Testimony
of
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Summary

In my prepared statement below, I note that giving a government agency the power to designate companies as systemically significant and to regulate their capital and activities is a very troubling idea. For the reasons I outline, it has the potential to destroy competition in every market where a systemically significant company is designated and to fundamentally change the nature of our financial system.

I say this as a person who has spent ten years studying, writing about, and warning that Fannie Mae and Freddie Mac would have a disastrous impact on the financial world, and that ultimately the taxpayers of this country would be required to bail them out.

This wasn't a wild guess on my part. Because they were seen as backed by the government, Fannie and Freddie were relieved of market discipline and able to take risks that other companies could not take. For the same reason, they also had access to lower cost financing than any of their competitors. These benefits enabled them to drive out competition and grow to enormous size. Ultimately, however, the risks they took in exploiting their subsidy caused their collapse and will cause enormous losses for U.S. taxpayers.

When Fannie Mae and Freddie Mac were taken over by the government, they held or had guaranteed $1.6 trillion of subprime and Alt-A mortgages. These loans are defaulting at unprecedented rates, and I believe will ultimately cost U.S. taxpayers $400 billion. That's major league risk-taking.

There is very little difference between a company that has been designated as systemically significant and a GSE like Fannie or Freddie. Almost by definition, a systemically significant firm will not be allowed to fail—because its failure could have systemic effects. As a result, it will seem less risky for creditors and counterparties and will thus be able to borrow money at lower rates than its competitors. This advantage—as we saw with Fannie and Freddie—will allow it to dominate any market it chooses to enter. This is a nightmare for every smaller company in every industry where a systemically significant company operates.

Some will contend that in light of the failures among huge financial firms in recent months only regulation will prevent such things in the future. But this is obviously wrong. Regulation does not prevent risk-taking or loss. Witness the banking industry, the most heavily regulated sector in our economy. Many banks have become insolvent, and many others have been or will be rescued with billions of taxpayer dollars.

On the other hand, as far as I am aware, no taxpayer dollars have been spent to rescue hedge funds, although they are entirely unregulated for safety and soundness.

Extending regulation beyond banking, by picking certain firms and calling them systemically significant, would be a monumental mistake. We will simply be creating an unlimited number of Fannies and Freddies that will haunt our economy in the future.

There are many questions about the idea of systemic risk and regulation. Why choose certain companies as systemically significant? I assume it's because some think that their failure will cause others to fail, and the cascade of losses through the financial system will adversely affect the larger economy.

But is the U.S. banking system in trouble because of the failure of one or more large companies? Of course not. It's in trouble because of pervasive losses on trillions of dollars of bad mortgages. So, will regulation of systemically significant companies prevent a recurrence of a financial crisis in the future? Again, no. Any external shock that causes asset prices to fall precipitously will have the same effect, whether we regulate systemically significant firms or not. And regulation—as with banks—will not even prevent the failure of systemically significant companies. It will only set them up for bailouts when inevitably they suffer losses from their risk-taking.

We cannot prevent external shocks—earthquakes, the political collapse of a major oil producer, a pandemic—and any of these can cause an abrupt decline in global commerce or investors' confidence in the future, either of which can cause a crash in asset prices.

Beyond all this, is it realistic to believe that any agency can set capital ratios for companies as diverse as banks, hedge funds, insurance companies, securities firms, private equity firms, and finance companies? All these firms operate in different ways and compete with one another. Even if some regulator is skilled enough to pick the right capital ratio for every kind of company, will it be able to tell whether a particular product is safe for one kind of company but risky for another? Will it be able to recognize how a change in the capital requirements of the systemically significant firms in one industry sector will affect their competitive effect on all the other industries involved? It is highly doubtful that any systemic regulator will be able to do these things effectively, and no agency, I submit, could do it more effectively than the market.

Finally, the Federal Reserve would be by far the worst choice for systemic regulator. As lender of last resort, it could bail out the companies it is supervising without the approval of Congress or anyone else. Its regulatory responsibilities will conflict with its central banking role, and its involvement with the politics of regulation will destroy its credibility as the nation's monetary authority.

We will achieve nothing by setting up a systemic regulator. If we do it at the cost of destroying faith in the dollar and competition in the financial market, we will have done untold harm to the American economy.

