

General Discussion: Institutions and Policies for Maintaining Financial Stability

Chairman: Jacob Frenkel

Mr. Frenkel: Thank you very much. The speed with which you spoke at the end is just the proof of what Morris Goldstein said yesterday—that speaking quickly is the only solution when you have a time constraint. And you did refute an old dictum that Avinash Dixit of Princeton once said. He once said that the invention of the word processor reduced the relative cost of producing words relative to ideas, with predictable results. But again, I want to emphasize that by the quality of your remarks you demonstrated that this is not a general theorem.

Mr. Kroszner: I would just like to say that my notes were handwritten.

Mr. Frenkel: Let me just say that when you spoke about Václav Klaus and Donald Brash sitting in the *center* I had the opportunity to see their body movement, and those of you who were here the first evening noticed that the wall separating the two parts of the room can be dismantled, opened. Therefore, the concept of *center* is to be defined as the place to the right of where Donald Brash and Václav Klaus sit. Let me open the floor for discussion. The first remark: Jerry Corrigan.

Mr. Corrigan: Actually, I could probably spend the rest of the morning, given all that has been said here. But let me just touch on a couple of things very quickly. I want to start by going back to some

of the discussion yesterday morning, and then coming right into a couple of things that are in Bob's paper. Yesterday morning I said that I welcomed the fact that Stan Fischer had put this issue of "going public" on the table. In so doing, Eddie George told me in a casual conversation that he was a little surprised that I was glad that Stan Fischer put that on the table, because he interpreted my remarks as saying that I was somehow rather in favor of a set of institutional arrangements through which some official body, the Fund or otherwise, would take on the role of the whistleblower. Eddie, I want to reassure you that was not my intent. My intent was to get the issue on the table, because there were too many circumstances in which, it seemed to me, that I was interpreting various comments by various observers to say that such an arrangement would be a panacea, whereas in fact I don't see it that way at all. I think it runs severe risks of weakening the process of official oversight by the Fund or whomever. But worse than that, it does bring a clear and present danger of a self-fulfilling prophecy in a context of which we never know for sure whether we are right or not. Again, as was acknowledged by Morris and others, you do have false signals. If you decide to be a whistleblower, your batting average has to be 1.000; and nobody's is. So, again, I just want to set the record straight on that. This brings me to a couple of points in Bob Litan's paper. For example, Bob makes the point again that he thinks it is a good idea for supervisors to disclose publicly supervisory ratings. He even goes so far as to say that it would be good to do that without bothering to disclose the details, which to me makes it even worse. Again, I would just make the observation that the false-signal problem and the weakening of the process problem, I have no doubt in my mind that this arrangement would tend to water down the efforts of the supervisory and examination personnel. It would inhibit them from doing what they should do and doing it promptly. But again, there is the false-signal problem. I have very little doubt, for example, that if we disclosed the supervisory ratings of some of the major U.S. financial institutions in the late 1980s and early 1990s, that we probably would have had a real mess on our hands. I don't see how that does much to enhance the cause of sound public policy. I do think that, whether it is countries, or companies, or banks, enhanced public disclosure and all of the rest of it make a lot

