

# Banking Policies and Too Big To Fail

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## Introduction

At the risk of belaboring the obvious, it is both undeniable and an understatement to observe that these are challenging times for participants in financial markets and the economy, and for policymakers as well. Beginning about 20 months ago, financial markets were rocked by a series of shocks, which ultimately had global implications and whose repercussions remain severe to this day. Policymakers, here and abroad, many of whom have deep confidence in the self-equilibrating nature of a market economy, have responded aggressively and, in some instances, with unprecedented action. It is still too early to tally results, and it is also unclear if further steps will be required to restore stability. However, I am guardedly optimistic that many pieces are now in place to contribute to improvement in financial market conditions and in business activity.

The heart of my remarks this afternoon will be a discussion of economic policies suitable to the challenges that continue to confront the economy and financial system. But before getting into the policies themselves, it is necessary to devote some time to a description of both current conditions and near-term prospects, so that we start from the same base. And I will remind you that, as always, I am speaking only for myself and not for others in the Federal Reserve.

## Current Conditions and the Outlook

I will initially turn to the state of the economy and the credit markets and prospects for the next two to three years. Conditions in credit markets have improved over the past several months, although in general appreciable strains persist. On the positive side, term funding is more readily available than at the height of the crisis, and risk premia have diminished in parts of the corporate market. On the other hand, markets for many securitized products remain closed, and significant doubts persist about asset values and the solvency of some large institutions. Much has been made recently about banks' unwillingness to lend to creditworthy borrowers and a so-called credit crunch; in my view, there is likely more here than meets the eye.

There is little doubt that many creditworthy customers are today being financed by their banks as they normally have been. There is also little question that some borrowers with satisfactory or better credit histories are finding it more expensive, if not impossible, to obtain financing. There are at least a couple of factors at work, abstracting from any fundamental deterioration in the condition of the borrower. Commercial banks have long been thought of,

and indeed have functioned as, the backup source of liquidity for many other financial institutions and markets. Banks continue to play this role, but it has become more challenging to do so because some lenders find themselves capital-constrained as a result of recent losses and/or sizable, unanticipated additions to their balance sheets of formerly off-balance-sheet instruments. Equally important, the so-called shadow-banking system grew rapidly relative to the traditional banking sector over the past two decades or so. And now the demands on the banks from these nonbank financial institutions are that much greater, making it difficult for banks to respond adequately to all customers.

Overall, it seems to me that these credit strains are significant and pervasive, and that these conditions are likely to weigh on economic activity for some time. Moreover, since banks are traditionally a major source of financing in times of stress, it is important to restore the health of the industry so that it can fulfill this role. As it is, the economy is in the midst of a serious recession that seems likely to persist at least through mid-year. Most sectors of the economy are contracting, and it is difficult, as it always is, to identify with confidence the engine, or engines, of expansion that will propel the recovery in activity.

Still, there is reason to think that improvement is not too far off. Interest rates are low and financial conditions are improving, albeit unevenly. Major fiscal policy stimulus is now under way and should add to aggregate demand in a timely way unless consumers and businesses turn exceedingly cautious. Moreover, adjustments which typically occur in a contraction ultimately help to lay the foundation for renewed growth. For example, as business continues to reduce output and employment, inventories shrink and at some point aggregate supply falls below even the diminished level of demand, leading to increases in hours worked, net new hiring, and a general pickup in activity.

Once under way, the pace of the expansion is likely to be subdued for a time. There is historical precedent for this, since the recovery of the early 1990s was initially quite modest, as was the recovery earlier this decade. More importantly, in view of the state of the credit markets, it seems a fair bet that it will take time for momentum to build. But with the passage of time – as we get into the middle of 2010 and beyond – I would expect to see a resumption of healthy growth.

What of the outlook for inflation? Not all that long ago, there was considerable concern about prospects for inflation, fueled in large measure by the run-up in energy and other commodity prices. These concerns have subsided with the dramatic fall in the price of energy, replaced, as it were, by two competing issues, namely: (1) concern for future inflation, stemming from the Federal Reserve's provision of huge amounts of liquidity in response to the financial crisis; (2) deflation, resulting presumably from the downturn in global economic activity.

Neither concern can be dismissed out of hand but, if economic growth resumes in the U.S. as I expect, the threat of deflation should diminish commensurately. As for liquidity provision and inflation, it is important to recall that the relation between growth in the money supply and the path of prices holds in the long run, over periods of at least five and more likely 10 years. Thus, there is ample time to withdraw excess liquidity as appropriate.

