Federal Reserve's attention more toward Wall Street and less on Main Street. Nearly a century ago, Congress established the Federal Reserve as a decentralized central bank, by chartering 12 regional Reserve Banks, overseen by the Board of Governors in Washington, D.C. The structure provides checks and balances – between centralization and decentralization, between the public and private sectors, and between Wall Street and Main Street – all to ensure that policy decisions are balanced and independent.

Today, the Federal Reserve supervises about 5,000 bank holding companies and 850 state-chartered banks. These responsibilities help give the Fed direct contact and knowledge of banks and communities on Main Streets across America. In the Third District, the Philadelphia Fed supervises over 100 bank holding companies and 23 state-chartered member banks. These supervisory responsibilities support and complement the central bank's ability to meet its congressional mandates for financial stability and monetary policy. Losing direct supervision of all but the largest bank holding companies would dramatically reduce the Federal Reserve's abilities to monitor the economy and financial market developments, to act as an effective lender of last resort, and to identify risks to the financial system. That is why I believe the Fed must retain supervision of bank holding companies of all sizes and state member banks.

Finally, I am concerned that the bill contains provisions that seek to politicize the governance of the Federal Reserve, including making the New York Fed president a political appointee with a five-year term. This proposal would gravely dilute governance structures that have sheltered the central bank from short-term political influences. Fed Governors are appointed by the President and confirmed by the Senate, but serve 14-year terms to encourage a long-term perspective and shelter them from partisan politics. Federal Reserve Bank presidents are selected in a nonpolitical process by their boards of directors, subject to the approval of the Board of Governors in Washington.

There are two important reasons for protecting monetary policymakers from direct political pressures. First, monetary policy affects the economy with sometimes long and variable lags. Monetary policy actions will not have their full effect on the economy for several quarters and perhaps as long as several years. Congress recognized that delegating monetary policy decision-making to an independent central bank with a long-term perspective would limit the temptation to pursue short-term gains at the expense of future outcomes.

The second important reason to give monetary policy decision-making to an independent central bank is to separate the authority of those in government responsible for making the decisions to spend and tax from those responsible for printing the money. This lessens the temptation for the fiscal authority to use the printing press to fund its public spending, thereby substituting a hidden tax of inflation in the future for taxes or spending cuts.

The Senate bill would create a new political appointee based at the New York Fed. The rationale for this change was that the New York Fed president has a permanent vote on the Federal Open Market Committee and traditionally serves as vice chairman of the FOMC, the main monetary policymaking body within the Fed. Congress gave votes on the FOMC to the seven Governors, to the New York Fed president, and to four other Reserve Bank presidents on a rotating basis. Changing the New York position to a Presidential appointee would greatly skew the center of power and influence to New York and Washington and further reduce critical input to monetary policy from the rest of our country. There would be a powerful temptation to mitigate the effects of a crisis using the Federal Reserve's power to print money, rather than through fiscal action. Even in normal times, added political pressure might keep interest rates lower in order to stimulate short-term

growth, at the expense of long-term inflation. This is not a partisan issue. Political influence over monetary policy is dangerous no matter which party is in control.

I also stress that I do not raise these objections simply to maintain the status quo. The Federal Reserve should and will change to improve the strength and effectiveness of our nation's regulatory system. As I have outlined, I am for changes in bankruptcy laws to create a credible way to fail troubled nonbank financial firms, so we never again need to bail out individual firms. In recent months, I have also called for the following reforms:

Eliminate or curtail the Fed's 13(3) lending authority, which allows lending to corporations, individuals, and partnerships under "unusual and exigent circumstances." I believe the fiscal authorities should do emergency lending and that the Fed should be involved only upon the written request of the Treasury. With an appropriate bankruptcy process that protects the financial system from the failure of one firm, the need for 13(3) type lending is vastly reduced.

Enhance market discipline by requiring financial firms to hold contingent capital in the form of convertible debt that could be converted into equity in periods of financial stress. Contingent capital would be less costly than simply raising capital requirements. Perhaps most important, it would provide a means of recapitalizing these firms in a crisis without the necessity of government rescues and bailouts. Moreover, the market price of such debt would provide regulators with a signal about the health of the firm and the market's perception of risk.

Support greater transparency by requiring the Fed to deliver a semi-annual Financial Stability Report to Congress and the public. Similar to the Fed's requirement to submit its Monetary Policy Report, this requirement would improve the transparency and accountability of the Fed's financial oversight responsibilities, which would help ensure public trust and credibility.

Have the Federal Reserve conduct monetary policy using a portfolio that contains only Treasury securities, which would promote a clearer distinction between monetary policy and fiscal policy, help uphold the Fed's independence, and assign fiscal decisions to the Congress where they belong.

Here in Philadelphia, just blocks from the Philadelphia Fed, you can find the vestiges of the First and Second Banks of the United States, two earlier attempts at a central bank, which both failed because they became embroiled in politics. I ask you to keep this historical perspective in mind as you weigh the decisions on financial reform in the weeks ahead. Above all, we should avoid any changes that would impede the Fed's ability to meet its congressionally mandated objectives for sound monetary policy to ensure price stability and maximum sustainable economic growth.

Sincerely,

Charles I. Plosser

President and CEO

Federal Reserve Bank of Philadelphia

cc: Third District Senators and Representatives

Third District Directors

Third District State Banking Associations

Third District State Banking Commissioners