of sense. But I think a sensible person, at least in my judgment, has to be very cautious about how far to push that process. We have enough problems without making more. Having said that, Bob, I do want to congratulate and acknowledge the extent to which you have put these payments and settlement systems issues on the table, and, Randall, the same for you. I'd like to say you heard it here first, but I think you acknowledged that. But let me just make a couple of further points, if I may. First of all, the focus that you put on CHIPS, FedWire, and foreign exchange is all well and good. But again, it's very, very, very important to recognize that there are dozens if not hundreds of net settlement systems of one kind or another all over the world. Each and every one of these can be as potentially important as the ones that you've mentioned. So again, I just want to make sure that no one is under any illusions that if we get these particular ones under control, we can all go on vacation. There is an enormous amount of effort and work still to be done in this area. I want to also say that, in all fairness, that both of you did a little bit of a disservice to CHIPS. Even as things stand right now, CHIPS has come much further, much faster in getting toward true finality—they're within kissing distance and some would say they're even there now—so I don't want anybody in the markets or in the media to come away with the feeling from your comments that CHIPS as it exists today has any fatal flaws in it because it does not. The other thing I would want to say in this area is that one or both of you basically come pretty close to saying (and maybe I'm putting words in your mouth) that FedWire should drop its own form of finality, the so-called guarantee, and I think, Bob, you make the argument partly on the grounds that the presence of the Fed guarantee results in a competitive anomaly. I don't think that is true at all. The fact of the matter is CHIPS and FedWire are very imperfect substitutes for one another, given the types of transactions they handle and all the rest of it. And it is very, very important to keep in mind that most of these systems, at least the ones that are dollar-denominated, do their net settlements through the FedWire system, and it is the finality of the FedWire net settlement system that ultimately makes these things work. So again, I personally think, and, Alice, I don't want to be stepping on you, or Alan, or Mike Kelley, but I personally think that, while it is very sensible and appropriate for the Fed to continue to work in the

direction of—either by administrative actions or otherwise—limiting interday exposure on FedWire through collateral arrangements and other types of things, I think the idea of doing away with central bank real time gross settlement systems that provide instantaneous finality would be a terrible, terrible mistake. Jacob, one footnote: In an earlier discussion here there was some discussion about the IMF and the World Bank becoming the international bank supervisors. I think that is a lousy idea. I think they have to play a major role in technical assistance and help build systems at the national level. Ultimately, this is a sovereignty question. I think the BIS has a role to play here too. But, the IMF, to put it in the most graphic terms, has enough political baggage now without adding new baggage to the already considerable amount of baggage it has. Thank you.

Mr. Frenkel: Thank you very much. Some of you may not follow the technical debate between CHIPS and wires. And it is very important that we get familiar with it. There was this guy who was offered a Russian watch. He decided to buy it. He was asked at home, “Why did you buy it?” He said, “Well, they told me that there were three reasons. First, it is nicer; second, it is cheaper; and third, it is running faster.” Donald Brash.

Mr. Brash: It won’t surprise anyone here to know that I find myself in very substantial agreement with both what Bob Litan and Randall Kroszner said. I have no doubt that market forces can be used more effectively to increase efficiency and reduce risk, particularly if we can make improvements in real time gross settlement systems simultaneously. One problem, though, is that in the here and now in all our countries there is still a very strong public belief that depositors are effectively guaranteed, be it by a safety net or a formal deposit insurance system. For that reason, in the here and now at least, we can’t move to having absolutely no public sector involvement in the banking sector, as Bob Litan says and Randall himself might well acknowledge. For that reason, even in New Zealand where we have a very light regulatory framework as you know, we retain a lender-of-last-resort system, we retain a capacity to deal with banking crises. We retain the Basle minimum capital ratio. We retain limits on connected lending, but we also, and most important,

I guess, we specifically mandate bank disclosure. We don't allow banks to choose the level of their disclosure; we mandate a very substantial level of disclosure and indeed oblige bank directors to sign off on that. So we don't rely on market forces as the sole guarantor of financial stability, but what we do try to do is to use market forces as much as possible to assist in ensuring financial stability. Unfortunately, as many will know, New Zealand is not the ideal laboratory to test these systems because we do have a high level of foreign ownership in the New Zealand banking system. I have to say that we had a somewhat lower level of foreign ownership when this system was first contemplated in the early 1990s. In fact, the introduction of the system has probably increased the level of foreign ownership, not perhaps surprisingly because a domestic bank forced with having to disclose its credit rating in competition with large foreign banks inevitably finds selling out to a foreign bank an attractive option.

Mr. Frenkel: Thank you very much. Michael Darby.

