Charles I Plosser: Simplicity, transparency, and market discipline in regulatory reform

Remarks by Mr Charles I Plosser, President and Chief Executive Officer of the Federal Reserve Bank of Philadelphia, at the conference on "Enhancing Prudential Standards in Financial Regulations", cohosted by the Federal Reserve Bank of Philadelphia, the Wharton Financial Institutions Center, and the *Journal of Financial Services Research*, Philadelphia, Pennsylvania, 8 April 2014.

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The views expressed are my own and not necessarily those of the Federal Reserve System or the FOMC.

Highlights

- President Plosser believes simple regulations are easier for financial firms to follow, increase the likelihood that supervisors will consistently enforce them, and are more likely to foster financial stability.
- President Plosser argues that revealing more information about an individual firm's risk will reduce the likelihood of contagion and runs because such events are generally a result of a lack of information, rather than too much information.
- President Plosser continues to advocate for a new bankruptcy mechanism suitable for all financial firms, whether systemically important or not, because it would restore the incentives of market participants and creditors, in particular, to monitor risk taking by these institutions.

Introduction

I am delighted to welcome you to the Federal Reserve Bank of Philadelphia. We are very pleased to partner with the Wharton School and the *Journal of Financial Services Research* in this joint conference on "Enhancing Prudential Standards in Financial Regulations". I want to acknowledge and thank the organizers for assembling such a distinguished group of academics and practitioners to discuss the ongoing efforts to improve our financial system.

I am going to take advantage of my role as host to offer some of my own thoughts on financial regulations and financial stability. I will present a high-level perspective of the subject. I don't plan to let the messy details get in the way of lofty thoughts. Instead, I believe it is helpful to step back from the complicated details of financial regulation to think more broadly about the goals and objectives of reform and the strategies that might best get us there. Of course, these views are my own and should not be interpreted as representing the Federal Reserve System.

I think we all agree that financial markets and intermediaries play an important economic role by pooling funds from savers and investors and allocating these resources to their most productive uses. Such allocations require financial intermediaries to assess and price various risky claims. They then can sell some of the risks, either duration or credit risk, to investors and others who are willing to bear that risk. Thus, intermediaries help allocate resources and risks throughout the economy, thereby improving efficiency and productivity.

At times, however, financial intermediation can result in risks becoming concentrated in ways that increase rather than reduce the fragility of the financial system more broadly. This is what many people mean when they refer to systemic risk. While today I will use the term in this fashion, I would note that the concept is quite vague. One of the major difficulties we face in managing systemic risk is defining what it is and how to measure it. Ideally, one important goal of financial supervision and regulation is to monitor risk in the financial system and reduce the chances that it inadvertently leads to financial fragility or instability. Regulation, however, should seek to do so without impeding the healthy functioning of financial markets and institutions.

In response to the financial crisis, Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act in 2010, which included enhanced capital and liquidity standards and risk-management requirements for large financial institutions thought to be systemically important.

In addition to new regulations, the crisis brought about important changes in supervision. Supervisors are taking a macroprudential approach to their responsibilities. Rather than focusing on the risk in a single institution, supervisors are spending more time analyzing risks across firms. Large financial firms are now required to have stronger data and information systems so they can better monitor and manage their own risks. And these firms are required to report higher quality data to supervisors. The Federal Reserve now utilizes these data as well as other information it receives to conduct more in-depth and timely assessments of emerging risks. Access to better data has also enabled supervisors to conduct the supervisory stress tests required by Dodd-Frank, which assess the ability of these large institutions to withstand a severe economic downturn.

This conference will address the efficacy of many of these individual elements of Dodd-Frank and of supervisory reforms, which are still evolving nearly four years after the legislation was first enacted. For the remainder of my remarks, I wish to explore three broad principles that I believe we need to consider as we search for ways to improve the stability of our financial system. The first is simplicity. Our regulatory framework is becoming increasingly complex, which has led to rising compliance costs as well as enforcement costs. The second principle is transparency. Financial markets and instruments have also become increasingly complex and in some cases occasionally opaque. Ensuring that financial instruments and firms are sufficiently transparent can contribute to greater efficiency and awareness of risks exposures. The third principle I will stress is the role that market forces can play in effectively controlling risk-taking and enhancing supervision.

Simplicity

Let me begin with simplicity. The financial world has become very complex and so has financial regulation. It is easy to claim that complex regulation is necessitated by the increasing complexity of the financial markets. After all, regulations are, in part, shaped by evolving market structures. In some cases, new regulations arise in response to a crisis or a perceived failure of some kind. Unfortunately, markets often evolve faster than the regulations; detailed rule writing that underlies much of the complex regulation can become obsolete, which then requires more rule writing.

