Western Kentucky University
TopSCHOLAR®

Faculty/Staff Personal Papers WKU Archives Records

2010

UA37/29 Gary Ransdell - Fed. Reserve Board - Ben Bernanke's Swearing In/Kevin Warsh's Speech & Op-Ed

St. Louis Federal Reserve Board

Follow this and additional works at: https://digitalcommons.wku.edu/fac_staff_papers

Part of the Economics Commons

Recommended Citation
St. Louis Federal Reserve Board, "UA37/29 Gary Ransdell - Fed. Reserve Board - Ben Bernanke's Swearing In/Kevin Warsh's Speech & Op-Ed" (2010). *Faculty/Staff Personal Papers.* Paper 4.
https://digitalcommons.wku.edu/fac_staff_papers/4

This Other is brought to you for free and open access by TopSCHOLAR®. It has been accepted for inclusion in Faculty/Staff Personal Papers by an authorized administrator of TopSCHOLAR®. For more information, please contact topscholar@wku.edu.

CORRECTED: February 3, 2010, Chairman Bernanke's swearing-in remarks; Governor Warsh's speech and op-ed on reforming the financial regulatory system

Please disregard the previous e-mail. Thank you.

Chairman Bernanke delivers remarks at his swearing-in ceremony.

Excerpts follow.
This document is not an official transcript. The text is selectively drawn from the original and summerized. Full text: http://www.federalreserve.gov/newsevents/speech/bernanke20100203a.htm.

The past four years have shown the Federal Reserve at its finest, as we moved rapidly, forcefully, and creatively to confront the deepest financial crisis since the Great Depression and help prevent a looming economic collapse. At the same time, this institution, like our country, faces enormous challenges.

The resumption of growth in the nation's output of goods and services is encouraging. But far too many people remain unemployed, foreclosures continue at record rates, and bank credit continues to contract. We at the Federal Reserve cannot hope to solve all these problems but we must continue to do all that we can to help to guide the country's return to prosperity in an environment of price stability.

The crisis revealed weaknesses and gaps in the regulation and supervision of financial institutions and financial markets. The Fed staff and the Board have made considerable progress in identifying problems and improving how we carry out our oversight responsibilities. We will continue to work with the Congress to develop an effective, comprehensive reform of financial regulation.

The Federal Reserve has been granted considerable independence and autonomy. That independence serves important public objectives. Critically, it allows the Federal Open Market Committee to make monetary policy in the longer-term economic interests of the American people, rather than in the service of short-term political imperatives. It also allows the Federal Reserve to make supervisory decisions based on the facts of each case and the need to preserve financial stability, not on political considerations. In the interest of maintaining public confidence and promoting economic and financial stability, we must continue to protect our independence.

At the same time, in a democratic society, institutional independence brings with it fundamental obligations of transparency, responsiveness, and accountability. The Federal Reserve is already one of the most transparent and accountable central banks in the world, providing voluminous information and explanations concerning all its activities. However, we should be prepared to become even more transparent. It is essential that the public have the information it needs to understand all aspects of our operations and be assured of the integrity of all our operations, including all aspects of our balance sheet and our financial controls. We will continue to work with the Congress to ensure maximum transparency of America's central bank, without compromising our ability to conduct policy in the public interest.

Governor Warsh's speech before the New York Association for Business Economics discusses regulatory reform of the financial system.

Excerpts follow.
This document is not an official transcript. The text is selectively drawn from the original and summerized. Full text: http://www.federalreserve.gov/newsevents/speech/warsh20100203a.htm.

We remain in a period of great consequence for the U.S. economy. The policy judgments currently being considered are as significant as those made during the darkest days of the Panic. And here, I am not only referring to the appropriate conduct of monetary policy. Fiscal, trade, and regulatory policies may turn out to be no less determinative to the path of the U.S. economy.

A Time for Choosing
The financial crisis conditions of the past two years have substantially abated. And Washington is seeking to repair the regulatory system. Improvements in regulatory policy--if part of a broader review of the financial architecture--could herald greater prosperity for future generations.

Efficacy should be the foremost goal of policymakers....We will have done ourselves no favors if "comprehensive regulatory reform" over-promises and under-delivers. We need a broader understanding of what occurred, more basic changes in our financial architecture, and more useful tools in our arsenal for reform efforts to be worthy of the name and equal to the challenge.

Empowering Regulators
The prevailing theory (is) that financial firms, particularly the largest and most systemically significant, engaged in practices that begat the financial crisis. To redress these wrongs, regulatory powers should be substantially expanded, the theory goes. The incumbent regulators lacked sufficient authorities, or were not up to the task. But the structure in which their successors operate will purportedly make them masters of the craft. Apparently, a new grant of broad and sweeping regulatory powers will treat the infirmities that ail us. In my view, this theory has some understandable appeal but the narrative and recommended reforms are still deficient.

