

Thomas M Hoenig: Central banks: changing markets – changing mandates

Speech by Mr Thomas M Hoenig, President and Chief Executive Officer of the Federal Reserve Bank of Kansas City, at the Central Bank of Argentina 2008 Money and Banking Conference “Financial turbulence – impact on developed and emerging economies”, Buenos Aires, 1 September 2008.

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It is a pleasure to be in Buenos Aires today to participate in this high-level conference sponsored by the Central Bank of Argentina. Revolutionary changes in financial markets, combined with events such as the market disruptions associated with the subprime lending debacle, have raised anew questions about the role of central banks in maintaining financial stability. Though central banks have traditionally had some responsibility for financial stability, such responsibility has typically not been placed on par with more explicit mandates for price stability and economic performance, in part perhaps, because of the episodic nature of financial crises. Yet, recent market disruptions in the United States make it very clear that the financial markets, the general public and political authorities will look first and foremost to the Federal Reserve to respond to any significant threats to financial stability.

In this context, it may be useful to take a closer look at a central bank’s mandate for financial stability. Today, the Federal Reserve plays a role in “crisis prevention” through its regulation and prudential supervision of banks and bank holding companies. It also plays a role in “crisis management” by providing liquidity to stem financial disruptions and by using monetary policy to reduce the impact of financial disturbances on economic activity. In the current crisis, the Federal Reserve has taken unprecedented steps to manage and contain the crisis. As we examine lessons learned from these events, we will have to decide whether financial stability can be best maintained in the future, as some have suggested, by extending the Federal Reserve’s supervisory and lending authority to a broader part of the financial system. In doing so, we need to examine both the intended and possible unintended consequences of such a decision. Alternatively, if we do not envision a broader role for the Federal Reserve, we need to articulate what other institutional reforms might be needed to avoid a repeat of the recent crisis and to reduce the crisis management burden on central banks going forward.

A second issue worthy of further discussion is how a central bank’s mandate for financial stability can be balanced with its other macroeconomic responsibilities. For the Federal Reserve, adding a more explicit financial stability mandate to its existing dual mandate for price stability and economic growth raises important and difficult questions about the compatibility of these responsibilities and the problems that might arise in attempting to achieve them all simultaneously.

Let me begin my remarks by examining more closely what is meant by “financial stability” and the Federal Reserve’s current role in maintaining financial stability. Then I will look at the changing structure of the financial system, how the Federal Reserve has responded to the current crisis and the issues surrounding the possible extension of the Federal Reserve’s responsibilities. Finally, I will address some of the possible implications of a broadened financial stability mandate for the Federal Reserve’s other macroeconomic responsibilities.

Financial stability and systemic risk

As we are all aware, a stable financial system is essential to a growing economy, particularly in terms of providing a sound payments mechanism and efficient, sustainable credit intermediation. Since disruptions to this payments system or credit intermediation process

will directly and adversely affect real economic activity, I believe that public policy has an important role to play in mitigating these market breakdowns.

One aspect of public policy is to provide a resilient and rational framework within which financial institutions and markets can operate. History, however, suggests that some breakdowns will inevitably occur within any dynamic financial system and economy. Consequently, maintaining financial stability from a public policy perspective does not mean preventing all financial disruptions, but rather mitigating those market and institutional breakdowns that could have a significant impact on aggregate economic activity. A key implication from this perspective is that financial losses or the failure of an individual firm, even a large one, does not warrant governmental intervention unless the outcome poses a substantial threat to the economy.

This public policy role is most clearly warranted in addressing systemic risks to the financial system. Systemic risk can be broadly defined as the risk that problems at an individual institution or segment of the market would spread to a wider set of institutions and markets and pose a major threat to economic activity. This type of contagion could occur because of the array of linkages that may exist among institutions and markets through counterparty, payments and other risk exposures. While counterparty exposures at large institutions have constituted the traditional view of systemic risk, I would also extend the definition of systemic risk to include instances where many institutions – and not just the largest – are exposed to a common set of adverse factors, such as during the real estate, energy and agricultural collapses in the United States during the 1980s and early 1990s.

Commercial banks have long had a unique role in supporting the economy through their credit intermediation activities and in connecting individuals and businesses to the payments system. These activities have placed banks at the center of policy concerns over systemic risk. However, given the growing role of capital markets and nonbank institutions in the intermediation process, we should begin to ask ourselves whether these broader market segments pose systemic concerns that are independent from those already arising from their linkages to the banking system.