Yet, we should consider that causality can work both ways. Regulations themselves give rise to incentives to evade the rules. Such regulatory arbitrage can result in increasingly complex financial structures designed to fall outside existing rules. This activity then begets more complex rules that markets once again seek to avoid. Consider the increasing complexity and granularity of the Basel risk-weighting classifications. The logic of assessing capital requirements based on the risk of an institution's assets is sensible in principle; however, it creates incentives for institutions to structure assets in ways that minimize the use of capital, perhaps resulting in risks that become hidden in opaque or complex structures that are not addressed by specific rules or classifications found in the Basel framework.

Such a cycle of increasing complexity raises both compliance costs and enforcement costs. Thus, I believe, there is merit in developing simpler, more transparent regulatory solutions designed to work reasonably well in a wide range of situations. For example, higher capital requirements based on the leverage ratio, as opposed to overly complex risk-weighting schemes, might lower both compliance and enforcement costs while achieving similar or better outcomes in terms of the safety and soundness of individual institutions as well as overall financial stability.

Moreover, there are examples of how market participants' reactions to regulation may have contributed to the recent financial crisis. For instance, the expansion of the shadow banking system was in many ways a result of attempts to circumvent regulations placed on banking institutions. Similarly, the use of bond ratings in setting bank capital requirements for securities holdings or in making eligible certain structured products for various investment purposes created incentives to inflate ratings of collateralized debt obligations, or CDOs, and other structured products backed by subprime mortgages. Consider bankruptcy rules that exempt overnight swaps and repurchase agreements from the traditional stays when a company files for bankruptcy. Such rules reduce the incentive for lenders to monitor counterparty risk and thus effectively lower the relative cost of using short-term funding to finance an intermediary's or investment firm's balance sheet. As we know, the reliance on short-term funding from sources totally immune from counterparty risk can contribute to increasing risks of contagion and runs on financial institutions.

Increased regulatory complexity can make consistent enforcement of the rules more difficult. Inconsistent enforcement can make it harder for financial institutions to predict how regulators are likely to behave. Such uncertainty can make the financial system less efficient and can undermine the credibility of the regulatory regime, thereby making the regime less effective in fostering financial stability. In contrast, simple regulations are easier for financial firms to follow, increase the likelihood that supervisors will consistently enforce them, and are therefore more likely to have the desired effect.

Transparency

Next, let me turn to transparency. Economists for the most part think transparency is a good thing, and I am no exception. I will talk about transparency from two perspectives. The first is transparency regarding financial institutions and financial products. The second is transparency by regulators.

As is true of financial regulations, financial instruments have become increasingly complex, whether due to market demands or incentives created by regulation. Whatever the reason, it is entirely appropriate to require adequate disclosure and transparency regarding the structure and risk of both the instruments and the institutions. Such transparency allows markets to better price the inherent risks of the securities and the firms. So put me in the camp of more disclosure and transparency.

But just as markets can use information on securities and firms to improve market prices and assess risk exposures, markets are also likely to find value in regulatory information. As a bank regulator, the Federal Reserve gets a detailed view of how large financial institutions measure and manage risk. Banks and supervisors now use a host of sophisticated models and techniques to assess risks.

There has been a long debate about the potential costs and benefits of releasing some regulatory information once treated as confidential. Many policymakers now believe that public disclosure of additional information concerning the financial condition, risk exposures, and supervisory assessments of firms would be beneficial to financial stability. Greater transparency would enable market participants to better assess the risks of counterparties and thereby exert more effective market discipline.

Increased transparency about supervisory practices would also allow financial firms to have greater confidence about the "rules of the road". This would reduce regulatory uncertainty and the inefficiencies of regulatory arbitrage as firms try to guess what's on the minds of regulators. When firms have a better understanding of regulatory requirements, they can appropriately evaluate the economic costs and benefits of their decisions.

Of course, there are concerns that too much transparency can have unintended consequences. The added information could lead to instability by creating runs on financial institutions if market participants misunderstand or overreact to negative news. Increased transparency might reduce the quality and quantity of information that financial firms would share with regulators. While these concerns may be legitimate, I would argue that revealing more information about individual firms will reduce the likelihood of contagion and runs, as such events generally arise from a lack of information, rather than too much information, about the riskiness of an individual firm.

Market discipline

The final principle I would like to stress is the role of market discipline. I believe that market discipline can be a powerful tool in controlling the risk-taking of financial institutions. Notice that transparency is an important ingredient in effective market discipline, since a more informed market is likely to function more efficiently and set the prices of securities and firms more accurately.