Prepared Statement for the Record

Mr. Chairman and members of the committee: I very much appreciate this opportunity to comment on the issue of systemic regulation and the designation of systemically significant financial institutions. My prepared testimony follows.

Defining Systemically Significant Institutions

Before it considers creating or designating a systemic regulator, especially one that has the authority to designate systemically significant companies, Congress must first agree on a definition of systemic risk and how to identify institutions that might cause or enhance it.

Since the beginning of the financial crisis, there has been increasing attention to the concept of systemic risk. The traditional view of systemic risk is that the failure of a large company will cause the failure of others as its losses cascade through the economy and the financial system. However, the current crisis was not precipitated by the failure of one or more financial institutions. Those failures, which began with Bear Stearns, were the result of an external shock to the financial system: specifically, the sudden recognition among investors that asset-backed securities of various kinds—but especially mortgage-backed securities—were far less safe as investments than their ratings implied. When this occurred in the summer of 2007, the asset-backed securities market suddenly dried up. Funding for portfolios of these securities could not be found, and intermediaries were compelled to sell them at distress prices. The substantially reduced market prices caused the write-down of the same or similar assets on the balance sheets of other financial intermediaries, and the crisis began. Looking at the current financial crisis, accordingly, its origin can be found in the combination of a deflating housing bubble in the United States with an unprecedented number (25 million) of subprime and other nonprime mortgages that were distributed around the world. Secondary causes were poor analysis by rating agencies, low costs for borrowed money, and a mark-to-market accounting system that caused asset values (and hence bank capital) to spiral down as distress sales occurred.

Serious academic papers have referred to this sequence of events as an example of systemic risk—the danger of widespread losses coming from a systemic shock.[1] This may well be true—if we want, we can define systemic risk as the risk of a systemic shock. But this does not mean that we can prevent systemic risk, as so defined, by regulating systemically significant companies. Any number of external shocks—a major earthquake, the political collapse of major oil supplier, a pandemic—can cause investors to lose faith in the future and cause an asset price crash. This kind of systemic risk arises not from the failure of a large institution, or even a small group, but from an exogenous event—a shock to the system—that can come from a potentially infinite number of sources. Regulating systemic risk or systemically significant companies will not have any effect in preventing this from happening, as it would not have prevent the current

[1] Ibid.; see also Philip F. Bartholomew, "Banking Consolidation and Systemic Risk," in *Brookings-Wharton Papers on Financial Services: 2000*, ed. Anthony M. Santomero and Robert E. Litan (Washington, DC: Brookings Institution Press, 2000), 373.

crisis. Meanwhile, however, the regulation of these companies—as I argue below—will raise costs, suppress innovation, and seriously impair competition in every industry where a systemically significant company is designated.

Even if we think of systemic risk in the traditional way—as the result of a cascade of losses coming from the failure of a large and interconnected institution—how would we identify such an institution? One way, of course, is by size, but that is not likely to be sufficient. For example, the interbank payment system is one clear potential source of systemic risk. If one bank in the system were to fail to meet its payment obligations to the others, there could be a cascade of losses as the recipient banks would be unable to meet their own obligations at the end of the day. Within this system, however, relatively small institutions can have outsized effects if they fail to meet their payment obligations; these same institutions are unlikely to be considered systemically significant. In 1974, the failure of Herstatt Bank caused a systemic breakdown, even though no one would have previously considered Herstatt to have been a systemically significant bank.

Finally, what might be considered systemically significant is highly context-specific. Consider the failure of the securities firm Drexel Burnham Lambert in 1990 and the failure of Lehman Brothers in 2008. Drexel was a very large firm in the context of the market at the time, and its failure did not cause any systemic distress; Lehman's failure during the jittery and fragile market that resulted from the wide distribution of poor quality mortgages caused a worldwide freeze-up of interbank lending.