Mr. Darby: In thinking about avoiding financial crises, policy loans have come up only within the context of transparent policy loans, such as those that led to savings and loans being restricted to mortgages. There are a lot of opaque or semi-opaque policy loans, certainly in the rest of the world and even some in the United States, in which banks have significant amounts of their portfolios lent to friends of the government. So it seems to me that when we look at at least some of the newly industrialized economies—certainly the emerging economies—we have banks that probably (when marked to market) generally have negative equity, unless you assume the lender of first resort, whatever it may be in those countries that have been financing these loans to friends of the government, continues in perpetuity. So part of the issue that has been left out of here is: How do you unwind those? How do you get the Southeast Asian or Northeast Asian countries out of these policy loans, as well as in Latin America and a lot of other places not to mention the G-10? So anyway, I think that's an issue that has been left aside. It has been assumed that the central bank only lends as last resort, and that the market forces are the only thing that leads bankers to issue credits.

Mr. Frenkel: Thank you very much. Yes, please.

Mr. Barnes: Bob Litan, you noted that derivatives help people reduce risks. We heard yesterday from Rick Mishkin and others about the role of asymmetric information flows in promoting financial instability. I would like to ask you whether you are concerned about asymmetric information in the derivatives market. I guess there are two aspects: One, identifying derivatives' positions—and clearly the latest FASB proposals on company reporting have created a little bit of controversy; and, two, the pricing of derivatives and some more exotic, unique instruments where there seems to be more understanding of the pricing of these on the part of the issuer rather than the end users.

Mr. Frenkel: Thank you. Wayne Angell.

Mr. Angell: It certainly is true that time does equal risk. And it is also true that opening FedWire at 12:30 a.m. does not mean that there are going to be a lot of transactions because reserve requirements at 12:30 a.m. are the same as they are at 8:30 a.m. and that is zero. Since reserve requirements are zero, there is no intraday federal funds market and consequently we have the risk, ersatz and otherwise, that time during the day before 5:30 p.m. New York time involves risk. There will not be motivation to do real time gross settlement for clients of CHIPS or anyone else until we have an intraday federal funds market. The solution is very simple. The Federal Reserve simply goes to real time reserve requirements, minute by minute.

Mr. Frenkel: Thank you. Please.

Mr. Becker: Chairman, I thank you. When you mentioned the speed of the speakers, I had the feeling listening to those brilliant American academics, the higher the speed, the higher the quality of the academics, so I feel sorry for Mr. Sachs. He was so clear and so strong. But I loved it. Being in the banking supervision field, I was not surprised (but it is always a bad thing to hear) that the world could be and should be without banking supervisors. Randall, you

mentioned that what would it be in looking at the costs and the effects of that maybe not much would happen. And you mentioned New Zealand as one case. I don't know if I agree, because there is not much of a gap because those foreign banks working in New Zealand are supervised very intensively by their home supervisors. So supervision even covers New Zealand. And New Zealanders themselves have only very few small institutions based in that country so they really don't matter. Another point you mentioned is international euro markets. The markets are fairly free, I think, but the participants have not been free. They have to adhere to the different strong and tough regulations of their home countries, which are more or less valid all over the world. So I think that is again not an example for no regulation at all. Another thing is true: There is a big discussion on how to make regulations more marketable and more free. I think this discussion has to be continued and we have to see what is coming out of that. The Group of Thirty is also asking to set their own standards, being valid for the whole world. I think that might be a good idea. But, on the other side, when the banking industry is asking to set its own standards—and some of them have the okay of the supervisors—the industry should be ready to think of how to take up more responsibility when things go wrong. This side of the topic has not been discussed so far. Thank you.

Mr. Frenkel: Thank you very much. Indeed, the issue of speed is key, because that depends on when you start. There was this boy who was known for always missing the bus. He ran very quickly and when he arrived at the station, the bus went away. An old man came to him and said, "My dear child, you should have run a little faster." And the boy replied, "No, I ran as fast as I could. I should have started a little earlier." That is a very important point. Henry Kaufman.

