Federal Reserve as a Systemic Regulator

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The financial crisis that began in 2007 had a great impact on the US financial markets. It was probably the biggest shock since the Great Depression, and it affected the American economy as well as the Federal Reserve. With that in mind, the purpose of this paper is to explore the pros and cons of having the Federal Reserve as a systemic regulator.

The current framework for banking regulation rests on the principle that regulation should ensure the soundness of individual institutions against the risk of losing assets. However, focusing on individual institutions has obscured the growing importance of the shadow banking system and the manner in which financial markets have taken over from traditional banks. There is another respect in which the focus on individual institutions has been problematic. Of course, it is a truism that ensuring the soundness of each individual institution ensures the soundness of the system as a whole. However, it is possible, indeed often likely, that attempts by individual institutions to remain solvent in a crisis can undermine the stability of the system as a whole. If one financial institution lends to a second institution but then decides to be prudent by reducing lending, the action may cause a sharp withdrawal of funding from the second institution (Morris & Shin, 2008). This is precisely the sort of run that happened to Bear Stearns, Lehman Brothers, and the U.K. bank, Northern Rock, all of which became crippled by the run (Mishkin, 2008).

In addition, a focus on the risks of individual institutions can create boom/bust cycles that can cause severe financial crises to worsen, as occurred during the most recent episode. Through employing modern price-sensitive risk management practices, banks with short-term incentives experience exposures when measured risks are low, only to shed them quickly when risks materialize, regardless of the consequences for the rest of the system. The recoiling from risk by one institution generates greater materialized risks for others. It is this spillover to the wider economy that creates the biggest social costs.

Given the above scenarios, there have been calls, most prominently by the U.S.

Treasury (Geitner, 2009), for a regulator that has a system-wide perspective that can meet the challenges ahead. One choice for this systemic regulator is a central bank, the Federal Reserve, in the case of the United States. It is pertinent to consider the pros and cons in having the Federal Reserve take on the systemic regulator role.

There are four arguments in favor of having the Federal Reserve as the system regulator. First, it has daily trading relationships with market participants as part of its core function of implementing monetary policy. As such, it is best situated to monitor market events and to flag looming problems in the financial system. No other (public) institution has comparable insight and access to the broad flows in the financial system than the Federal Reserve. Second, it is the lender of last resort. It has a balance sheet that can be used as a tool in meeting systemic financial crises. As the lender of last resort, the Federal Reserve will be called upon to provide emergency funding in times of a crisis. However, too often during the current crisis, the Federal Reserve has been called upon at the last minute to provide funding for an institution in crisis when the Federal Reserve had no first-hand knowledge of the institution. For example, Northern Rock in the United Kingdom was supervised by the Financial Services Authority, and Bear Stearns in the United States was supervised by the Securities and Exchange Commission. No amount of information sharing is a substitute for the first-hand information gathered in direct on-site examinations. If an individual saves money in an institution, that individual is expected to oversee those savings.

Third, the Federal Reserve’s mandate to preserve macroeconomic stability is consistent with the role of ensuring the stability of the financial system. Macroeconomic policy and macroprudential policy are tailor-made for each other. Fourth, central banks are among the most independent of government agencies. Successful systemic regulation requires a focus for the long-run. However, politicians often have incentives to focus on the short-run for the purpose of being elected. Insulating the systemic regulator from day-to-day

interference by politicians is, thus, an important element to ensuring a systemic regulator's success. The respect and independence that central banks enjoy, therefore, make them natural candidates to be systemic regulators (Mishkin, 2008).

Despite these arguments for having the Federal Reserve as the systemic regulator, there are some dangers in giving it this additional responsibility. First, the clear focus on achieving output and price stability will become blurred once the Federal Reserve also takes account of financial stability objectives. Second, there are also legitimate concerns about the Federal Reserve overreaching itself in the resolution stage of a crisis when it greatly extends its balance sheet to lend to private institutions. Third, there are dangers of increased politicization of the Federal Reserve's actions due to its role in the resolution stage of a crisis (Mishkin, 2008).

References

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