Still, it is possible to argue that regulating large companies that we might designate as systemically significant could prevent these companies from failing and causing losses to other companies in the traditional way that systemic risk has been defined.[2] This is probably the underlying impulse for regulating "systemically significant" companies. The problem, however, is that regulation consistently fails to achieve this objective. We have only to look at the current financial crisis to see the abject failure of regulation in the case of commercial banks. In 1991, the U.S. adopted the Federal Deposit Insurance Corporation Improvement Act (FDICIA), an extremely tough banking law and subsequent regulations, in the wake of the collapse of the S&L industry and the failure of 1600 commercial banks. At that time, as now, members of Congress said that the legislation they were adopting would prevent any future banking crisis. Obviously, it didn't. We are now in the midst of the greatest banking crisis since the Great Depression, and perhaps the greatest of all time. Calling for more regulation is in fact a simple-minded solution—a band-aid—done more to solve Congress's problem (the need to show the public that it is taking *action*) than a clear-eyed response to what is really the issue.

But even if regulation could prevent systemically significant financial institutions from failing, it's not clear why we should want this, and even if we should want to prevent the failure of financial institutions it is also important to consider the costs of doing so. We should keep in mind that we don't really know whether the failure of any financial institution that we might

[2] George G. Kaufman, "Bank Failures, Systemic Risk, and Bank Regulation," *Cato Journal* 16, no. 1 (Spring/Summer 1996): 20.

deem "systemically significant" will have a significant adverse impact on the rest of the economy, or that—if such an effect were to occur—that it could not be handled simply by the Federal Reserve providing some temporary liquidity to the market. If so, we are doing affirmative harm by trying to keep failing institutions alive. Business or financial failure can be the result of bad management or a bad business model. If we preserve failing companies we are saving both. That does not improve the efficiency or quality of our economy or our financial system. Accordingly, if the consequences are not too severe, it would be a better idea to let large institutions fail and take the relatively minor consequences rather than trying to keep them alive.

The Problems of Differential Regulation

But if we still believe that it is worthwhile to regulate systemically significant companies, and that regulation—contrary to all our experience—will actually prevent their failure, we should consider the adverse effects of doing so. One of the most severe of these adverse consequences is the effect on competition of designating certain institutions as systemically significant and thus placing them in a favorable competitive position with respect to their competitors.

Even assuming that we can identify systemically significant institutions, what would be the consequences of regulating them? In my view, designating some companies as systemically significant would have a disastrous effect on the competitive financial system in the United States. This is true because a designation as a systemically significant company is a statement that the government will try to prevent such a company from failing. It is systemically significant because its failure, by hypothesis, will have an adverse effect on the other financial institutions and on the economy as a whole.

In other words, such an institution will be considered too big to fail, and in that respect to have the backing of the government. As we have seen with Fannie Mae and Freddie Mac, an indication that a private firm has the implicit backing of the government—especially if the backing comes from an agency like the Fed, with the power to extend financing—is likely to persuade the markets that loans to this institution would involve less risk than loans to an institution that is operating without this special designation. For this reason, a firm that is designated as systemically significant would be able to raise funds at lower cost than its competitors, would likely be more profitable than its competitors, and would have greater access to capital. Overall, the systemically significant firms would grow larger in relation to others in the same industry and would gradually acquire more and more of their less successful competitors. Eventually, we would see a market much like the housing market that Fannie and Freddie have come to dominate, with a few giant companies, chosen by the government, that have pushed out all competition.

Limitations on a Regulator's Scope of Knowledge

Even if the regulation of systemically significant companies did not have such adverse consequences for our economy and financial system, there is real doubt whether any agency would be able to regulate and supervise systemically significant firms from more than one industry. It goes without saying that banking is a completely different business from insurance, which is different from securities trading, which, in turn, is different from the risk-taking and arbitrage transactions of hedge funds. The regulation of each company must take account of these differences. In order to decide on such issues as the appropriate amount of capital or leverage for systemically significant companies from different industries and utilizing different business models, the systemic regulator of each company must have a detailed knowledge of the business practices, accounting standards, and taxation of each business model, as well as the competitive environment in which it functions.

Accordingly, in order to be a systemic risk regulator for varied financial industries and business sectors, a regulator would have to acquire a great deal of knowledge and expertise in every field of finance. It would be required to understand how these industries function and why they function the way they do. Every change in capital or leverage would have an effect not only on the competition within the industry in which the particular firm is located, but also on the ability of the firm to compete with other members of the financial services sector. In today's financial services world, banks, insurers, securities firms, hedge funds, mutual funds, finance companies, leasing companies, and even private equity firms compete for business, for capital, and for credit. Any significant mandated change in how the largest firms in each of these financial services industries are able to do business will have an impact—positive or negative—on firms in every other financial services industry.