The importance of maintaining financial stability and addressing systemic threats to the economy justifies the federal safety net and the need for prudential supervision. We have a long history of using prudential or safety and soundness supervision of the banking system to limit the potential risks to this safety net. The premise behind this approach is that the health of the financial system can be solidified by monitoring and controlling the risks assumed by individual banks and by requiring appropriate levels of capital and liquidity to support their operations. To the extent these supervisory objectives can be met, the risk of serious failures and safety net losses can be reduced. Our changing financial markets, though, are now prompting us to examine how far this framework of prudential supervision and safety net protection can and should be extended.

The Federal Reserve's current role

As the central bank for the United States, the Federal Reserve has been assigned a critical role in promoting financial stability and responding to financial crises. This role is inherent in many of its powers including: banking supervision, the provision of liquidity through the discount window and open market operations, and payments system oversight.

The Federal Reserve's responsibilities for banking regulation and prudential supervision are largely aimed at preventing financial crises and protecting the federal safety net. Accordingly, these efforts encompass capital adequacy standards for state member banks and holding companies, consolidated oversight of the risk exposures and risk management practices of these institutions, and corrective enforcement actions to deal with serious problems. The System's responsibilities for supervising holding companies and state member banks also provide valuable insights on the operation of individual institutions and banking markets.

Moreover, with regard to crisis management, this supervisory experience and the information obtained in the supervisory process have been increasingly important in designing appropriate responses to financial disruptions.

To deal with or manage potential crises, the Federal Reserve also relies on its authority to inject liquidity into the financial system. Although other regulatory agencies also bear responsibility for helping to ensure financial stability, the Federal Reserve's authority to supply liquidity gives it a unique role during a financial crisis. This role represents a fundamental purpose behind the creation of the Federal Reserve System and the reason why the Federal Reserve is expected to take the leading role in maintaining financial stability and mitigating breakdowns in the financial markets.

The Federal Reserve may inject liquidity through open market operations. To provide liquidity in a more targeted manner, the Federal Reserve may lend through the discount window to any depository institution and may also lend to any individual, partnership or corporation in "unusual and exigent circumstances." These different ways to inject liquidity thus give the Federal Reserve a choice in how it will supply liquidity to institutions and the overall economy.

The new financial structure and the broadening mandate for central banks

Traditionally, the Federal Reserve's supervisory responsibilities and its financial stability concerns have centered on commercial banks. This approach reflects the multifaceted role of banks including: their responsibilities in the payments system, their participation in the credit intermediation process, and their role as a source of liquidity and acting as a counterparty in financial transactions.

I think we would all agree, though, that the current market turmoil points out how much the financial system has changed over the past several decades. Recent events illustrate that financial disruptions can arise from outside of the traditional banking channels, while taking on new dimensions and features. As an example, many of the recent problems arose from mortgage-backed securitization activities that not only involved U.S. banking organizations, but also brought in a complex mixture of other firms. Such firms have included investment banks, mortgage originators, credit rating agencies, mortgage servicers, securities issuers, asset managers, investors and financial institutions across many different countries.

This experience clearly indicates that more of the credit process is now taking place outside of the banking system and within a much broader global financial marketplace. Investment banks, in particular, are an important segment in this expanding marketplace as they go beyond their traditional focus on underwriting and distribution of securities and private placement activities. Today, we can see that investment banks derive an increasing portion of their business from more sophisticated securities and derivatives activities, mortgage and commercial lending, and the operation of thrift and industrial loan company subsidiaries.

The current financial crisis also shows the extensive and complex set of counterparty risks to which major institutions are now exposed and the difficulties such risks may pose in maintaining market confidence and addressing problems at individual institutions. In fact, the collapse of Bear Stearns provides a striking example of how the ramifications of a single nonbank firm's troubles can extend throughout the financial system, threatening public confidence and complicating any resolution efforts.

These developments thus raise a number of issues for managing financial crises. The sheer size of the financial markets, the many different counterparties and the interdependencies among participants suggest that significant disruptions from any portion of the market – bank or nonbank – could "freeze" financial transactions and activities and consequently harm the real economy. Most notably, the growing role that capital markets and nonbank institutions play in the financial intermediation process suggests that systemic concerns can arise

independently or in conjunction with the linkages that already exist through the banking system.

To deal with the financial breakdowns that have occurred in this expanded financial system, the Federal Reserve has taken several steps that are of a nearly unprecedented nature. These include opening the discount window to primary dealers, taking in a wider range of collateral on loans, lending \$30 billion to support the takeover of Bear Stearns, and pledging backup support to Fannie Mae and Freddie Mac. I would note that such steps are taking the Federal Reserve well beyond its traditional policy boundaries and are broadening its financial stability mandate to encompass much more than the banking system and its usual links to the financial marketplace and the overall economy.

