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A Systemic Regulator for Financial Markets

Squam Lake Working Group on Financial Regulation
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The Squam Lake Working Group on Financial Regulation is a nonpartisan, nonaffiliated group of fifteen academics who have come together to offer guidance on the reform of financial regulation.

The group first convened in fall 2008, amid the deepening capital markets crisis. Although informed by this crisis—its events and the ongoing policy responses—the group is intentionally focused on longer-term issues. It aspires to help guide reform of capital markets—their structure, function, and regulation. This guidance is based on the group’s collective academic, private sector, and public policy experience.

To achieve its goal, the Squam Lake Working Group is developing a set of principles and their implications that are aimed at different parts of the financial system: at individual firms, at financial firms collectively, and at the linkages that connect financial firms to the broader economy.

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A Systemic Regulator for Financial Markets

INTRODUCTION

Financial regulations in almost all countries are designed to ensure the soundness of *individual* institutions, principally commercial banks, against the risk of loss on their assets. This focus on individual firms ignores critical interactions between institutions. Attempts by individual banks to remain solvent in a crisis, for example, can undermine the stability of the system as a whole. As we saw with Bear Stearns, Lehman Brothers, and the UK bank Northern Rock in the current crisis, if one financial institution prudently reduces its lending to a second, the loss of funding may cause grave problems for the borrower. Similarly, the failure of one financial institution can inflict severe losses that threaten the viability of many others.

The focus on individual institutions can also cause regulators to overlook important changes in the overall financial system. For example, although the markets for securitized assets and the shadow banking system of lightly regulated financial institutions grew dramatically in the years before the current crisis, the existing regulatory structures did not evolve with them.

The solution to this narrow institutional focus is simple: *One regulatory organization in each country should be responsible for overseeing the health and stability of the overall financial system. The role of the systemic regulator should include gathering, analyzing, and reporting information about significant interactions between and risks among financial institutions; designing and implementing systemically sensitive regulations, including capital requirements; and coordinating with the fiscal authorities and other government agencies in managing systemic crises. We argue below that the central bank should be charged with this important new responsibility.*

WHAT SHOULD THE SYSTEMIC REGULATOR DO?

The primary role of the systemic regulator should be to prevent financial crises.

First, the systemic regulator should gather, analyze, and report systemic information. In a related paper, we argue that a new information infrastructure is needed for regulators to understand trends and emerging risks in the financial industry. This will require reporting from a broad range of financial institutions, with standardized measures of position values and risk exposures. Such information is valueless unless it can be analyzed, and this is a natural function of the systemic regulator. In addition, to enhance general awareness of systemic issues, we argue that the systemic regulator should prepare an annual report to Congress on the risks of the financial system.¹

Second, the systemic regulator should design and implement financial regulations with a systemic focus. For example, capital requirements for regulated financial institutions should depend on the systemic risk they pose. Large banks holding illiquid assets and relying heavily on short-term debt should be required to hold proportionately more capital than smaller banks with more liquid assets

and more stable financing arrangements. The systemic regulator should design and administer these capital requirements, and should negotiate with regulatory authorities in other countries to ensure that capital requirements are broadly comparable internationally.²

The crisis prevention role of the systemic regulator is paramount. Ideally, crises should be prevented. In the unlikely event that a crisis does erupt, however, a third role for the systemic regulator is to contribute to the management of the crisis.

We argue elsewhere that banks should be encouraged, and possibly required, to issue hybrid securities that have the properties of debt unless and until a financial crisis occurs. At that time, the securities convert to equity if the financial condition of the issuing bank is sufficiently weak, recapitalizing the bank in an efficient manner without any need for an injection of taxpayer funds. The systemic regulator should be responsible for declaring the occurrence of a financial crisis, which is one part of the double trigger for debt-equity conversion.³

To be sure, the fiscal authority (the Treasury and the Federal Deposit Insurance Corporation, or FDIC) will be ultimately responsible for the use of public funds, but the systemic regulator will be the eyes and ears of the coordinated public response once a financial crisis is under way, as well as the channel for specific policy responses, such as emergency loans, to mitigate the crisis.

WHY IT IS IMPORTANT TO SEPARATE SYSTEMIC REGULATION FROM OTHER FINANCIAL REGULATION

Financial regulators are often asked to protect consumers and to enforce “conduct of business” rules against insider trading and other market abuses. The skills and mindset required to fulfill these important regulatory roles are fundamentally different from those required by a systemic regulator.

Protecting consumers and prosecuting market abuse involve setting and then enforcing the appropriate rules under a transparent legal framework. Such work is primarily done by lawyers and accountants who specialize in rule-making and enforcement. As we have seen with the U.S. Securities and Exchange Commission in the current crisis, a legally oriented, rule-enforcing regulator is ill-equipped to cope with a systemic crisis caused by a financial system that has outgrown the existing set of rules. What is needed is a regulator with the expertise to monitor financial innovations, such as the growth of the shadow banking system; to diagnose likely weaknesses in the financial system; and to pursue policies that can head off likely systemic problems.

The orientation of an effective systemic regulator must be different from that of a rule-enforcing consumer protection or conduct of business regulator. A regulator charged with both enforcing rules and managing systemic risk will eventually devote too much of its attention to rule enforcement. By their nature, severe systemic crises are rare events. In the normal day-to-day business of a regulatory organization, the individuals who flourish are those who have demonstrated expertise solving current problems, not those addressing systemic concerns that may never materialize. As a result, the regulatory culture will gravitate toward consumer protection and conduct of business roles. This is apparent in the behavior of the financial regulators around the world who have adopted the U.K.-style unified regulatory system.⁴

A second problem with the combination of systemic and consumer regulation is that consumer regulation is highly charged politically. Because consumer regulation affects so many constituents, politicians sometimes put tremendous pressure on regulators to take actions to protect consumers without worrying about unintended consequences. Political pressure on a systemic regulator due to

politicians' unhappiness with its role as a consumer regulator may interfere with the regulator's independence and ability to perform systemic regulation.