It is for this reason that the Senate report on the Gramm-Leach-Bliley Act did not give the Fed the authority to supervise the nonbanking subsidiaries of financial holding companies. "It is inefficient and impractical," the report noted, "to expect a regulator to have or to develop expertise in regulating all aspects of financial services."[3] This was the judgment of Congress when securities and insurance were the only activities that were subject to any form of safety-and-soundness regulation (which, in the case of securities firms, was regulation intended primarily to protect customer accounts). If the legislation under consideration ultimately authorizes the Fed (or some other regulator) to supervise every financial intermediary that is systemically significant, it will create a giant regulator that will be required to understand in detail how each of these businesses operates and how a change in the capital, leverage, or business model will affect every other member of the financial services industry.

The underlying theory of a systemic risk regulator is that the agency will not only be able to supervise the systemically significant members of the financial services industry—no matter what business form they take—but will also be able to recognize the development of systemic risks before they place the financial system in jeopardy. Accordingly, not only would the regulator have to be able to forecast the effect of new products and business activities on the future financial health of the particular company and the financial system as a whole, but it will be required to know and apply the best capital level for companies in many different businesses and with many different risk profiles that are adopting or creating new financial products. It must also understand what particular activities or investments present excessive risks when undertaken by such a business. The answers to these questions for hedge funds and insurance companies, for example, are quite different from one another and quite different from those for

[3] *Financial Services Act of 1998*, 105th Cong., 2nd sess., September 18, 1998, S. Rep. 105-336.

banks. Hedge funds are traders and risk-takers; insurance companies are specialists in pooling risks. Hedge funds are financed by equity; insurance companies are generally corporations with capital ratios and long-term assets. Banks are part of a global payment system. Can a single agency make these varied judgments effectively—more effectively than the market itself? This is very doubtful, yet that is what is apparently expected of a single agency that is supposed to regulate and supervise systemically significant companies.

The Federal Reserve as Systemic Risk Regulator

Much of the discussion of the systemic regulator has focused on the Federal Reserve, yet that agency would probably be the worst possible choice to perform this function.

The Fed and Systemic Risk: A Historical Perspective

The Fed has been aware of the concept systemic risk since at least 1998—when the Federal Reserve Bank of New York (with the acquiescence of the Federal Reserve Board) stepped in to prevent the collapse of the hedge fund Long-Term Capital Management (LTCM) when it thought that the collapse would have far-reaching systemic effects. Although the term "systemic risk" is not used in the Bank Holding Company Act of 1970, for the last thirty years the Fed has had all the powers under that act that it might conceivably be given in any legislation in which the Fed is constituted as a systemic regulator. Whether the Fed was correct in stepping in to prevent the default of LTCM will never be known. Many commentators believe it acted precipitously and unnecessarily,[4] but there is no question that the Fed is sensitive to the issue of systemic risk.

The act allows the Fed to regulate bank holding companies (BHCs) in the same way that a bank supervisor can regulate a bank—by regulating their capital and their nonbanking activities and influencing the lending policies of the underlying bank. If the Fed had wanted to control the risk-taking of the largest banks—the institutions most likely to be declared systemically significant—it could have done so through its control over their holding companies. Accordingly, before handing the Fed the power to control systemic risk, Congress should want to know why the Fed has not exercised its existing power to control systemic risk in the banking system—and why it was unable to prevent the near failure of Citibank, the principal subsidiary of Citigroup and an institution that everyone would define as systemically significant. Looked at with hindsight, the Fed failed to perform a useful role as a systemic risk regulator before the current financial crisis, and there is no reason to believe that the agency will be able to do any better with the far more difficult role of regulating the systemic risk of the entire financial system.

Conflicts among the Fed's Roles

[4] See Shadow Financial Regulatory Committee, "The Issues Posed by the Near-Collapse of Long-Term Capital Management," September 28, 1998, available at www.aei.org/docLib/20051114_ShadowStatement151.pdf.

