

**Comments on
“Microprudential Versus Macroprudential Supervision:
Functions That Make Sense Only as Part of an
Overall Regime for Financial Stability,”
by Paul Tucker**



**Loretta J. Mester
President and Chief Executive Officer
Federal Reserve Bank of Cleveland**

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Introduction

I thank President Rosengren and the Boston Fed for the opportunity to participate in this year's economic conference. This conference series has been a source of valuable discussions and insights over many years, and I'm happy to note that this year's conference marks number 59 in the series, a remarkable track record. I'm even happier to say that I, myself, haven't yet reached that milestone – although it does remain a goal of mine!

A discussant's task is never an easy one. Sometimes it is difficult because of the simple fact that there just isn't that much in the paper to talk about. Other times it is difficult because the paper is filled with so much interesting material that it inspires a plethora of new thoughts and ideas. In this case, Paul Tucker's paper definitely falls into the latter camp. If you have not yet had the chance to read the paper, I encourage you to do so. And if you have read the paper, I encourage you to read it again, because more is revealed on each reading.

In my brief time this morning, I will be able to touch on only some of the important issues that Paul's paper addresses. My main point is that the principles of sound monetary policymaking can be productively applied to financial stability policymaking. As always, the views I'll present today are my own and not necessarily those of the Federal Reserve System or my colleagues on the Federal Open Market Committee.

Paul was asked to address the larger question of whether the objective functions for microprudential supervision and macroprudential supervision differ, and if so, how any conflicts should be resolved. I agree with his conclusion that the two types of supervision need not be in conflict so long as they are situated within a well-designed financial stability framework, or what Paul calls a regime. I would take this a step further and suggest that micro- and macroprudential supervision should work together. As Paul acknowledges, building such a framework is not trivial. But it is the responsibility of public officials

to do so, since the costs imposed on society for failing to do so are very large. The difficulty derives not only from the fact that the global financial system is very complex, which means a lot of intellectual ability needs to be brought to the problem, but also because the framework involves institutions. As underscored by the work of Nobel Prize winner Douglass North and others, institutions matter.¹ And those institutions necessarily find themselves having to operate within a political economy that needs to be taken into account.

Over the past 50 years, research and practice have increased our understanding of some basic principles that underlie an effective monetary policymaking framework. These include starting with well-articulated and achievable goals, designing features that foster a credible commitment to those goals, and incorporating a mechanism for holding accountable the institution responsible for promoting those goals. In my view, more systematic, less discretionary policymaking, transparency, and clear communication are important features of sound monetary policymaking. I believe that financial stability policymaking can benefit from these same principles and features.

Objectives

The first principle of effective monetary policymaking is having a well-articulated objective that is achievable with the available tools. Paul starts there too. I particularly like that he articulates the goal of financial stability in terms of the resilience of the financial system. In the U.K., the Financial Services Act 2012 formally established the Financial Policy Committee (FPC) within the Bank of England and charged it to act “to remove or reduce, systemic risks with a view to protecting and enhancing the

¹ Douglass C. North, *Structure and Change in Economic History*, London, U.K.: W.W. Norton, 1981; Douglass C. North, *Institutions, Institutional Change, and Economic Performance*, Cambridge, U.K.: Cambridge University Press, 1990; and Douglass C. North, “Institutions,” *Journal of Economic Perspectives* 5, 1991, pp. 97-112 (<https://ideas.repec.org/a/aea/jecper/v5y1991i1p97-112.html>).

resilience of the U.K. financial system.”² In contrast, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 doesn’t mention resilience, but U.S. policymakers might want to consider changing our rhetoric from financial stability to financial resilience. “Stability” gives the impression of being static. But the economy and financial markets are dynamic; they will be hit by shocks and they will respond to those shocks. There will be ups and downs. The goal should not be to thwart all volatility in markets, but rather to limit tail risks. We need to be thinking in terms of the resilience of the financial system to those shocks. As Paul says, “The system must be sufficiently resilient to continue providing the core financial services of payments, credit, and insurance in the face of big shocks.” Another way we might think about the objective is that it chooses a maximum tolerable expected loss from a financial crisis, where the expected loss reflects both the probability of a financial crisis and the cost imposed on the rest of the economy when a crisis-sized shock hits the financial system. Different prudential tools will work on one and/or the other of these two components.

