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Comment on Benston and Wood

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It is a pleasure to be here today and to join you in celebrating the many accomplishments of Anna Schwartz. Anna has written widely on the subjects of this panel—bank regulation and the lender of last resort policies of central banks—and has played an important role in shaping policy in these areas. When I was asked to be a discussant on this panel, it brought to mind a story that I had heard about bank regulation, so I would like to begin with that story.

God becomes very discouraged with the way the world is operating and decides to start over, but he wants to give some warning of what he is about to do. So he calls together three important people to meet with him: President Clinton from the United States, President Putin from Russia, and Chairman Greenspan of the Federal Reserve. He sits them down, tells them that he is going to destroy the world in 30 days, and asks them to go back and spread the word. President Clinton convenes the presidential cabinet and tells them: ''I have good news and bad news. The good news is that God exists. The bad news is that He is going to destroy the world in 30 days.'' The President of Russia convenes his advisors tells them: ''I have bad news and bad news. The bad news is that God exists. The other bad news is that He is going to destroy the world in 30 days.''

Chairman Greenspan convenes a joint session of the Board of Governors and the Open Market Committee and says, ''I have good news and good news. The good news is that God exists. The other good news is that we will not have to discuss bank regulation any more.''

The point of this story is that, despite innumerable discussions and conferences on the topics covered by the speakers on this panel, academics have generally failed to achieve a consensus even among ourselves as to what the optimal form of bank regulation is, and we have certainly failed to convince most central bankers that we know what they should do. It is also not very reassuring that during the last 20 years there have been 90 banking crises throughout the world in which banking system losses have equaled or exceeded those experienced by the U.S. banking system in the Great Depression. We should also not forget to count, as we should, our own savings and loan debacle in the 1980s.

All of this makes one wonder whether there is such a thing as a ''best'' or ''optimal'' bank regulatory structure, or at least whether there is an optimal regulatory structure that fits all countries at all times. After all, if such a thing existed, one would have thought that we might have stumbled upon it sometime during the past couple hundred years and achieved a consensus of thinking on the issue. Our failure to do so certainly has not been due to a lack of effort or a deficiency of intellectual talent.

I suspect that one reason we have not achieved a consensus is that the optimal bank regulatory structure in a country may depend on the economic and institutional infrastructure in that country. In particular, the best bank regulatory structure for an

emerging market economy may not be the same as it is for a country with highly developed capital markets, like the United States. Similarly, regulation that may have been optimal for the United States 100 years ago may not be optimal for the United States today because of the immense changes that have taken place in financial markets and financial technologies.

The ultimate goal of bank regulation and financial stability, after all, is to foster economic growth in a country, and the trade-off between the risk of financial instability and economic growth may differ for countries depending on their stage of economic and institutional development. There is some evidence, for example, that less developed countries may be able to achieve a higher level of economic growth by pursuing policies that expose them to a higher risk of financial instability.

A second reason for our failure to achieve a consensus is that there is a strong proclivity for bank regulation to get mixed up with politics and government, and with the social and political goals of a country. To the extent that the goals for bank regulation are different in different countries, or differ over time in the same country, it is hardly surprising that there should be disagreement about the optimal bank regulatory structure. Thus, the failure to achieve a consensus on bank regulation may reflect a lack of a consensus about what a country's political and social goals should be, rather than fundamental differences about bank regulation itself.

The two excellent articles by George Benston and Geoffrey Wood discuss the historical rationales for bank regulation and the history of central bank lender of last resort (LOLR) policy. Both conclude with concrete policy recommendations for improving both bank regulation and LOLR policy. Specifically, George Benston, after a succinct and tightly reasoned review of the historical rationales for bank regulation, proposes additional reforms to current bank regulation that he believes will solve, or at least mitigate, the moral hazard and agency problems that have plagued bank regulation since bank regulation was conceived by man.

These proposals, in essence, have three basic objectives: to make capital requirements the central, indeed the sole, regulatory mechanism for maintaining bank solvency and bank stability; to increase the market discipline of banks by enhancing bank transparency and forcing banks to meet an explicit market test; and to prevent bank regulators from falling into the seemingly irresistible temptation of forbearing when they should be either forbidding banks from doing things or demanding that they raise additional capital.

At first blush, the proposals advanced by George Benston appear to be proregulation—they recommend additional regulations, such as higher capital requirements and a subordinated debt requirement. In reality, they are highly deregulatory. Once the regulatory structure that he proposes is adopted, other prudential regulations can presumably be eliminated.

