Thomas C Baxter, Jr: Financial stability – the role of the Federal Reserve System

Remarks by Mr Thomas C Baxter, Jr, Executive Vice President and General Counsel of the Federal Reserve Bank of New York, at the Future of Banking Regulation and Supervision in the EU Conference, Frankfurt am Main, 15 November 2013.

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Today we gather to celebrate the career of a great central bank lawyer, Antonio Sáinz de Vicuña, who is retiring from his position as general counsel of the European Central Bank. The accomplishments of the European Central Bank (ECB*)* in a short period of time are a huge credit to the people who built the organization. Antonio is one of those people. He was there even before the very beginning, given his position as general counsel of the European Monetary Institute back in 1994.

Many here have heard Antonio talk about those seminal first days, when European monetary union was considered nothing more than a remarkable experiment that would never become a reality. Of course, monetary union within the Eurozone has become reality, and the success of the ECB has inspired the ECB's latest challenge. As Antonio retires, the ECB is taking the first important steps toward becoming a pan-European banking supervisor. The fact that banking supervision is being entrusted to the ECB is perhaps the best evidence of its overwhelming success as a European institution.

Of course, it is rare that great success comes without hardship. The global financial crisis has tested both the ECB and the organization that I am privileged to serve, the Federal Reserve. The Federal Reserve's financial stability role, my topic for today, was at the center of the response to the crisis in the United States. Because this was the worst financial crisis in the United States since our Great Depression, conditions within our national economy produced instability, which naturally provoked a reaction from the Federal Reserve.

From my personal perspective, one of the most inspiring moments was when Chairman Bernanke spoke in February of 2009 at the National Press Club. There, he said "the Federal Reserve has done, and will continue to do, everything possible within the limits of its authority to assist in restoring our nation to financial stability and economic prosperity . . . ."[1] No statement encapsulated the financial stability objective as succinctly and as clearly.

In speaking here at the ECB, I would be remiss if I did not mention a substantially similar statement by ECB President Mario Draghi in July of 2012. President Draghi said that "[w]ithin our mandate, the ECB is ready to do whatever it takes to preserve the euro".[2] Whenever I have referenced President Draghi's "whatever it takes" statement, Antonio is quick to note that President Draghi, unlike Chairman Bernanke, appended a forecast to his version of "whatever it takes". He assured everyone that "it will be enough".

Now this audience of lawyers will pay special attention to both quotations, because each notes that the central bank must act within the bounds of its legal authority. It is not simply "whatever it takes" come hell or high water; it is "whatever it takes" within the central bank's mandate, thereby turning attention to the limits set by the substantive law. The Bernanke and Draghi statements are consequential not only because they highlight objectives of critical importance to each central bank, namely financial stability for the Federal Reserve and preservation of the euro for the ECB. The statements also highlight that the central bank

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1 Ben S. Bernanke, Chairman, Board of Governors of the Federal Reserve System, Speech at the National Press Club Luncheon, February 18, 2009.

2 Mario Draghi, President of the European Central Bank, Speech at the Global Investment Conference in London, July 26, 2012.

objective is to be achieved within the boundaries set by the rule of law. Who is it that is called upon to declare and interpret the boundaries of the central bank mandate? It is the central bank's legal counsel.

I am asked periodically about the legal basis for the Federal Reserve's financial stability objective. Students of the Federal Reserve read our nearly 100-year-old enabling statute, the Federal Reserve Act, and cannot find the words "financial stability" anywhere in the Act. How, then, can financial stability be a part of the Federal Reserve's mandate? My response is that you do not need to see the words "financial stability" in the Federal Reserve Act for that to be a key part of our mandate. The Federal Reserve's financial stability mandate is seen in the penumbra of the Federal Reserve Act, and that is legally sufficient. Without trying to cover this important topic exhaustively as in a formal legal opinion or a brief filed with a court, let me outline here the essence of the analysis.

The starting point in every discussion of the Federal Reserve's mandate is Section 2A of the Federal Reserve Act, known to many as the dual mandate. It directs the Federal Reserve "to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates."[3] While there are actually three discrete objectives in the dual mandate, most economists would say that moderate long-term interest rates are a tool to produce maximum employment and price stability. Such economic reasoning also involves some clever and simple arithmetic – it reduces a tripartite mandate to a dual mandate. With respect to financial stability, leading economic thinkers would now say, and the financial crisis seems to offer us the perfect illustration, that price stability and maximum employment are possible only in a context of financial stability. This is an implicit part of what Chairman Bernanke was communicating at the National Press Club – until financial stability could be restored, the ability to achieve the goals of maximum employment and price stability through the monetary transmission mechanism were beyond the Federal Reserve's reach. Accordingly, the Federal Reserve used its monetary policy tools to lower the targeted Fed funds rate to zero. In addition, the Federal Reserve used its lender of last resort authorities in new and creative ways to restore financial stability to the U.S. economy.