First, the Panic of 2008 that exacerbated the recession is the result of a multitude of flawed private and public practices, with regulatory error being only one part. Some meaningful blame should be placed at the doorstep of regulators, here and abroad. But the investigation should not cease (there). The mortgage finance system is owed far stricter scrutiny to gather a fuller appreciation of the causes of the crisis. (For example,) the government-sponsored enterprises (GSEs), Fannie Mae and Freddie Mac, for example, were given license and direction to take excessive risks. They were granted conflicting missions and governed by competing masters. And their funding backstop was predicated on "constructive ambiguity," which turned out to be neither constructive nor ambiguous. Ultimately, if the diagnosis of the crisis fails to account for some of the broader failings of public policy, of which the GSEs are just one part, the prescription is unlikely to be effective.

Second, the regulatory reform discussion of the past year seems overly preoccupied with questions of institutional design. There are doubtless efficiencies to be gained in…integrating operations, and minimizing regulatory gaps among regulators. But, it is far from obvious that real regulatory reform hinges on figuring the optimal number of regulators, or the precise composition of an oversight council.

If real reform were chiefly about the number of financial regulators--or even the precise relationships between financial regulation and the role of the central bank--we should find an institutional design among major financial centers around the world that lived up to its promise. We find no such example. Policymakers, in my view, should be more focused on what constitutes effective prudential supervision, rather than the less consequential discussion as to who should perform it.

Third, if policymakers had gone into the crisis with the resolution authority to shut down non-banks and complex bank holding companies quickly, we might well have had better options to ensure an orderly disposition of failing firms. (Having this authority, however,) is not enough to arm us for the challenges ahead. Granting (discretionary) new powers to resolve failing firms…is unlikely, in the near-term, to drive the market discipline required to avoid the recurrence of financial crises.

To be clear: New resolution authority is a welcome step forward, but its efficacy should not be overstated. And this authority could be made more credible by replicating, as much as practicable, well-understood bankruptcy protocols, (providing) clearer rules of the road for creditors in advance of any resolution. Still, the financial architecture requires additional reforms to mitigate the too-big-to-fail problem.

Resurrecting Market Discipline to Redress Too-Big-To-Fail

Moral hazard in the financial system is higher than any of us should countenance. There is a high burden on policymakers to mitigate it. Some newly-empowered and untested regulatory structure is not likely--in and of itself--to be sufficient to tackle institutions that are too-big-to-fail, particularly as memories of the crisis fade. Regulation is too important to be left to regulators alone.

We must resurrect market discipline as a complementary pillar of prudential supervision. Otherwise, the too-big-to-fail problem--exacerbated by recent events--could undermine our financial system and do long-term harm to the real economy. The growing specter of government support threatens to weaken market discipline, confuse price signals, and create a class of institutions that operate under different rules of the game. This is not acceptable.

We need a system in which insolvent firms fail. Market discipline only works if governments can demonstrably and credibly commit to allow firms to fail. This system isn't just about giving government officials better options on Sunday nights. It is about making sure that market discipline is operative in the prior months and years to avoid altogether the proverbial Sunday night judgments.

Market discipline, like regulatory discipline, is imperfect. It too has a tendency to become lax late in

economic booms and excessively tight in busts. But, a system must be designed so that market discipline works--not to the exclusion of regulatory discipline--but in support of it. So, how do we design a new financial architecture that--in addition to improved resolution authority--more squarely confronts the too-big-to-fail problem?

First, in order to resurrect market discipline, shareholders, creditors, and regulators need better, more timely information about financial firms. Asset quality and funding sources for financial firms must be more understandable and readily comparable among peers. Stakeholders can then make better informed judgments of potential risks and rewards. Markets can help effectively discipline the behavior of firms by re-pricing funding costs as perceived risks change. And regulators can use market prices and changes in funding mix, among other information, to evaluate whether firms are being evaluated independent of government backing.

Second, reforms must encourage robust competition. Market entry and market exit can be a more effective means of developing a stronger, more resilient financial system. The too-big-to-fail problem could be mitigated if smaller, dynamic firms seized market share from less nimble incumbents. The financial services industry is ripe for a healthy dose of creative destruction. But, this won't happen if policy divides firms that are too-big-to-fail from those that are not. It won't happen if select incumbents have permanent funding advantages. And, it won't happen if policy preferences deter would-be competitors from taking on the big guys. Policy (must allow) competition to take root. Competition is undermined when a privileged class of financial firms has the implicit support of the government. No firm ought to be entitled to favored consideration by regulators or government policy.

Third, stronger capital and liquidity buffers, more effective boards of directors, and more rigorous risk-management practices are important safeguards. And, here, there has been some substantial progress. But additionally, firms should have the burden of persuasion to demonstrate that they can fail without need for extraordinary government support. Simplifying corporate forms and structures so firms can quickly be unwound, particularly across borders, would be a welcome development.