Fundamental questions that underlie Benston's proposals are, first, what does the required level of the capital-to-asset ratio need to be to achieve financial stability? Second, are capital requirements in fact the only prudential regulation needed to assure financial stability? And, third, will the proposed regulatory structure work in much of the rest of the world, where economic and institutional development is often quite different than in the United States?

With respect to the first issue, there does not seem to be any logical way of deducing what the optimal capital-to-asset ratio should be. Should it be 10% or 20%? Further, should a bank that has hedged most of its asset risk have to hold the same capital-to-asset ratio as a bank with the same level of on-balance sheet assets but that has not hedged any risks? Or should a bank with a large swap book and considerable "potential" exposure be treated the same way as a bank with no swap or derivatives book but with the same level of on-balance sheet assets? These seem to me to be difficult questions that may give regulators pause in adopting the policies that Benston proposes.

But in this case I must plead a conflict of interest. As Benston has duly noted in his article, the proposals he advances are the very ones advanced by the Shadow Financial Regulatory Committee (SFRC), of which I also am a member, as is the other discussant on this panel, George Kaufman. Thus, since I have already endorsed these proposals, I am hardly in a position to adopt the critical and objective posture of the traditional academic discussant with respect to these proposals. However, now that I have officially made this disclosure, I feel perfectly free to add that any sensible and objective person cannot help but see the fundamental wisdom and good sense that underlies the proposals advanced by Benston and the SFRC.

The recent Long-Term Capital Management (LTCM) episode clearly demonstrates that there still exist serious incentive and moral hazard problems in the banking industry, even in the United States. How else can we explain why banks agreed to lend so much money to LTCM (a hedge fund with large speculative positions) and why they took such large counterparty risks vis-a-vis LTCM without knowing more about what LTCM was doing? At a minimum, banks appear not to have pressed for the information needed to evaluate the risks, or, if they had this information, did not use it to evaluate the risks associated with LTCM. As such, the LTCM episode raises the disturbing prospect that neither bank owners nor depositors nor bank regulation and bank regulators appear to be able to keep even the largest banks from taking imprudent risks.

It is clear that we need to enhance the ability and the incentives of bank depositors, creditors, and outside shareholders to monitor banks and to discipline them when they take excessive or imprudent risks, and we need to better align the interests of bank owners and managers with those of depositors and creditors. The SFRC's proposal to raise bank capital requirements and institute a subordinated debt requirement are intended to accomplish these objectives. Adopting these proposals will surely be beneficial, while the potential costs of doing so seem small.

Turning now to Geoffrey Wood's article, Wood admonishes central bankers for persistently trying to expand their traditional role as Lender of Last Resort (LOLR): the injection of liquidity into a banking system to stave off a panic. The first part of Wood's article is an historical review of the proclivity of central bankers to expand their LOLR responsibilities to encompass such objectives as financial market stability generally, and of the tendency of central banks to bail out important, usually large, individual financial institutions in the name of maintaining such stability.

In the second part of his article, Wood sets out the key conclusions that he draws from this historical review. The most important of these are (1) that the sole objective of central banks as LOLRs should be to prevent a banking crisis; (2) that central banks unquestionably have the ability to stop banking crises by the prompt provision of

liquidity to the market and to banking institutions; (3) that central banks do not have to stabilize asset markets (or asset prices) to prevent either a banking crises or a recession; and (4) that there is no such thing as a bank (or any other institution) that is too big or too important to fail.

Thus, his overall recommendation, not surprisingly, is that central bankers should be kept on the straight and narrow path of what has come to be known as the *classic* eighteenth century LOLR policy: the general provision of liquidity to the *banking system* and lending to individual *banks* only on the basis of good collateral and at a penalty rate.

I do not disagree with most of what Wood has to say. However, the importance he places on banks and the banking system may be increasingly suspect as the financial system changes. The line between banks and other institutions is not as bright as it once was. What is and is not a *bank* today is far less clear than in the past, as is the role of banks in the payments system and in the provision of liquidity vis-a-vis other institutions and new technologies. Indeed, there is no longer general agreement even about the definition of *money*. In the future, therefore, it may become necessary for central banks to come to the aid of financial institutions other than banks in order to maintain market liquidity and to prevent a financial crisis. Historical experience may not be the only guide to policy. Some things do change.