Mr. Kaufman: It seems to me that in looking at an age-old problem here of supervision on the one hand, and letting the market clear the transaction on the other hand, there are certain developments historically that have to be recognized. First of all, periods of crises tend to lead to more financial concentration. In recent years following

crises, financial concentration has intensified. Fewer banks, fewer insurance companies, a substantial concentration in the mutual fund industry by those who are really the companies that motivate these stockholders involved, and therefore, we have a situation where over time the financial markets will have fewer leading players rather than a larger number of leading players. That, of course, will induce more supervision and more regulation, because no one will want to undertake the systemic risk involved here. So eventually, if this process of greater and greater financial concentration would go on, what we will have are institutions that really become public utilities.

Mr. Frenkel: Thank you very much. We are converging to the end of this session. One last remark, please.

Mr. Dugger: I'd like to make a comment that relates to the issues of information analysis and incentives. Earlier, Scott Pardee pointed out that there may be conflicts in incentives and mentioned the first of possibly three sets of private incentives that might obscure or delay a currency adjustment signal. For example, because we know markets fall generally three times faster than they rise, companies like mine whose business is trading, are particularly attracted to potential declines and are not incented to publicly discuss our expectations or what we're doing.

Scott pointed to profit incentives arising from institutional relationships with the host government. In addition, there may be incentives arising from the institution's own dealer operations and from the needs of proprietary trading clients, including its own proprietary trading desks. As Scott pointed out, if a financial institution has a significant business relationship (or desires one) with a country government, that institution will be understandably slow to criticize the government in words or actions.

Furthermore, if an institution is actively offering long- and short-side derivative hedging products to corporate clients, it may be reluctant to downgrade its published judgments of the government's policies until the evidence weighs clearly one way or the other. For an institution, long- and short-side positions have to balance. To continue

to sell short-side products to clients, the institution has to continue to market long-side ones also. This need is an incentive to continue to speak at least neutrally about government policies until matters are quite clear.

Last, as the evidence begins to swing against a government's policies, proprietary trading operations will significantly outweigh short-side positions to profit from anticipated near-term market movements. Proprietary traders have no incentive to comment negatively about a government until their position-taking is completed.

The cumulative effect of incentives like these in a low-information, relatively non-transparent currency market may be a delay in the market's apparent response to actual economic conditions and government policies, and a powerful discontinuity when the response occurs. In other words, institutions may comment positively until it is clear that another positive comment will be counterproductive; then there will be no positive comments and the market will adjust suddenly and overwhelmingly. At the micro level, it is marginalism at its best. At the macro level, the adjustment is a seemingly inexplicable discontinuity, which leaves no time for the government to adjust. The answer clearly is to improve transparency to the point that institutional profit incentives are not material in influencing the timing of a currency market's adjustment.

Mr. Frenkel: Thank you very much. We will soft land with two minutes by the author and one minute by the discussant. Please.

Mr. Litan: Let me briefly address Jerry Corrigan. I was not surprised that Jerry focused on the CAMEL disclosure recommendation in my paper, which I didn't have time to talk about publicly. He raises the question, "If we had disclosed CAMEL ratings in the late 1980s for large banks, would it endanger us?" Well the fact of the matter is that I would argue that the CAMEL issue is really the tail, not the dog. The dog is the subordinated debt requirement. If you had a mandatory subordinated debt requirement, you would have a lot of investors out there paying a lot of attention to the true health of banks. Investors knew the large banks were in trouble in

the 1980s. All they had to do was read Jeff Sachs' paper in 1988 in the *Brookings Papers on Economic Activity*, and a lot of other papers like it, that documented the heavy discounts that the market was placing on LDC debt. If there had been a mandatory sub debt requirement then, the market would not have let large banks grow. It also would not have let them pour more money into lousy real estate deals. Now I raised the issue of CAMEL ratings to respond to a criticism that I have gotten on sub debt. It is the Bank of New England problem, namely, that you had a lot of insiders at the Bank of New England who kept on buying the stock even in the year before it was in trouble, even while the regulators had marked down the loans of the bank. All I was saying is that if all investors had access to the CAMEL ratings of the Bank of New England, you would not have had that problem.