There are inherent conflicts between the role of the Fed as the nation's central bank and its potential role as a regulator of systemically significant companies. As the U.S. central bank, the Fed is responsible for maintaining price stability while fostering economic growth and employment. To a large extent, this role would conflict with the Fed's assignment as a systemic risk regulator. As Robert E. Litan and Charles W. Calomiris noted in a 2000 article: "[W]eakness in the financial sector can tempt a central bank with supervisory authority over financial institutions to pursue a looser monetary policy than it would otherwise follow, imparting an inflationary bias."[5] For example, it might be that at a time of bank weakness, a tight monetary policy would have an adverse effect on the health of the systemically significant financial institutions under the Fed's supervision. Instead of considering the overall health of the economy when it makes its monetary policy decisions, the Fed as bank supervisor or systemic regulator could defer a necessary rate increase in order to reduce the pressure on the institutions it supervises, especially if they were—by definition—too big to fail; they must be kept healthy lest their failure cause an adverse systemic event and resulting criticism of the Fed's regulatory administration. An opposite outcome is also easily imaginable; imagine that the Fed decides not to invoke its power to close down a weak institution because it fears that such an action will then require it to increase market liquidity in order to prevent further financial institution defaults.

Ideally, if there were to be a systemic regulator, it should have the health of the institutions it supervises solely in mind when it makes its decisions. However, the Fed's interest in promoting market stability can lead it to encourage—rather than discourage—risk-taking by the banks it supervises. One example of this phenomenon in action was the Fed's successful effort in 1982 to get various U.S. banks to extend loans to Mexico at a time when Mexico was unable to meet its foreign exchange obligations. Although the banks themselves were threatened by losses on their Mexican loans, they followed the Fed's direction and made new loans to Mexico. At the time, Fed chairman Paul Volcker assured the banks that these risky loans would not be held against them: "[W]here new loans facilitate the adjustment process and enable a country to strengthen its economy and service its international debt in an orderly manner, new credits should not be subject to supervisory criticism."[6] This is not to say that Volcker's decision was wrong in that instance, but only to point out a clear example of the conflict of interest that affects the Fed's administration of its bank regulatory functions.

It is perhaps for this reason that central banks in almost all developed countries have no role other than that of monetary policy. The European Central Bank was established with only a monetary policy role, and only the United States and Israel give their monetary authorities any role in financial system regulation. Elsewhere—Switzerland, Canada, Australia, Germany, Sweden, Spain, the United Kingdom, and Japan, to name just a few—banks are regulated by other government entities. And the trend has been strongly in this direction, with the United

[5] Charles W. Calomiris and Robert E. Litan, "Financial Regulation in a Global Marketplace," in *Brookings-Wharton Papers on Financial Services: 2000*, ed. Anthony M. Santomero and Robert E. Litan (Washington, DC: Brookings Institution Press, 2000), 292.

[6] Quoted in Bernard Shull, *The Fourth Branch: The Federal Reserve's Unlikely Rise to Power and Influence* (Santa Barbara, CA: Praeger, 2005), 150.

Kingdom, Japan, and Australia having taken bank regulation away from their central banks in recent years.

The traditional position of the Fed has been that its bank regulatory activities assist it in keeping tabs on the economy. The theory is that the examination of banks and reports from banks provide a source of confidential information, not available elsewhere, for judging the health of the overall economy. In reality, however, the Fed does not examine many banks; almost all the large banks are nationally chartered and examined and regulated by the Comptroller of the Currency (OCC). The Fed regulates and supervises BHCs, the companies that control banks. Most of the day-to-day supervisory work on BHCs is done by the regional Federal Reserve banks and not the Federal Reserve Board itself. If necessary, both the OCC and the Federal Deposit Insurance Corporation receive reports from banks and could furnish the confidential information in these reports to the Fed.

Threats to the Independence of Monetary Policy

The Federal Reserve System was designed to be independent of both Congress and the executive branch. The seven members of the Board of Governors of the Federal Reserve System are appointed by the president for fourteen-year staggered terms—by far the longest in the federal government—and the agency is independent of the congressional appropriations process. The chairman is appointed by the president for a four-year term, but his term is not coextensive with the election of the president, so that the Fed chair remains in office for at least the first two years of the new president's term.