An apt analogy would be to say that the recent market turmoil has taken us to the other side of the river from where we have traditionally operated. Consequently, we must ask ourselves if we should stop and stay where we are today, continue and go even farther into this uncharted territory, or try to find a way to go back across the river to our previous and well-known position.

More specifically, should the Federal Reserve, as well as other central banks facing the same pressures, seek to formalize this broader role in financial stabilization? If so, a logical step in this process would be for central banks to take on whatever supervisory authority would seem necessary for overseeing the entities operating in this expanding marketplace and for protecting a much wider safety net. Or, alternatively and after the current crisis abates, we could select a path that would take us back to our traditional role and a more carefully defined and contained safety net? Under this approach, many would take steps to strengthen or provide more inherent resiliency to those areas that have suffered the most from recent market breakdowns, which would reflect the positive side of market discipline.

What course we choose is of critical importance to the future role of central banks and to their ability to maintain independence in formulating policy. I would like to explore these questions next in terms of two issues: the appropriate use of the federal safety net and the implications for monetary policy under a broadening mandate.

Safety net issues and moral hazard concerns

The public policy actions directed toward Bear Stearns, primary dealers, and Fannie Mae and Freddie Mac have resulted in a significant expansion of the safety net and the Federal Reserve's lending practices. Now that more financial activities have gravitated outside of the banking system, more financial stability concerns seem destined to arise. Our lending to support the takeover of Bear Stearns and to provide liquidity to primary dealers, for example, has taken the Federal Reserve well beyond its traditional approach of injecting discount window funds through the commercial banking system.

This new financial framework, consequently, leaves us with several distinct choices. Some, for instance, have suggested that we should extend more of a bank-like supervisory and regulatory framework over the major players in this broader financial marketplace in return for their having access to the discount window and other possible forms of public assistance. Others, though, believe that such oversight and safety net responsibilities could lead to a range of problems and an even more fragile marketplace by compounding moral hazard problems and by reducing the role that market discipline could play in strengthening our financial markets and fostering innovation.

In general, most recognize that we must think carefully about permanently extending the financial safety net and the Federal Reserve's lending responsibilities. Using the Federal Reserve's resources to address breakdowns within a broader financial marketplace will necessarily benefit the assisted institutions, and the particular market segments or financial instruments associated with the problems. Also it is important to keep in mind that many other market participants who have made more prudent decisions will be left at a

disadvantage by having to compete without such special favors. For the Federal Reserve and other public authorities, such a role would thus involve a host of difficult decisions during a financial crisis and would potentially put the Federal Reserve in the position of having to pick the winners and losers from a broad range of financial institutions and investors. Moreover, as the Bear Stearns experience shows, these decisions may have to be made in a hurry and with limited information in many cases, and any actions will likely raise questions about why some segments of the economy are protected while others are not. This is a difficult position to find ourselves in and its consequences must be carefully weighed before we choose such a course of action.

In providing liquidity or other assistance to market participants who have made unwise decisions, we risk magnifying the moral hazard problems in financial markets. These moral hazard problems will arise as any substantial public assistance works to undermine market outcomes and thereby reduce the incentives that institutions and investors have to manage risk and make sound choices. One need only look to the GSEs Freddie Mac and Fannie Mae to witness the effects such favored treatment has in the marketplace.

Perhaps the most prominent example of moral hazard risks is the “too-big-to-fail” problem associated with large commercial banks. As I have noted in prior speeches, this has proven to be a very intractable issue for banking regulators. We all recognize that extending public safety nets, discount window lending and bank-like supervision to a much broader marketplace risks creating a financial system of less inherent stability and an ever larger class of “too-big-to-fail” institutions. Over time it would involve making difficult decisions regarding what segments of the broader financial system should be supervised, how extensively they should be supervised, and whether this supervision would adequately protect the safety net in this new environment.

When we consider these consequences it becomes more apparent, to me at least, that we must strive to limit public safety nets and minimize their associated moral hazard problems. There are a number of policy steps we should consider to help markets function in a more orderly fashion and become more resilient to financial crises. To return to my analogy, this means doubling back across the river to a more historical central banking role, and making clear a future crossing would be rare. And we must accept that the credibility of such an assertion will depend critically on how future crises are handled.