### Macroeconomic Policies

I previously noted that a sizable fiscal stimulus package is in place and seems likely to provide impetus to aggregate demand. As far as monetary policy is concerned, the Federal Reserve has already reduced short-term interest rates to historically low levels and has established a variety of programs to directly provide liquidity, in volume, to an enhanced range of institutions and markets. We have indicated our willingness to use these, and other nontraditional policy tools such as purchases of mortgage-backed securities and the TALF, to help support credit markets and economic activity. This is an aggressive policy of "credit easing;" indeed, the Federal Reserve's balance sheet, which as recently as mid-September 2008 (about six months ago) stood at about \$1 trillion, is now in the range of \$2 trillion. The U.S. Treasury and FDIC have also stepped in to initiate or increase guarantees of financial firms' liabilities, and the Treasury has provided capital to banks as well. Many policymakers abroad have engaged in similarly extraordinary actions.

All of this leads to the conclusion that macroeconomic policies are directed forcefully to reestablishing conditions for sustainable economic growth. It may take time, but I expect these policies, together with the underlying flexibility and resilience of the economy, to succeed.

## Financial Policies

There should be little doubt that, in the wake of the financial crisis we have experienced, there will be considerable focus on remediation of policies governing the financial services industry in the months ahead. This emphasis is fully appropriate, and it is critical that we get what I will for convenience call “banking policies” right. On this occasion, I would like to explicitly comment on several aspects of such policies.

It seems likely that, going forward, there will be increased emphasis on tight regulation of financial institutions and their activities, especially of large, complex, “too-big or too-interconnected-to-fail” institutions. Clearly, there will be a role for conventional supervision and regulation in the future. Observers have rightly noted that the financial sector suffers from various market failures around issues of information and misaligned incentives, and conventional supervision and regulation can help address those concerns. At the same time, we have to be careful to avoid two potentially serious pitfalls: (1) excessive reliance on conventional supervision and regulation, essentially asking more than can be delivered; and (2) excessive regulation, resulting in an inefficient financial sector with negative consequences for economic performance.

This latter point is, I think, relatively easy to see. If the rules, although well intentioned, are too onerous, the resulting financial system may be very safe, but simultaneously it may be unnecessarily costly for households and businesses to obtain funding for worthwhile projects. This is not a desirable outcome. To drive this point home, let me quote Ken Rogoff, a distinguished economist at Harvard who has considerable public policy experience as well: “But I’m more concerned about what happens to our financial sector at the end of this, what’s left of it. I just don’t know what’s going to emerge after the political system works it over. I hope that we do not throw the baby out with the bathwater. If we rebuild a very statist and inefficient financial sector – as I fear we will – it’s hard to imagine that growth won’t suffer for years.”

The first concern I mentioned, about the risk of excessive reliance on conventional supervision and regulation, is more subtle but no less important. Additional regulations and resources devoted to enforcing them are not likely, by themselves, to effectively address the incentive issues in banking and the potential for serious systemic risk, even if accompanied by increases in standard capital requirements for large institutions. Reasons for this conclusion include the inevitable lag between supervisors’ identification of a problem and its ultimate

correction, the incentives of management to find ways around regulation, and the time inconsistency problem which frequently makes forbearance look attractive.

The recent track record in this area does not inspire confidence: We have, right now, higher expectations and more intensive supervision for the largest banking firms, and the outcomes speak, loudly and clearly, for themselves. Similarly, in the current episode, supervisors have been unable once again to prevent excessive lending to commercial real estate ventures, a well-known, high-risk, high-return business which contributed importantly to the banking problems of the late 1980s and early 1990s.

To reiterate, conventional supervision and regulation, even if heightened, is unlikely to be adequate; to be sure, long shots occasionally come in, but it is tournament time and we know that a 15 seed rarely beats a number two. So what should we do? The response to this question brings us to another type of banking policy and also brings us to the substance of a book I co-authored (with Ron Feldman) in 2004, titled *Too Big To Fail: The Hazards of Bank Bailouts*.

The book is about 200 pages in length, and you will be relieved to learn that I do not intend to cover it in detail this afternoon. But the book makes several points critical to future banking policies that are worthy of emphasis and of adoption. Equally importantly, I think that if policymakers had focused on our recommendations, we would at a minimum have been better prepared to address the problems that have arisen over the last 20 months.