When the crisis in the United States abated in late 2009, following the successful introduction of stress testing, the Federal Reserve began to speak about terminating some of its emergency facilities. These facilities had been introduced during the "whatever it takes" era, and when the Federal Reserve was executing the delicate task of winding these facilities down, the Federal Open Market Committee (FOMC) made clear that financial stability remained a key objective. For example, the Committee said in its release of December 16, 2009 that "[t]he Federal Reserve is prepared to modify these [wind down] plans if necessary to support financial stability and economic growth."[4]

The legal basis for deriving implied powers from the penumbra of other express powers is best seen in Justice Douglas classic opinion in ***Griswold v. Connecticut.***[5] In the ***Griswold*** case, the United States Supreme Court struck down a Connecticut law prohibiting the use of contraception. Justice Douglas' opinion struck that law down as inconsistent with a Constitutional right of privacy, notwithstanding that the U.S. Constitution nowhere mentions any such right, let alone even using the word "privacy". Justice Douglas noted that individual privacy concerns were protected by a series of express Constitutional provisions, like the Third Amendment's prohibition on quartering soldiers during peacetime, the Fourth Amendment's right to be free from unreasonable search or seizure, and the Fifth Amendment's right against self-incrimination. He also reasoned that "the First Amendment

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3 12 U.S.C. § 225a.

4 Federal Open Market Committee statement, December 16, 2009.

5 381 U.S. 479 (1965).

has a penumbra where privacy is protected from governmental intrusion,"[6] in particular the right of association.

Similarly, the Federal Reserve Act has a penumbra where the Federal Reserve derives its mandate to ensure financial stability, such that it may achieve the Section 2A dual mandate of price stability and maximum employment. The key point here is that the Federal Reserve's financial stability mandate is derived from what lies in the penumbra, not from any express reference to financial stability in the Federal Reserve Act itself. Of course, in the wake of the financial crisis, the scope of Federal Reserve power was directly affected by remedial legislation.

The remedial legislative response to the financial crisis in the United States was the Dodd-Frank Act.[7] While the Federal Reserve Act did not use the words "financial stability", this was not the case with the Dodd-Frank Act. Instead of being observed in the penumbra, financial stability is an open and obvious topic of the new law. Title 1 of the Dodd-Frank Act is named the "Financial Stability Act of 2010."

One of Title 1's most consequential provisions is Section 165, which empowers the Board of Governors to develop enhanced prudential standards for systemically important financial institutions.[8] In a provision directly affecting central bank powers, the Congress instructs the Federal Reserve to develop prudential standards "to prevent or mitigate risks to the financial stability of the United States that could arise from the material financial distress or failure, or ongoing activities, of large interconnected financial institutions."[9] There are other provisions of the Dodd-Frank Act granting new powers to the Federal Reserve with respect to financial stability, and time does not permit me to review all of them here. One very obvious provision is the Dodd-Frank Act's Section 604, which amends the Bank Holding Company Act to direct the Federal Reserve to consider, when it evaluates an application for approval of a proposed acquisition, merger, or consolidation, whether it "would result in greater or more concentrated risks to the stability of the United States banking or financial system."[10] In commenting during a recent press conference about the Federal Reserve's objective as a consolidated supervisor of the holding company of many systemically important financial groups, Chairman Bernanke said "the primary goal of the consolidated supervision by the Fed is to make sure that the firms – the firm doesn't in any way endanger the stability of the broad financial system."[11]

Today, both the penumbra of the Federal Reserve Act and the express terms of the Dodd-Frank Act place financial stability within the Federal Reserve's legal mandate. During the crisis, the Federal Reserve needed to restore financial stability so that the Federal Reserve could work to achieve price stability and maximum employment. The effort at restoration caused us to explore techniques we had never used before, and, as Chairman Bernanke exhorted us, to do "whatever it takes." To succeed with this mission, lawyers at the Federal Reserve needed to interpret our authority in new and different ways, and we did so.

I hope that my remarks today reflect on that important function of counsel. The role of counsel, of course, does not end with interpreting legal authorities to address new and unanticipated challenges. It also involves patrolling the frontiers of our powers and

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[6] Id. at 483.

[7] Dodd Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111–203, 124 Stat. 1376 (2010).

[8] 12 U.S.C. § 5365.

[9] 12 U.S.C. § 5365(a)(1).

[10] 12 U.S.C. § 1842 (c)(7).

[11] Ben S. Bernanke, Chairman, Board of Governors of the Federal Reserve System, September 18, 2013, Press Conference.

recognizing where and when the rule of law forecloses options. This is essential to the credibility of the central bank, a concept closely connected with the public's trust.

To conclude, I hope these remarks about financial stability also reflect on what our legal colleagues have accomplished at the ECB. In this regard, I pay tribute to the leadership of Antonio Sáinz de Vicuña, and to his work not only in presiding at the birth of the euro, but guiding the ECB to take the extraordinary actions necessary to preserve the euro. As President Draghi accurately forecast, they have been enough. Antonio, as you step down as general counsel, I congratulate you on the accomplishment of the mission, and applaud you for a job well done.

Thank you, ladies and gentlemen, for your kind attention.

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