Wood also may be a bit too cavalier in rejecting the notion that central banks might act as crisis managers in fulfilling their LOLR function. He argues that acting as a crisis manager is quite different than acting as a LOLR, and that "... combining both activities under one name ..." only serves to confuse the issue (pp. 31–32). In contrast, I believe that central banks may become crisis managers as a substitute for classic LOLR actions—in other words, in order to keep a liquidity crisis from occurring in the first place.

This is clearly the way that the Federal Reserve viewed its recent role in engineering the rescue of Long-Term Capital Management. Chairman Greenspan, in his Congressional testimony (1998, pp. 1, 5), said "The act of unwinding LTCM's portfolio in a forced liquidation would not only have a significant distorting impact on market prices but also in the process could produce large losses, or worse, for a number of creditors and counterparties, and for other market participants who were not directly involved with LTCM...." The creditors and counterparties that the Federal Reserve was worried about were undoubtedly our biggest banks and securities firms, which may well have been threatened themselves by an LTCM default. By preventing the collapse of LTCM, the Federal Reserve, arguably, avoided having to come to the aid of several large banks, which would have had to take substantial losses in their own portfolios and as counterparties if an LTCM liquidation had "seized up" bond markets and driven market prices to unrealistic levels.

It is noteworthy that in the LTCM episode the appropriate institutional mechanism for resolving LTCM in an orderly liquidation apparently did not exist (Edwards, 1999). Typically, bankruptcy law provides for an automatic stay of the firm's assets, which prevents individual creditors from disposing of assets under their control to gain an advantage over other creditors. However, LTCM's situation was different because of its huge derivatives positions. Derivatives contracts are given a statutory exception to the

automatic stay provisions contained in the relevant bankruptcy code. Derivatives contracts, such as swaps, have clauses that give the counterparties the right to terminate the contract in the event of a default of any kind by a counterparty. Further, in the event of such default and termination, counterparties have the right to liquidate any of the defaulting counterparties' assets that they have in their control for any reason, even assets that are not directly related to the derivatives contracts in question. Thus, any default by LTCM, on any of its obligations, would almost certainly have triggered a "run" by its derivatives counterparties: all of LTCM's derivatives counterparties would have terminated their contracts with LTCM and liquidated whatever assets they had under their control in order to limit their exposure to an LTCM default. The Federal Reserve, by in effect inserting itself as a trustee-in-bankruptcy where the law did not provide for one, may arguably have enabled the Federal Reserve to escape having to come to the aid of some large banks that would have been significantly weakened by the wholesale liquidation of LTCM assets.

There may, therefore, be a role for central banks in acting as crisis managers when the institutional mechanism or legal procedures are not in place for there to be an orderly liquidation of an institution, including the prompt valuation of its assets, and when there are important informational asymmetries that central banks have a decided advantage in overcoming. Such circumstances may also not be as unusual as one might think, given the rapid liberalization of financial markets around the world and the growing internationalization of financial transactions and financial markets. There are bound to be situations where the laws in one country conflict with those in another, and where the legal ambiguities are such that the quick and orderly liquidation of a financial transaction or institution may prove to be far more cumbersome than initially believed.

Thus, the prospect of central banks intervening as crisis managers seems likely enough that this issue needs to be addressed directly and not relegated to the backwaters of the LOLR debate. We need to develop guidelines under which central banks should or should not act in this capacity, just as we need guidelines to determine when central banks should intervene as lenders of last resort. Indeed, the development of transparent guidelines is the crux of the matter. If history teaches us anything, it is that central banks have a proclivity to take an active role if there is some doubt about financial market stability. The political and economic forces to which central bankers are typically subject understandably results in their viewing the potential personal and economic costs of not intervening as more immediate and significant than the potential moral hazard costs that may result from intervention. The latter costs are difficult to calculate and, in any case, may not materialize for some time—perhaps even beyond the terms of the current central bankers. It is vital, therefore, that we articulate transparent principles and conditions under which central bank intervention should occur, and that central banks have to explain their actions as consistent with these principles in an open public forum.

In closing, it has been my great pleasure to comment on these excellent articles, and to be part of this wonderful conference celebrating Anna for her perceptive and provocative work on financial markets and monetary institutions. Anna herself has strong views on both LOLR policies and bank regulation, and I suspect that we have not heard the last word from her on these subjects.

References

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