In a global economy…U.S. leadership is critical to establish the new rules of a new financial architecture. Policy coordination with our Group of 20 colleagues should not take a backseat.

If Too-Big-To-Fail Prevails…

Government interventions during the past couple of years, however necessary, revealed a set of policy preferences. Expectations hardened that governments will come to the rescue of large ailing markets and large failing firms. These expectations must be unlearned by market participants. Eradicating the too-big-to-fail problem should be the predominant policy goal.

If we fail to achieve this critical objective, the next-best regime may involve choosing a point between two competing models for systemically-significant firms: regulating what financial institutions can do, and regulating how they do it. Clear rules--more focused on the "what" than the "how"--could liberate firms

from…Washington so they can get back to business. Supervisors, of course, would still serve an important role, leaning against the prevailing winds, providing guidance to firms, and ensuring best practices. But, Washington would steer clear of managing the affairs of private firms.

Obscuring the choice altogether--both directing the "what" and ordering the "how"--strikes me as imprudent. The tendency by Washington to micromanage can harm an economy that desperately needs a competitive, vibrant, sustainable banking system.

Rule-based regimes on issues of capital, liquidity and scope are inevitably crude and imperfect. And to be effective, these rules would need to reduce systemic risks meaningfully. Still, this regime strikes me as superior to one in which our financial firms are micromanaged as quasi-public utilities, subject to the changing preferences of Washington and immunized from real competition. The U.S. economy runs grave risks if we slouch toward a quasi-public utility model.

I worry that some systemically significant firms may end up willing to accept new, permanent government masters and supplementary public purposes in order to protect their status. Apportioning economic rents to appease the official sector … is destructive to the financial and economic system overall. We should not want clients of the state at the core of our financial system.

Conclusion

The standing of market-oriented principles is being severely tested. Our policy response …should necessarily be broader in scope than some new team of financial regulators with new powers. We need a new financial architecture, one in which improved regulation and supervision play an important but co-extensive role with greater market discipline. The new architecture must stoke competition, allow failure, and reward innovation and success. The new architecture should establish the rules of the game without micromanaging the affairs of private firms. And the new architecture should not give perpetual license to select, incumbent firms to dominate the financial landscape. For in the new regime, no firm should be too big to fail.

Governor Warsh discusses reforming the regulatory system in a *Financial Times*op-ed which summarizes remarks he delivered this afternoon to the New York Association of Business Economics.

The text is selectively drawn from the original. Full text available at http://www.ft.com.

Washington is seeking to repair the regulatory system. Efficacy, not convenience, should be the goal of policymakers.

The prevailing theory is that financial firms engaged in practices that begat the financial crisis (and that), broad and sweeping new regulatory powers (are needed). This theory is deficient in important respects.

First, the Panic of 2008 was the result of a multitude of flawed private and public practices, with

regulatory error being only one part. For example, the mortgage finance system, particularly the role of Fannie Mae and Freddie Mac, needs far stricter scrutiny.

Second, the regulatory reform discussion of the past year seems overly preoccupied with questions of institutional design. It is far from obvious that real regulatory reform hinges on figuring the optimal number of regulators. I happen to believe that the US Federal Reserve should play a critical role in the supervision of financial firms, but that should not obfuscate the larger point. Policymakers should focus on what constitutes effective prudential supervision, rather the less consequential question of who should perform it.

If policymakers had gone into the crisis with the ability quickly to shut down non-banks and complex bank holding companies--resolution authority--we might have had better options on Sunday nights to deal with failing institutions. Still, however welcome, resolution authority is not enough to arm us for the challenges ahead.

So, how do we design a new financial architecture that confronts moral hazard and the too-big-to-fail problem? We must resurrect market discipline as a complement to prudential supervision.

First, stakeholders need better, more timely information about financial institutions.

Second, reforms must encourage robust competition. But this won't happen if policy divides those that are too big to fail from those that are not. It won't happen if select incumbents have permanent funding advantages. And it won’t happen if policy deter(s) would-be competitors from taking on the big guys.

Third, it is up to financial institutions to demonstrate that they can fail without a need for extraordinary government support. Simplifying corporate forms and structures so companies can quickly be unwound, particularly across borders, would be a welcome development. Greater dispersion of assets and liabilities demands unprecedented international co-operation.

Government interventions during the past couple of years revealed a set of policy preferences. These expectations must be unlearned by market participants. Eradicating the too-big-to-fail problem should be the main policy goal.

If we fail to achieve this critical objective, regulating what financial institutions can do, strikes me as superior to micro-managing banks and others as quasi-public utilities The US economy runs grave risks if we slouch toward a quasi-public utility model.