Let me set aside an important issue that Paul addresses in his paper, namely, who should set the resilience standard. Regardless of where that responsibility lies, it is important that the objective be articulated so that the public and its elected representatives understand that there are tradeoffs. Financial systems are able to provide valuable credit, risk-management, and liquidity services to businesses and households because they comprise institutions designed to take on risk and leverage. Even with an optimally designed financial resilience regime, there could be a tradeoff between the average level of economic growth over the longer run and the desired degree of resilience, because risk-taking and risk management are at the heart of the financial system. Indeed, in the U.K., the Financial Services Act recognizes this potential tradeoff and indicates that the act does not authorize the FPC to act in a way that the committee

² Section 9C(2) of the U.K.’s Financial Services Act 2012 says: “The responsibility of the Committee in relation to the achievement by the Bank of the Financial Stability Objective relates primarily to the identification of, monitoring of, and taking of action to remove or reduce, system risks with a view to protecting and enhancing the resilience of the UK Financial System.” See http://www.legislation.gov.uk/ukpga/2012/21/pdfs/ukpga_20120021_en.pdf.

feels is “likely to have a significant adverse effect on the capacity of the financial sector to contribute to the growth of the U.K. economy in the medium or long term.”³

Too high a resilience standard will thwart risk-taking and innovation, which will undermine longer-run economic growth.⁴ In setting the standard, we need to come to some common understanding about the amount of growth and prosperity we are willing to give up in order to lower the risk to financial stability. In the U.S., people who are 80 years old have lived through two major financial crises (the Depression and the 2008-2009 financial crisis and Great Recession). Is that too many? Would we rather lower the probability of such an event to one every 1,000 years? What would we be willing to give up to do that?

Of course, there may be things we can do to improve the framework that will lower the risk to financial stability without much cost in terms of longer-run growth. If we think of there being a frontier relating the risk to financial stability to the economic return that a well-functioning financial system can provide, then it isn’t hard to imagine that we were operating at a point well off that frontier in the run-up to the crisis, and that improvements in the financial resilience regime could move us onto the frontier without sacrificing growth. However, once we reach that point, we’ll have to make a choice about how much growth we are willing to give up in good times to limit the likelihood of a future financial crisis.

Regardless of which institution chooses the standard of resilience, and therefore the tradeoff between economic growth and the level of systemic risk, the standard will need to be well communicated to get

³ Section 9C(4) of the U.K.’s Financial Services Act 2012 (http://www.legislation.gov.uk/ukpga/2012/21/pdfs/ukpga_20120021_en.pdf).

⁴ Quantifying that tradeoff is difficult. Paul cites Romain Rancière, Aaron Tornell, and Frank Westermann, “Systemic Crises and Growth,” *Quarterly Journal of Economics* 123, February 2008, pp. 359-406 (<https://ideas.repec.org/a/tpr/qjecon/v123y2008i1p359-406.html>). Using a large group of countries, they find that average growth over 1960-2000 was higher in countries that have experienced occasional financial crises, as measured by the negative skewness of credit growth. They provide a model in which the enforceability of contracts plays an important role in engendering risk-taking and investment, which leads to higher growth.

political and public buy-in. That's going to be a difficult task – if you happen to be someone living during the once-in-a-thousand years event, how comforting is it to know that that was a design choice?

Systematic Financial Stability Policymaking and Incentives

Now let's turn to some of the features that should be included in the regime set up to meet the resilience standard. Paul suggests that one of the key components of a well-designed financial stability regime is dynamic macroprudential policy that is applied systematically. I agree that a systematic approach will be beneficial to financial stability policymaking, just as it is to monetary policymaking.

The benefit of taking a systematic approach to monetary policy is well established. When monetary policymakers respond in a systematic fashion to incoming information, the public will have a better sense of how policymakers are likely to react to economic developments – whether those developments are anticipated or unanticipated – so their policy expectations will better align with those of policymakers. This alignment helps households, firms, and financial market participants make better saving, borrowing, investment, employment, and transaction decisions, thereby making monetary policy more effective.

An additional benefit of a systematic approach is that it provides a mechanism through which policymakers can commit to policies aimed at promoting policy goals over the longer run. That is, being systematic can help alleviate time-inconsistency problems. Note that by systematic policy I do not necessarily mean that monetary policy be set mechanically by a policy rule. Nor do I require the policymaker to be prescient about the shocks that will hit the economy – if these were predictable, they would not be “shocks.”