I fully agree with Jerry's remarks on CHIPS. CHIPS is not in imminent danger of collapse. I make that point in my paper and, for all the journalists here, I would point out that in fact the measures that CHIPS already has taken have insulated it from an unwind from even the two largest banks failing on the system today. I just argue in my paper that CHIPS could eliminate all the remaining risk by going to real time gross settlement.

On the issue of an intraday funds market that Wayne Angell recommended, I agree 100 percent. And finally, on the asymmetric information issue in the derivatives area that was raised by Martin Barnes, the point here is that most of derivatives trading is concentrated among the big guys: big banks, insurance, securities companies. It is not asymmetric there; they know what they are doing. One argument is that that is good, because the players all know each other so there is not a systemic problem. There are critics, however, who believe that the concentration of derivatives trading provides a recipe for disaster. If one party goes down, they are all interlinked with each other and all hell could break loose. I point out that in my paper we won't know which side is right unless we have an event that demonstrates it, which we all don't want to happen.

Mr. Frenkel: Thank you very much. Please.

Mr. Kroszner: Jerry Corrigan raised concerns about what would have happened if regulators had disclosed their ratings of large banks during the late 1980s and early 1990s. Moody's, Standard & Poor's, and other private agencies, however, did sharply lower their ratings of these banks. The price of Citicorp stock, for example, fell by more than 80 percent during this period. Also, large banks like Citicorp had issued auction-rate preferred stock on which the interest rate was reset every forty-nine days. This security plays a role similar to that of the short-term subordinated debt instrument suggested by Litan. The markets forced Citicorp to pay almost 700 basis points more than what other large banks, such as J. P. Morgan, were paying on these issues. The markets were aware that something was wrong and made them pay for it. These downgrades and high interest rates did not precipitate runs, panics, or contagion effects. So, it is not clear that disclosing the CAMEL ratings would have any worse effect. On CHIPS, I want to emphasize that I am not criticizing the current structure of CHIPS but analyzing why it took so long for CHIPS to adopt the sensible risk-sharing, collateralization, and monitoring procedures it now has. The Federal Reserve had been providing implicit subsidies and guarantees, and these have recently been disappearing. The Chicago commodities and derivative markets, which never had access to the Fed subsidies, adopted sound procedures for their private clearing and settlement systems long ago. Michael Darby raised what I believe is an extremely important point about the potential dangers of insider or connected lending, especially for emerging-market countries. Interestingly, historical work on banking in the United States, particularly New England, suggests that the original purpose of many banks was to provide insider lending, that is, business people pooled their resources to found a bank and initially did most of their lending to each other. Connected lending, thus, is not necessarily a problem. It can be destabilizing, however, when such lending is not provided on a market basis but is really a policy loan, that is, implicitly subsidized lending that is part of the government's redistribution or industrial policy. On the euro markets, I did mention that they may implicitly piggyback off domestic regulations, so their success does not directly address how unregulated markets would operate. My key point is to ask: Exactly what value do the regulators add? Would they survive

a careful cost-benefit analysis? Are regulators better informed than the market? Although Bob Litan mentions that some insiders were buying stock in Bank of New England soon before its collapse, the General Accounting Office official report is subtitled: “The Office of the Comptroller of the Currency’s Supervision of the Bank of New England Was Neither Timely nor Forceful.” Perhaps if regulators were required to disclose their ratings and be subject to public scrutiny, they would become more effective monitors. On concerns about high concentration in banking, academic studies on scale economies provide almost no evidence of “natural monopoly” in banking and finance and, historically, there does not appear to have been any systemic risk problems associated with highly concentrated banking systems. Hong Kong is a prime example of a stable, yet concentrated, banking system.

Mr. Frenkel: Thank you very much. I think the consensus that emerged here reflects both consensus on the substance as well as the recognition that we all want to break for coffee. So let me again thank the speaker and the discussant.