Goal Conflicts and Financial Stability

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Goal Conflicts

- US financial regulatory agencies have multiple goals
  - Fed is prime example where its main focus is monetary policy
    - But also have micro prudential concerns as regulator for state member banks, bank holding companies and now under Dodd-Frank, responsibility for systemically important non-banks so designated by the FSOC
    - In the past, has had consumer protection duties
    - Enforcement of SEC regulations when it comes to financial disclosure
    - Payments systems operations
    - Placement of monetary policy and prudential regulatory authority in Fed was series of responses to past crises.

- Eisenbeis and Wall(1999) argue that sometimes these goals can be in conflict and discuss how best to resolve them
  - Sometimes these conflicts are best resolved internal to an agency while other times they are best resolved externally in the political arena
  - During the 1960s and early 1970s banking agencies were responsible for enforcing financial disclosure regs and much info on banks were not available. Changed with growth of BHCs as dominant institutions and disclosure policies were effectively externalized
  - Recent example is consumer protection which was moved from banking agencies by Dodd-Frank Act to new Consumer Financial Protection Bureau
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Types of Conflicts

- The potential for regulatory and policy objective to conflict with financial stability goals have four potential dimensions
  - Conflicts between monetary policy and financial stability
  - Conflicts between financial stability and the mechanisms employed to implement monetary policy
  - Conflicts among regulators pursuing different regulatory policies that may adversely affect financial stability
  - Conflicts between government policies (ie. housing) and financial stability
- Will concentrate on the first two of these four potential sources of conflict

Historical Evidence of Conflict Between Monetary Policy and Financial Stability

- Bad monetary policy during the Great Depression and 1970s thrift crisis had adverse consequences for employment and price stability and also financial stability
  - Enforcement of gold standard rules and reliance upon real bills doctrine and misreading of real v nominal interest rates lead to 30% decline in money supply and exacerbated Great Depression
  - In 1970s Burn's Fed attempt to exploit the short term tradeoffs between employment and inflation led to the run up of inflation and created conditions that led to the thrift crisis
    - Thrift crisis was also a child of misguided regulation – namely Reg Q
- There are times when government policies, such as toward housing, can conflict with the Fed's financial stability and monetary policy objectives – thrift crisis is prime example and perhaps Great Recession
- We are not likely to see the same policy mistakes of Great Depression and 1980s but consequences of QE and ZIRP may prove to be a problem as well.
  - Now being argued that ZIRP has damaged monetary policy transmission mechanism and is heightening contagion risk as banks struggle

Possible Conflicts Re Monetary Policy and Financial Stability Policies

- Monetary policy based on flawed concepts of how the economy works is also bad for financial stability as history has shown
  - However, given the present state monetary policy theory, are there still the risks of adverse consequences for financial stability?
  - Fed actions taken in the Great Recession are consistent with the goals of financial stability.
- But even when the concepts aren’t flawed potential conflicts can still arise.
  - Changes in nominal interest rates affect incentives of agents to increase their debt level and take on more risk.
  - Conversely, macroprudential regulation seeks to constrain debt levels and risk taking to prudent levels.
  - This sets up a potential conflict between monetary policy and macroprudential policy with regards to the amount of leverage and risk taking in the economy.

The Great Recession and Conflicts in Implementation

- Many of the same institutions and markets important for financial stability are also critical for the conduct of monetary policy
  - The crisis was amplified because of the interconnectedness among major US financial market participants
- Three mechanisms employed by the Fed to implement its monetary policy decisions have contributed to and enhanced problems of interconnectedness, and was amplified by the practice of rehypothecation.
  - Creation and reliance upon primary dealer system
  - Reliance upon tri-party repo market
  - Conducting market activities only once a day