If we choose to double back, then we must also direct more supervisory focus to the market interdependencies among commercial banks, and we must institute better mechanisms to unwind failing nonbank financial institutions and their counterparty exposures. We should continue to pursue initiatives with the private sector to increase market transparency, enhance corporate governance mechanisms and market incentives, and strengthen settlement systems and trading and securitization markets. And it should be clear that major nonbank financial institutions that seek discount window assistance will immediately come under Federal Reserve oversight. This oversight would be directed toward ascertaining the viability and exposures of such institutions and controlling potential safety net losses.

Implications of a broadening mandate for central banks

Finally, let me now turn my remarks toward a discussion of the macroeconomic implications of broadening the Federal Reserve’s traditional dual mandate for price stability and maximum employment to include more explicit responsibilities for financial stability. The events of the past year have been especially useful in articulating the challenges that may arise in implementing a tripartite mandate. I would like to focus on the following four questions as particularly important to our understanding of how financial stability fits into a central bank’s portfolio of responsibilities.

First, can we define a set of principles to guide a central bank’s mandate for financial stability? This is a key issue for a central bank in determining when it needs to take actions to

preserve financial stability or, conversely, when it should refrain from doing so, particularly in situations when political and industry pressures may be calling for a policy response. It is also essential if a central bank is to know when to unwind and remove policy accommodation or special liquidity measures. Defining the principles guiding our financial stability mandate is also important for central banks in communicating with the public and for formulating meaningful debates within the central bank.

Second, does a central bank have the ability to effectively pursue a tripartite mandate? That is, does it have enough policy tools, and will these tools be effective in a financial crisis? I think it is fair to say that, at the outset of the current crisis, central banks did not have practiced mechanisms in place to provide liquidity to the institutions and markets most in need of liquidity. Over the past year, the Federal Reserve and other central banks have shown considerable flexibility and ingenuity in addressing these needs. It remains to be seen, of course, whether some of these facilities will be made a more permanent part of the central bank's policy toolkit.

At the same time, it is sometimes the case that the stimulus provided by lowering the policy rate is less effective in a financial crisis because important parts of the policy transmission mechanism are dysfunctional. This difficulty was highlighted in the current crisis where the financial difficulties centered on housing, which is typically a key component of the transmission mechanism. And, it was even more dramatically illustrated in the Japanese banking crisis a few years ago where monetary policy was pushed to its limits with very little effect. As I have indicated on other occasions, care must be taken not to ask too much of monetary policy or we risk adding significant inflationary pressures into an economy.

Third, how does a central bank trade off potentially conflicting objectives under a tripartite mandate? Central banks, for instance, may have more to deal with than a financial crisis. In the current situation, we have experienced a severe financial shock coupled with a surge in global inflation. In the face of accelerating inflation, it is important that we not calibrate policy principally to deal with the financial crisis if it involves compromising to an unreasonable extent our ability to achieve our mandate for price stability. In the United States, core PCE inflation has been above most definitions of price stability for the past four years and is poised to move even higher over the near term. The current stance of policy, while understandably calibrated for responding to the immediate financial crisis, will make it difficult to achieve our mandate for price stability over the longer term.

Finally, how can a central bank implement a financial stability mandate while maintaining the independence needed to actively pursue its other mandates? As I noted earlier, in the midst of a financial crisis, a central bank will likely be encouraged to take actions that are fiscal in nature or that directly affect the allocation of credit by targeting assistance or liquidity to specific institutions, markets or financial instruments. These actions necessarily affect expectations for similar actions in the future and bring forward political pressures that confirm such expectations for the future. In these circumstances, a central bank must be particularly aware of the difficult trade-offs between its financial stability and price stability mandate, especially where, like the United States, the central bank does not have a formal objective for price stability.

Concluding thoughts

Let me conclude by emphasizing the broader applicability of the issues that I have discussed today. Although I have focused my remarks mainly on the Federal Reserve, I believe many of the issues raised by this period of financial stress have important implications for other central banks as financial market liberalization and development proceed around the world. Maintaining financial stability in a changing financial system is a difficult task and, realistically, financial crises will occur in the future despite our best efforts to prevent them. Addressing these issues requires a delicate balance between markets and policy intervention and requires recognition of the important macroeconomic implications for central banks.

While there can be little doubt that central banks will continue to have responsibility for financial stability going forward, recent events raise important questions about how this mandate should be implemented.

Finally, for a market economy to work best, it must to the maximum extent possible find a balance between financial stability and a stable price environment and in doing so must be able to allow individual institutions to fail. The “Too Big to Fail” issue will only grow in importance as the consolidation of the financial industry grows in both size and scope in future decades.