The arguments above imply that the role of systemic regulator should be separate from a consumer protection and business practices regulator.

WHY CENTRAL BANKS SHOULD SERVE AS SYSTEMIC REGULATORS

The central bank is the natural choice to serve as the systemic regulator for four reasons.

First, the central bank has daily trading relationships with market participants as part of its core function of implementing monetary policy and is well placed 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.

Second, the central bank's mandate to preserve macroeconomic stability is well matched to the role of ensuring the stability of the financial system. Macroeconomic downturns are often tightly connected to the financial system, and similar analyses, drawing on the disciplines of macroeconomics and financial economics, can provide guidance for both types of oversight. As a result, macroeconomic policy and systemic regulation are tailor-made for each other.

Third, central banks are among the most independent of government agencies. Successful systemic regulation requires a focus on the long run. Because they face relatively short reelection cycles, politicians tend to focus on the short run. Insulating the systemic regulator from day-to-day interference by politicians will help ensure a systemic regulator's success. The respect and independence that central banks enjoy therefore make them natural candidates to be systemic regulators.

Fourth, the central bank is the lender of last resort. It has a balance sheet that it can use as a tool to meet systemic financial crises. As the lender of last resort, it will be called on to provide emergency funding in times of crisis. Too often during the current crisis, central banks have been drawn in at the last minute to provide funding to institutions about which they had no firsthand knowledge. Northern Rock in the United Kingdom was supervised by the FSA, and Bear Stearns in the United States was supervised by the SEC. No amount of information sharing can substitute for the firsthand information gathered in direct on-site examinations. If a central bank will be asked to lend money to save an institution, it makes sense for the central bank to have firsthand supervisory information.

Simply giving a central bank the authority to regulate systemic risk will not ensure that it devotes the appropriate attention and resources to the task. *Each central bank should have an explicit mandate to maintain the stability of the financial system so that it properly balances its role as a systemic regulator with its other mandates.*

Different central banks operate with different mandates. Some pursue a sole objective, such as price stability or a currency peg. Others pursue a dual mandate, such as the Federal Reserve's joint goals of price stability and maximum employment. Whatever a central bank's current charge, it should be expanded to encompass stability of the financial system.

We recognize the challenges that are introduced when the financial stability mandate is added to the duties of the central bank. The clear focus on achieving output and price stability will become blurred once the central bank also takes account of financial stability objectives. There are also legitimate concerns about the central bank overreaching itself in the resolution stage of a crisis when it

greatly extends its balance sheet to lend to private institutions. Finally, we recognize the dangers of increased politicization of the central bank's actions due to its role in the resolution stage of a crisis.

However, given the importance of the financial stability goal and the fact that *some* institution must play the role of the systemic regulator, we believe that the central bank should take on the task in spite of the difficulties this will pose. Some safeguards can mitigate the difficulties. For example, some central banks have used long-run inflation targets to keep the price stability goal firmly in view. In the resolution stage of crises, a clear demarcation of roles is important, especially when the use of public funds is contemplated. Only the fiscal authority (Treasury and FDIC with approval from Congress in the United States, for example) can authorize the use of public funds. The central bank as the systemic regulator assists the fiscal authorities, but it is the fiscal authorities who must ultimately be responsible in any resolution effort.

FIVE RECOMMENDATIONS FOR ESTABLISHING SYSTEMIC REGULATORS

The discussion above leads us to five recommendations.

Recommendation 1. *The regulatory structure for financial markets and institutions should include a systemic regulator that oversees the health and stability of the overall financial system. A systemic regulator will be able to limit systemic shocks of the sort that have recently arisen from the shadow banking system and from spillovers between financial institutions.*

Recommendation 2. *The central bank should be the systemic financial regulator. Central banks' independence, daily interactions with the markets, focus on macroeconomic stability, and role as lenders of last resort make them the natural systemic regulator.*

Recommendation 3. *The systemic regulator (the central bank) should not be involved in consumer protection and business-practices regulation. Those roles should be given to one or more separate agencies. The systemic regulator will be better able to maintain the proper organizational culture and resist political pressure if it is not burdened with these responsibilities.*

Recommendation 4. *The systemic regulator (the central bank) must be given adequate resources. Without sufficient resources, the systemic regulator will not be able to identify systemic risks and craft the needed regulations to promote financial stability. During the current crisis, the staff of central banks like the Federal Reserve has been stretched to the limit. Asking central banks to become systemic regulators will stretch already thin resources even thinner, perhaps even compromising the banks' ability to conduct monetary policy successfully.*

Recommendation 5. *The central bank should be given an explicit mandate for stability of the financial system. This will ensure that the central bank properly balances its role as systemic regulator with its other mandates. In the case of the U.S. Federal Reserve, this would imply a triple mandate—price stability, maximum employment, and financial stability.*

Endnotes

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1. Squam Lake Working Group on Financial Regulation, "A New Information Infrastructure for Financial Markets" (Council on Foreign Relations Press, February 2009).
 2. Squam Lake Working Group on Financial Regulation, "Reforming Capital Requirements for Financial Institutions" (Council on Foreign Relations Press, April 2009).
 3. Squam Lake Working Group on Financial Regulation, "An Expedited Resolution Mechanism for Distressed Financial Firms: Regulatory Hybrid Securities" (Council on Foreign Relations Press, April 2009).
 4. This can be seen as an example of the general human tendency, emphasized by Richard Posner, to spend too little time and effort preparing contingency plans to handle rare catastrophic events.

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