Primary Dealer Interconnectedness

- Prior to the Great Recession policy was implemented through affecting the supply and demand for scarce excess bank reserves by targeting the federal funds rate
- The SOMA desk engaged in overnight repos and reverse repos with designated primary dealers – large financial institutions that in their own right were systemically important
- This pre-Great Recession operating approach created potential problems from a financial stability perspective.
  - Reliance on the primary dealers and the importance of their dealer roles in Treasury and other fixed income markets increased the dealers' importance to maintaining financial stability.
  - However, as designated dealer, this added to their stature and perception they were too-big-to-fail
    - The perception was reinforced by the special treatment they received by programs put in place to support them such as the TSLF and PDCF
- The weakness of the primary dealers meant that
  - Some failed
  - New dealers were added – mainly foreign financial institutions
  - The new and existing entities didn't intermediate funds as expected because of balance sheet weaknesses
  - This restricted the effectiveness of attempts to ease policy

Tri-Party Repo Market and Interconnectedness

- (2013) New York Fed's President Dudley stated the tri-party repo market – a key market in the transmission of monetary policy - was inherently unstable for three reasons
  - Reliance upon trillions in intra-day credit from JPMorganChase and BNY Mellon meant these institutions were at the heart of an interconnected web of transactions
  - Market failed to appreciate the risk exposure of the two clearing banks
  - Risks were mispriced
- The NY Fed and an industry group recommended changes with the main focus on reducing intra-day credit – by 2014 it was reduced to 3%-5% of daily outstanding volume from about 80%

Daily Open Market Operations

- Presently, and historically, open market transactions take place once a day about 9:20AM
- Participants submit bids based upon the Fed and Treasury's estimates of the volume of funds needed to keep the target interest rate within the desired range
- Intra day then financial institutions obtain short term funding and at the end of the day can sometimes find themselves short of fund, particularly on the final day of a reserve settlement period
- This practice encourages the interbank market but also means that institutions become interconnected with many counterparties.
- The alternative would be for the Fed to simply engage in continuous trading during the day
  – This would eliminate or substantially reduce both intra-day variability in the target interest rate and
  – Reduce interconnectedness, since the Fed would be the main counterparty to most intraday transactions
  – This practice would also enhance the Fed's information of individual institution's funding needs and practices.

Rehypothecation

- Rehypothecation is the practice common in the wholesale money market and tri-party repo market of supplies of funds reusing pledged collateral to obtain additional short term funding
- In times of financial distress, a failure to return pledged collateral could potentially set off a chain of collateral delivery failures that can not be easily remedied without access to the courts
- The delays can trigger a chain reaction of financial distress that could easily be eliminated if the practice were prohibited.

Is the Primary Dealer System Necessary or Is There a Better Alternative?

- A Better Option - elimination of primary dealer status and allow all well-capitalized member banks, as a first step, to participate in purchase and sale of securities with the Desk and related repo activities
  - Technology would accommodate such a change and
  - It would parallel procedures employed by the ECB
  - It would channel funds where they can best be intermediated

- Additionally, should the System revert, as some have urged, to the old regime of targeting the Fed Funds rate when the Fed should continuously buy and sell Fed Funds throughout the day
  - Eliminate Daylight overdrafts
  - Clear and Settle only against good funds

- The two proposals would reduce interdependence among major financial institutions and essentially eliminate intra day variations in the effective Fed Funds Rate

Challenges Remain to This Day

- Little progress has been made on other two problems and systemic risks remain.
  - inadequate risk management practices by cash lenders and clearing banks, which tended to be procyclical
  - the lack of effective plans for managing the unwind of a significant securities dealer should that become necessary.
- The failure of both clearing banks to yet produce credible living wills only reinforces that concern
- By its nature the market embodies significant short term interconnectedness between the two clearing banks, other primary dealers and other institutions.
- Problems of interconnectedness are exacerbated by practice of rehypothecation of collateral
- Since the crisis, the market has shrunk but consideration should be given to a central clearing solution, either as a separate stand alone facility or separately charted and capitalized subsidiaries of the two clearing banks, and similar to the one existing in Europe
- Dodd-Frank would give Fed supervisory authority over the clearer
- Alternatively the Fed could run the central clearing facility and this would eliminate systemic interconnectedness

Disclosure

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