This extraordinary insulation from the elected branches gives the Fed credibility with the financial markets, which are justifiably concerned that the Fed's policies on price stability will eventually start to follow election returns, allowing the dollar to devalue for political rather than economic reasons. As Laurence Meyer, a former Fed governor, observed: "The motivation for granting independence to central banks is to insulate the conduct of monetary policy from political interference, especially interference motivated by the pressures of elections to deliver short-term gains irrespective of longer-term costs . . . [and] to provide a credible commitment of the government, through its central bank, to achieve . . . price stability."[7]

The Fed's independence has spawned a great deal of controversy, as it should in a democracy. The question is whether an organization that has the power to affect the economy in such substantial ways—resulting in more growth or less in both the economy and employment—should be able to function without accountability to the elected branches. The agency's independence has been repeatedly challenged by powerful members of Congress, usually when it tightens monetary policy and suppresses economic growth in the interest of maintaining stable prices.

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[7] Laurence H. Meyer, "The Politics of Monetary Policy: Balancing Independence and Accountability" (speech, University of Wisconsin, La Crosse, WI, October 24, 2000), available at www.federalreserve.gov/BOARDDOCS/SPEECHES/2000/20001024.htm (accessed February 20, 2009).

This conflict springs from important political interests. Price stability—that is, a stable currency value—favors lenders; inflation in currency values favors borrowers because they are able to repay their loans with inflated dollars. The tribunes of the common man, like William Jennings Bryan, opposed the "cross of gold" because they saw the tight money policies implied by the gold standard as a burden on the working man (now called "working families"). This controversy continues into the modern era. In 1989, for example, then-representatives Lee Hamilton (D-Ind.) and Byron Dorgan (D-N.D.) introduced legislation intended to make the Fed "more accountable" for its decisions, a move described as follows in the *New York Times*: "The Midwestern farmers and businessmen whom Mr. Hamilton and [Mr. Dorgan] represent often favor lower interest rates or 'easy money' to make borrowing easier. . . . But the Federal Reserve has traditionally agreed with bankers and bond dealers, who typically advocate 'hard money,' or higher rates, to prevent the inflation that can devalue the loans they make and the securities in which they deal."[8]

Today, the question of the Fed's independence revolves around the credibility of its policies. For the past twenty-five years, with the exception of a few years after the dot-com collapse in the early 2000s and current efforts to address the financial crisis, the Fed has followed a policy of keeping inflation low by controlling the money supply or otherwise attempting to limit price increases. This has resulted in a slow rate of inflation (1 or 2 percent a year) and relatively stable long-term interest rates. Long-term rates, which are essential for investment planning by business, will remain stable as long as the credit markets believe that the Fed will continue to follow a stable price policy in the future. In the late 1970s, the Fed's commitment to price stability had lost credibility, and long-term rates rose to historic highs. It took several years of painful Fed money supply management—and high unemployment—to win back the credibility that was required to bring these rates down.

The credit markets understand that the political pressures in a democracy favor inflation—there are simply many more borrowers than lenders—and so they watch carefully to determine if the Fed is buckling under pressure from Congress and the president. Thus, while the Fed's independence is inconsistent with democracy, it reflects a practical judgment that the nation's economy would be better off if its monetary policy is determined independently and objectively by economic rather than political considerations. A similar judgment, as noted above, has been made in many other major developed countries. Indeed, at least one study has shown that in countries where the central bank is also engaged in bank regulation, inflation rates tend to be higher.[9] This is what would be expected if the central bank is under pressure to put off credit-tightening in order to make sure that the banks it supervises are stable.

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[8] 10. Louis Uchitelle, "Moves On in Congress to Lift Secrecy at the Federal Reserve," *New York Times*, August 24, 1989.

[9] Carmine Di Noia and Giorgio Di Giorgio, "Should Banking Supervision and Monetary Policy Tasks Be Given to Different Agencies?" (Working Paper 411, Department of Economics and Business, Universitat Pompeu Fabra, Barcelona, October 19, 1999), 8, available at www.econ.upf.edu/docs/papers/downloads/411.pdf (accessed February 19, 2009).

Nevertheless, the cooperation between the Fed and the Treasury in the last year has been unprecedented, which raises serious questions about the Fed's long-term independence from the elected branches and hence the credibility of its stable price policies. When the crisis comes to an end, this will surely be one of the major issues that the financial markets will worry about. Will the Fed simply have become an arm of the Treasury Department, or will it be able to separate itself in the future from Treasury policies that it has had a major role in creating and implementing? Will the Fed sop up the liquidity that it has poured into the economy, or will it again cooperate with the Treasury at least through the election of 2012?