In short, we were right about several critical issues. To provide just one example of this, let me quote a few sentences from the book: “Capital market participants may simply pull their funding from banks whose condition is not transparent or where they perceive a material chance of failure. ... Concern about capital market participants cutting off banks is particularly acute because a greater percentage of funding for the largest banks is short term. The share of the very largest banks’ liabilities that are overnight borrowings, for example, has nearly doubled over the last 15 years. Quantity restrictions in short-term capital markets could generate a high degree of instability because banks rely on frequent and rapid replacement of such funding as it matures. For some institutions, no clear alternative exists to capital markets. ... Also troubling is that much of the short-term funding provided to banks comes from other banks in the so-called interbank lending market. The increased reliance on short-term interbank lending has also been linked to the increased interdependence of large banks.”

As its title suggests, the book argues that too-big-to-fail (or too-interconnected-to-fail) protection of uninsured creditors of systemically important financial institutions distorts incentives and leads to underpricing of risk and therefore excessive risk-taking, and this risk-taking in turn sets the stage for turmoil in financial markets and disruption in the economy. With the expansion of the safety net and increased protection provided during the current crisis, the TBTF problem has, without question, increased substantially, albeit for good reason.

But this development makes it all the more critical that future banking policies address TBTF. And the principal reason TBTF exists, that policymakers intervene to protect uninsured creditors of large institutions, is because of deep concern about the fallout, or spillovers, for other firms, financial markets, and the real economy when such an organization gets into difficulty. The key to addressing TBTF, then, is to reduce the potential size and scope of the spillovers, so that policymakers can be confident that intervention is unnecessary, which is to say that the institution is in fact not TBTF.

We have written and spoken extensively about our most recent proposal – called systemic focused supervision (SFS) – to accomplish this, so let me cover just the main points today. In general, SFS, unlike conventional bank supervision and regulation, focuses on reduction of spillovers, the key to addressing TBTF. It consists of three pillars: early identification, enhanced prompt corrective action (PCA), and stability-related communication.

*Early identification.* This is a process to identify and to respond, where appropriate, to the material exposures among large financial institutions and between these institutions and capital markets. This process is closely related to the scenario planning recommendation discussed at length in the book. The goals of the exercise are (1) to give policymakers a sense of which events are not likely to severely impair a large financial institution, thus permitting policymakers to avoid providing support, and (2) to identify those exposures that might bring down the firm, and thus are deserving of closer policy scrutiny and, most importantly, an effective and timely response.

*Enhanced prompt corrective action.* PCA works by requiring supervisors to take specified actions against a bank as its capital falls below specific triggers. One of its principal virtues is that it relies upon rules rather than supervisory discretion. Closing banks while they still have positive capital, or at most a small loss, can reduce spillovers in a fairly direct way. If a bank's failure does not impose large losses, by definition it cannot directly threaten the

viability of other depository institutions that have exposure to it. Thus, the PCA regime offers an important tool to limit systemic risk. However, this regime currently uses triggers that do not adequately account for future losses and give too much discretion to bank management. We would augment the triggers with more forward-looking data, outside the control of bank management, to address these concerns.

*Communication.* The first two pillars of SFS seek to increase market discipline by reducing the motivation policymakers have for protecting creditors. But creditors will not know about efforts to limit spillovers, and therefore will not change their expectations of support, absent explicit communication by policymakers about these efforts.

### Conclusion

Let me reiterate just a few points, in wrapping up these remarks. First, many financial markets remain strained, and credit issues are likely to weigh on the economy for some time. In part as a consequence, the recession is likely to persist through mid-year and the initial stage of the recovery seems likely to be subdued. Nevertheless, in view of the policies already in place here and abroad, a resumption of growth should not be too far off, especially given the economy's fundamental resilience. Before long, attention will appropriately turn to banking issues and policies. Getting these right is both critical and challenging. I have cautioned about placing an excessive burden on conventional bank supervision and regulation, although clearly such policies have a role to play. More constructively, I suggest prompt emphasis on SFS as a means of addressing TBTF and as a contribution to aggregate financial stability going forward. Destiny did not require society to bear the cost of the current financial crisis. To at least some extent, the outcome reflects decisions, implicit or explicit, to ignore warnings of the growing TBTF problem and a failure to prepare for and address potential spillovers. We should not make this mistake again.