A Financial *Stability* Board

Cutting the Gordian Knot of U.S. financial regulation.

BY CHARLES R. TAYLOR

A single macro-prudential regulator should have responsibility for the stability for any national financial sector. This is the emerging consensus in the United States and in other industrial countries. The buck, so to speak, has to stop somewhere.

What should this regulatory agency do? One idea is that it should look after large complex institutions that have been designated systemically significant. Such institutions do need better supervision, and concentrating the talent needed to supervise them better in a single place makes sense. But if a separate regulator does this, it will have a strong interest in perpetuating these institutions forever—a bad and in fact an impossible idea. Moreover, large numbers of institutions and markets would lie beyond its purview where history tells us that many systemic crises, including the current one, start.

A second idea is that the Federal Reserve should be given greater oversight authority. This doesn't seem completely persuasive either. Chairmen vary in their commitment to regulation: the last one neglected to use Congressionally delegated authorities to oversee mortgage origination. Besides, it is an institution dominated by monetarists and neo-classicists: neither group is especially well-equipped to understand disequilibria in complex evolving systems. Finally, no more power needs to be concentrated in the Federal Reserve. Its balance sheet and monetary sovereignty confer power enough. Its chairman needs, and has, great independence to wield monetary authority effectively. There is no compelling reason to put more power over the detailed workings of the financial system in one pair of hands.

So what is the answer? It is to create a new macro-prudential agency. Let's call it a Federal Stability Board, or FSB for short—to make it clear that in many ways it should be on a par with the Federal Reserve, even if it was quite a small

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institution It should be tasked with "looking through" the existing institutional and functional regulators for signs of systemic risk exposure and tuning incentives of one kind and another to shepherd the sector away from systemic risk. This is like the existing President's Working Group on Financial Markets, except with a wider and deeper purview, independence from Treasury, and staying power.

The FSB needs to be able to incent comprehensive cooperation and coverage from the functional and institutional regulators. One way would be to fund the FSB from a statutory tithe of perhaps 20 percent on the annual financial system oversight budgets of those agencies. This would help give the Board a degree of political independence which it will need if it is to remove the punch bowl at the beginning of booms. For the same reason, members should have long terms of office, like those of the Federal Reserve Board. It might also be given a major role in performance reviews for senior officers from the functional and institutional agencies—to incent their willing assignment to FSB projects.

The FSB would use its funding to support a small secretariat, for projects staffed from the agencies and to fund incremental short-term efforts by individual agencies to meet systemic needs. The Board itself should include experts from academia and the sector and, *ex officio,* the heads of the institutional and functional regulatory agencies. The Chairs of the FSB and FRB should sit on one another's Boards.

What should the FSB then do? It should look for signs of systemic instability and tune the system when those signs become sufficiently severe. Broadly speaking, this means in the first instance scanning the system for three sorts of change: first, declines in standards, such as standards of effective leverage, disclosure, or underwriting; second, disproportionate changes, such as rapid growth in sales or profits, or two price series moving far out of line such as rents and house values, which were harbingers of the current U.S. crisis plain for all to see as far back as 2004; or third, some change in populations, such as changes in the demographics of customers, or changes in the population of institutions engaging in a market, or changes in asset types held in the portfolios in a class of asset manager. Where there are information asymmetries, conflicts of interest, or potential for positive feedback loops—and, of course, if they occur together or on a sufficient scale—signs of this sort should prompt the FSB to act.

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How? It should tune institutional and individual incentives to slow or even reverse increasing systemic risk. That is, it should have the power to adjust the basic compensation structures, along with the margin, capital, and collateral requirements, and also the leverage rules set by institutional and functional regulators. Not only should it use these powers to restrain emergent booms and busts, but also to coax the system toward more robust and resilient configurations. For example, a systemic risk premium on capital adequacy requirements that rises with the institutional size might be gradually introduced to discourage sustained gigantism. That would over time give us a more healthy population of financial institutions—one where all individuals die in due course but the population as a whole continues to thrive.

In the United States, most systemic regulatory solutions are likely to fall afoul of the Gordian Knot of overlapping and conflicting interests of existing Congressional committees, lobbyists, bureaucracies, and industry segments. A new and independent "thin" FSB cuts through all of this. And, on top of this tactical advantage, it may well give us the best chance we can have to avoid systemic crisis for a long time to come. ◆

Exposure Metrics

Operational risk managers inside financial institutions are developing a variety of tools to manage risks that are as heterogeneous and interconnected as those faced by systemic stability regulators. Like perils to the financial system, perils of people, processes, and systems failing to support an institution's mission can sometimes appear quite minor, but when clustered together, can precipitate serious crises.

One of these operational risk toolsets centers on metrics for monitoring changes in risk exposure. If thresholds are passed, management attention is escalated or activity is curtailed. Systemic stability regulators may have use for analogous metrics and thresholds as stimuli of prompt corrective policy adjustment. Moreover, they are well-suited to reducing discretionary responses to certain classes of development, which may play an important role in insulating the FSB from political intervention when it "takes away the punchbowl" during the early stages of a bubble.

—C. Taylor