It is through this lens that the Fed's power over systemically significant companies should be viewed. Giving the Fed the power to regulate all the key financial firms in the U.S. economy would involve the agency in major decisions about how business is carried out by whole industries. Unlike monetary policy—which depends for its success on the financial markets' belief that the Fed is making its decisions on the basis of economic rather than political factors—there is no practical or policy basis for insulating the Fed's control over systemically significant companies from political influence. These decisions are clearly important enough that they should be subject to political influence.

Fortunately, there seems to be some recognition of the importance of this issue on the part of Senate Banking Committee chairman Christopher Dodd (D-Conn.). At a hearing on regulatory reform on February 4, 2009, Dodd noted the danger associated with giving the Fed a major regulatory role: "We must be mindful of ensuring the independence and integrity of the Fed's monetary policy function."[10] In the same hearing, former Fed chairman Volcker was asked about the broad authority some have talked about giving to the Fed. In response, he pointed out that there are dangers in loading up the Fed with responsibilities: "You will have a different Federal Reserve if the Federal Reserve is going to do all the regulation from a prudential standpoint. . . . You have to consider whether that's a wise thing to do when their primary responsibility is monetary policy."[11]

Use of the Discount Window

The Fed has one authority that no other regulator possesses—the ability to create and lend money without an appropriation from Congress. The flexibility of the Fed's authority as lender of last resort has been demonstrated in the current financial crisis by the agency's willingness to lend on an emergency basis to companies and organizations that are not banks or BHCs. The continued availability of this authority raises troubling questions if the Fed is to become the regulator of all systemically significant financial institutions, because it will institutionalize a substantial broadening of the Fed's lender-of-last-resort functions. The underlying reason for regulating systemically significant firms is concern that their failure will

[10] Christopher Dodd, "Modernizing the U.S. Financial Regulatory System" (remarks, Committee on Banking, Housing, and Urban Affairs, U.S. Senate, February 4, 2009), available at http://dodd.senate.gov/?q=node/4752 (accessed February 19, 2009).

[11] Quoted in Steven Sloan, "Dodd Voicing Doubt on Fed Systemic Role," *American Banker*, February 5, 2009.

cause failures elsewhere in the economy—that is why they are called “systemically significant.” Under these circumstances, giving the Fed authority to regulate and supervise these firms is essentially the same thing as giving it authority to use its lender-of-last-resort facility to provide them with the liquidity necessary to prevent their failure. The effect, of course, will be to extend the Fed’s safety net far beyond the banking industry.

The Group of Thirty report contains a recommendation that, in whatever form regulation might take, it should preserve the restriction in current law that prevents the commercial firms from acquiring control of insured depository institutions.[12] The longstanding reason for the separation of banking and commerce has been a fear (wholly unwarranted, in my view) that if commercial firms were to control banks, the government safety net—which includes the Fed’s discount window lending facility—would be spread beyond the banking industry. Yet the designation of the Fed as the systemic risk regulator—with authority to cover many institutions other than banks—would do just that. In addition, it raises questions whether—to protect the safety net—there should be restrictions on commercial companies owning financial institutions other than banks. For this reason, if any agency were to be given authority to regulate all systemically significant firms, the Fed should be the last agency on the list.

Conclusion

The case for creating a systemic risk regulator has not been made. There is no clear definition of systemic risk, and specially supervising companies arbitrarily designated as systemically significant would seriously disrupt competition in every field in which a systemically significant company operates. In addition, it is highly doubtful that any agency would be able to assemble and implement regulatory and supervisory policies that would entail setting capital levels and risk standards for companies as diverse as banks, insurance companies, hedge funds, finance companies, securities firms and private equity groups—all of which compete with one another. Finally, even if it were possible to identify systemically significant companies, and to overcome the competitive problems such a policy would entail, the Federal Reserve would be a very poor choice for the systemic supervisor. Such an assignment for the Fed would create significant conflicts with its monetary policy role and impair the independence that the agency needs to carry out that role effectively.

[12] See Peter J. Wallison, "Regulation without Reason: The Group of Thirty Report."