Being systematic about financial stability policy is perhaps even more important than in the case of monetary policy because of the important role played by incentives – those of both private actors and regulators – and asymmetric information. The crisis shined a bright light on significant moral hazard

problems that exist in financial markets. A financial stability policymaker that is systematic in how it applies its tools to promote attainment of the resilience standard will likely help tame some of the moral hazard problems. For example, systematically applying the resilience standard across the entire financial services landscape will limit regulatory arbitrage – one of the unintended consequences of regulating just a portion of the financial system. Applying the resilience standard to all parts of the financial system, while allowing the type of supervision to appropriately vary by the nature of the systemic risk associated with each part, is one component of Paul’s financial stability regime.

Regulators themselves are also subject to incentive problems. Ed Kane, a professor at Boston College, has written extensively on this subject.⁵ Misaligned incentives need not stem from regulatory capture, which has received some recent attention. Time-inconsistency problems could lead regulators to favor the short run over the long run. Adherence to a systematic approach in applying financial stability policy tools could serve as a commitment device for regulators to focus on long-run goals, but it’s important to have the right tools in order to align regulatory incentives. An important tool in this regard is financial institution resolution. Although, as Paul points out, an improved resolution method for large, complex financial institutions is not a panacea, in my view it is a large positive step. The lack of a credible resolution method meant that during the crisis, in the face of serious distress at a large financial firm, governments faced a dilemma: either rescue the firm and create future moral hazard problems or let the firm fail and risk causing a cascade of other failures. The fact that policymakers had to make these decisions in the heat of the moment using their best judgment based on limited information didn’t help. Without a credible resolution method, it is reasonable to expect that even well-intentioned policymakers will be biased toward bailouts. A resolution method that can be applied systematically can help alleviate this problem.

⁵ For one of his early works, see Edward J. Kane, “[Accelerating Inflation, Technological Innovation, and the Decreasing Effectiveness of Banking Regulation](https://ideas.repec.org/a/bla/jfinan/v36y1981i2p355-67.html),” *Journal of Finance* 36, 1981, pp. 355-367 (<https://ideas.repec.org/a/bla/jfinan/v36y1981i2p355-67.html>).

Transparency, Clear Communication, Independence, and Simplification

A second hallmark of effective monetary policymaking is transparency and clear communication. Of course, clear communication is not without challenges. In the late 1980s and 1990s, the public had a pretty good sense of how the FOMC's policy would respond to economic developments because after the great inflation of the 1970s, the FOMC became more predictable and systematic in how it reacted to changes in economic activity and inflation.⁶ The Great Recession required the Fed to behave in a way quite distinct from its past behavior, so the public's understanding about how policymakers are likely to react to incoming economic information needs to be reestablished.

In addition to policy effectiveness, transparency in monetary policy is necessary so that the public and elected officials have the ability to hold policymakers accountable for their decisions. The Fed, like many other central banks, has been given independence in setting monetary policy, and this independence has been well documented as yielding more effective policy and better economic outcomes. But accountability must go hand-in-hand with independence. A central bank cannot expect to remain independent from the political process unless it is transparent about the basis for its policy decisions.

A parallel can be drawn with financial stability policy. In the aftermath of the financial crisis, the framework and tools of financial stability policy are still being developed. It will take considerable effort on the part of the financial stability policymaker to explain the tools it will be using and the rationale for its policy decisions. This is likely to be even more challenging than it is for monetary policy because the financial system is complex, with various types of institutions and multiple regulators. In addition, regulators are likely to have more private information on which to base their policy decisions, making it more difficult for the public and elected officials to assess whether the decisions are appropriate ones.

⁶ For a discussion, see John B. Taylor, "[Monetary Policy During the Past 30 Years with Lessons for the Next 30 Years](http://object.cato.org/sites/cato.org/files/serials/files/cato-journal/2013/9/cjv33n3-2.pdf)," luncheon address at the Cato Institute's 30th Annual Monetary Conference on Money, Markets and Government: The Next 30 Years, Washington D.C., November 15, 2012 (<http://object.cato.org/sites/cato.org/files/serials/files/cato-journal/2013/9/cjv33n3-2.pdf>).

Here, I am in full agreement with Paul that while there are some arguments for keeping prudential supervisory information private, I think financial stability policymakers should strive for greater transparency and more disclosure. Similarly, they should require more disclosure from financial firms so that creditors and other market participants can exert market discipline.