As we seek to improve and strengthen financial stability, we should think about mechanisms to make market forces more effective, not just write rules that attempt to substitute for market forces. Creating incentives for markets to monitor and price risk-taking by financial institutions, rather than have markets simply assume that regulators have monitored the risk for them, is a desirable outcome. A complex and nontransparent regulatory regime can create its own form of moral hazard. Thus, efforts to enhance the effectiveness of market discipline are beneficial as they reduce the necessity of rules and interventions that can create perverse or unintended consequences and the potential for moral hazard.

As one example of how regulation could harness market forces to promote financial stability, some have proposed that financial institutions be required to issue subordinated debt. Owners of subordinated debt have a strong incentive to monitor risk-taking by these firms, as they are last in line in the event of failure. Others and I have argued for contingent debt that would convert to capital, in response to specific market triggers indicating that the firm was under stress. Such automatic recapitalization would help prevent firms from failing in the first place. Managers would have a strong incentive to avoid taking on risks that might lead to such events, as they would dramatically dilute existing shareholders.

Another way markets can aid supervision is through the information they can provide to supervisors. Markets aggregate many risk assessments into a single measure, such as the price or quantity traded of a security. These market measures can be compared across institutions to provide an indication of relative risk. The measures can also be monitored over time to provide indications of changes in risk. Market participants have strong financial incentives to correctly price a firm's risk. Since market prices of securities tend to be forward-looking, they reflect investors' expectations given the current information.

There are several examples of how market signals could be incorporated into the regulatory process. For instance, if financial firms were required to issue subordinated debt, as I have just discussed, supervisors could monitor a bank's subordinated debt spreads for indications of emerging risk and take appropriate actions in response. This strategy is supported by evidence that subordinated debt spreads do increase with the risk profile of the issuers.

Others have argued for using credit default swap spreads or market-based capital measures in the supervisory process. In particular, the Federal Reserve has proposed using market signals in establishing thresholds for "early remediation" under the Dodd-Frank Act.

The argument for greater use of market data in bank supervision is not that market signals are always superior to supervisory assessments, but that market data can complement information gathered by examiners. There is still much to learn about how best to combine market data with examiner data to improve supervisory assessments of risk in the financial system, and additional research in this area could prove highly useful.

Of course, if we want to effectively leverage market discipline, then we have to address the problem of too big to fail. If creditors perceive they will be rescued, then market discipline is undermined and moral hazard will lead to greater risk-taking by the institutions. It is important to recognize that the moral hazard problem is not mitigated by eliminating the potential for government support. It doesn't matter where the money comes from to rescue creditors. Any means of providing an implicit or explicit subsidy to protect creditors undermines market discipline and creates moral hazard. Without an effective and credible resolution regime that ensures no subsidies to creditors, there is less incentive for markets to monitor a firm's risk – thus, the firm's risk would not be accurately reflected in security prices.

Title II of the Dodd-Frank Act expanded the existing authority of the Federal Deposit Insurance Corporation (FDIC) to resolve failing banks including those that are deemed systemically important. While the objective is to end too big to fail, I have argued that the reforms as currently envisioned are unlikely to do so. The expansive discretionary power given to the FDIC under Title II could make it vulnerable to political pressure regarding the bailout of individual institutions or creditors. Keep in mind that Title II resolution is triggered only when there are concerns about systemic risks. The discretionary aspect of Title II could cause creditors to perceive that their payoffs would be determined through a regulatory resolution process, in which political pressure can be brought to bear, independent of the rule of law. Some have suggested that there be a tax on the financial industry to provide support for the resolution scheme proposed by the FDIC. While this may get the taxpayer off the hook, it does not solve the too-big-to-fail problem.

On a number of occasions, I have advocated a new bankruptcy mechanism suitable for all financial firms, whether systemically important or not, to alleviate most of the potential problems caused by the discretionary and targeted nature of Title II.[1] A bankruptcy process tailored for financial institutions would restore the incentives of market participants and creditors, in particular, to monitor risk taking by these institutions. I find this a more appealing and effective path to ending too big to fail.

Conclusion

To conclude, simplicity and transparency are important principles to enhance prudential standards in financial regulations and financial stability. Simple, transparent regulatory mechanisms make it easier for market participants to predict how regulators are likely to behave. This, in turn, makes it easier for regulators to credibly commit to implementing the regulations in a consistent manner, thereby increasing the effectiveness of the regulatory regime.

An increased role for simple regulatory mechanisms that are harder to evade – and even better, mechanisms that utilize market forces to discipline firm behavior – is superior to an ever-expanding list of complex rules that seeks to cover every possible outcome. In many circumstances, simpler and more transparent regulatory approaches, that also enhance the effectiveness of market discipline, can better achieve financial stability while maintaining a dynamic financial system that meets the needs of our economy.

1 See Charles Plosser, "Reducing Financial Fragility by Ending Too Big to Fail", speech before the Eighth Annual Finance Conference, Boston College Carroll School of Management , Boston, MA, June 6, 2013.