There are good arguments for giving financial stability policymakers a large degree of independence from the political process. If effective monetary policy means taking away the punch bowl just as the party gets going, then effective financial stability policy might mean taking away the punch bowl before the guests have even arrived because the risks to financial stability build up over time and action likely needs to be taken earlier in order to be effective. Contributing to the need for early action is the challenge of having to coordinate policy action across multiple regulatory bodies. If the need for monetary policy to be forward looking is a difficult concept for the public to grasp, the need for financial stability policy to act well before there are clear signs of instability may be even more difficult to explain. In thinking about the design of the financial stability regime, it might behoove policymakers to consider whether it would be better for central banks to keep their monetary policy and financial stability policy discussions separate so as to avoid jeopardizing the independence of monetary policy. Note, however, that in a situation in which financial stability risks are high and growing, the blurring of the line between financial stability goals and monetary policy goals would be high: if we assessed the risks to financial stability to be sufficiently great, achieving our monetary policy goals would be in jeopardy as well.

Another aspect of regulatory policy that likely makes it hard to explain and hard to monitor is its complexity. Andrew Haldane and Vasileios Madouros have argued that the complexity of the financial landscape does not call for a complex financial regulatory structure, but just the opposite.⁷ In my view, a sometimes overlooked lesson from the crisis is that regulatory complexity can complicate supervision,

⁷ See Andrew G. Haldane and Vasileios Madouros, “[The Dog and the Frisbee](#),” speech at the Federal Reserve Bank of Kansas City’s Economic Policy Symposium, “The Changing Policy Landscape,” Jackson Hole, WY, August 31, 2012 (<http://www.bis.org/review/r120905a.pdf>).

risk monitoring, compliance, and enforcement. Given the scope and ever-changing nature of the financial system, regulatory complexity is, to a certain extent, unavoidable. But the tradeoffs should be recognized. For example, it is reasonable to require higher levels of capital to be held against higher-risk assets, but a system of risk weights that is overly granular and complex would be counterproductive. In practice, too much complexity would make it harder for regulators to assess compliance and to determine whether institutions were engaging in some practices merely as a way to hide risk and lower their capital requirements. If regulators have made the rules so complex that they cannot assess compliance, then in practice there are no consequences for firms that fail to meet the standards. Complexity also makes it difficult to monitor the monitors.

Because the world is very complex, our models are simplifications with many embedded assumptions. A policy that is optimal in one model need not be optimal in another, yet we don't know which model is the correct representation of the world. Here, we might take another lesson from monetary policy in which a research agenda has documented some of the benefits of policy rules that are robust across various models. Some recent work in economic theory has also shown that simple dynamic contracts can perform approximately as well as optimal contracts, independent of the underlying process for returns.⁸ Although more work would need to be done, this suggests it is worth exploring whether we would be better off with a much simpler macro- and microprudential supervisory structure that is easier to implement and simpler to govern, one that is approximately right across various models and states of the world even if it is never optimal in any particular model or state.

Conclusion

In his presidential address to the American Finance Association earlier this year, Luigi Zingales asked an important question: "Does finance benefit society?" He pointed out the dissonance between the view of

⁸ See Sylvain Chassang, "Calibrated Incentive Contracts," *Econometrica* 81, September 2013, pp. 1935-1971 (<https://ideas.repec.org/a/ecm/emetrp/v81y2013i5p1935-1971.html>).

academics, who typically say “yes,” and that of the average American, who is much less certain.⁹ Luigi argues that academia has an important role to play in ensuring that finance will benefit society. I agree. Academic research can help detect those aspects of financial system design and practices that are beneficial to society and those that are harmful. But major responsibility lies with financial system policymakers, supervisors, and regulators to create a system that is seen by the American public as being beneficial and that truly is. I thank Paul for providing many thoughtful ideas in support of this endeavor.

⁹ See Luigi Zingales, “Does Finance Benefit Society?” *Journal of Finance* 70, August 2015, pp. 1327-1363 (<http://onlinelibrary.wiley.com/doi/10.1111/jofi.12295/abstract>). He cites the Chicago Booth-Kellogg School Financial Trust Index survey of a representative sample of about 1,000 American households, conducted by Social Science Research Solutions. Forty-eight percent of respondents to the December 2014 survey said that the U.S. financial system hurts the U.S. economy, while only 34 percent said it benefits the U.S. economy.