

Building a More Stable Financial System: Unfinished Business

Donald Kohn

Twice in this still-young century central banks have had to take steps, unprecedented in size and scope, to limit the economic fallout from financial instability. While we can't expect a financial system to withstand an overnight shut down of the global economy like we experienced in March 2020 without support from central banks and fiscal authorities, the financial market turmoil at that time highlighted vulnerabilities that were visible well beforehand. The system is stronger than it was going into the global financial crisis (GFC), but much remains to be done, especially in nonbank finance. I'm going to reflect on some of the actions that need to be taken, drawing on the recent recommendations of a Task Force on Financial Stability in the U.S. that I co-chaired, and on my experience as an external member of the Financial Policy Committee at the Bank of England.¹

To preview, here are the main points I plan to make.

1. Dealing with risks to financial stability is urgent. If the economic and financial situation evolves as seems to be expected in financial markets, credit should flow, and financial markets will continue to serve the needs of the economy. But the current situation is replete with fat tails—unusually large risks of the unexpected which, if they come to pass,

could result in the financial system amplifying shocks, putting the economy at risk. Shoring up our defenses against financial instability can't run on Federal Reserve or, even worse, FSOC (Financial Stability Oversight Council) time where near endless analysis and consensus building delay needed action for years.

2. Dodd-Frank and Basel reforms have greatly improved the resilience of the banking system. Still, I have two linked recommendations for banks. First, fix the Supplementary Leverage Ratio and perhaps some other post GFC regulations so they don't impede market-making in Treasury securities and related repo; second, improve risk-based capital regulation by utilizing a countercyclical capital buffer that builds bank capital in good times and releases it after shocks.
3. There's much more to do in nonbank or market finance. This was the focus of our Task Force and we ended up with a 135-page report with dozens of recommendations. I'm going to focus on the Treasury market, but many aspects of market finance need urgent attention.
4. Our regulatory processes and procedures need to adapt to provide more nimble, more transparent, more accountable responses to ever-evolving threats to financial stability. We must do a better job of spotting potential problems early and making concrete suggestions for dealing with them.

I will not be directly addressing the unevenness issue that is the subject of this year's Jackson Hole symposium. We learned during the GFC in 2007-09 that addressing wealth inequities by allowing leverage and maturity transformation to build up or encouraging easier lending criteria are not sustainable and can be counterproductive. Jay Powell's answer to a related question at the last press conference was spot on: We need strong and resilient financial systems that can serve everyone through the cycle; this is especially in the interest of low- and moderate-income people, who could well bear the brunt of the recession were financial systems to prove unstable. Tools other than capital or liquidity relief are required to address financial disparities and inequities.²

Urgency

I see considerable urgency for getting on with the task of making the financial system more resilient to unexpected developments. At the last FOMC (Federal Open Market Committee), the Board staff characterized financial vulnerabilities as “notable,” reflecting some asset valuations, leverage in corners of the financial system and persistent structural issues.³ Moreover, these vulnerabilities have arisen in the context of truly unprecedented circumstances, making it difficult, if not impossible, for policymakers or market participants to predict the future with confidence. There’s the virus of course and the public and private response to its evolution. In addition, fiscal policies are raising federal debt to income to record peacetime levels and a new monetary policy framework has yet to play out in practice. Yet, market participants appear to have priced in very low interest rates for a very long time even as the economy recovers and, judging from risk spreads and equity prices, are quite confident that higher debt levels can be serviced and sustained—even though a disproportionate increase in private debt has been among lower-rated business borrowers.⁴

Some of those vulnerabilities arise from the effects of the extended period of low rates on borrower and lender behavior. In the absence of robust macroprudential tools, monetary policy could be forced to act to contain these heightened risks, at considerable loss of economic output.

Moreover, the nearness of the ELB (effective lower bound) raises the cost of economic weakness arising from instabilities in the financial system because it constrains the ability of the central bank to cushion the effects by easing policy.⁵ And, given government debt levels, fiscal policymakers may perceive that their scope to respond to a financial meltdown also is limited. Potential constraints on fiscal and monetary policy easing in a future financial stress event bolster the case for making extra sure the financial system is resilient today.

And risks may materialize even if the ELB turns out to be less binding in the future than now expected. With recent fiscal policy quite expansionary, considerable excess savings to be spent, and a recent pickup in productivity growth, it’s possible that r^* is higher than

backward-looking models now suggest, at least over the medium term. And disruption to global supply chains and incomplete recovery in labor market participation might persist, heightening inflation risks. To be sure, higher r^* would mitigate some of the risks previously discussed, and persistent positive inflation shocks aren't entirely unwelcome after a decade of shortfalls. But the transition to a higher rate environment could be pretty bumpy given that a lot of asset values and assessments of debt sustainability are built on very low interest rates for very long.

Banking

Banks, bank holding companies and their subsidiaries—including the major dealers—appear to be in good financial shape, judging from the Fed's stress tests and from their performance in a real-life stress as COVID set in.

But some of the regulations that have yielded this welcome result have also constrained the major dealers from providing liquidity to Treasury and related repo markets when stress hits and holders of Treasuries need to convert them to cash. Dysfunction in the Treasury market has the potential for considerable spillovers into the real economy—hence the massive purchases by the Federal Reserve last March when Treasury markets were misbehaving.

In discussions with market participants, the supplementary leverage ratio (SLR) along with some aspects of the G-SIB (global systemically important banks) add-ons to risk-based capital requirements were frequently cited as having the effect of limiting the willingness of dealers to stabilize the market. Moreover, the SLR constraint is being made increasingly salient by the Fed's asset purchases; the Federal Reserve is forcing one type of asset into the system—deposits at the Federal Reserve—which is drawing the SLR ever more closely into bank capital planning, making the purchase of low-yield, low risk, Treasury securities potentially much more capital intensive and therefore less profitable. To be sure, some of the immediate pressure on banks' SLRs has been alleviated by inducing deposits to be diverted from banks to money market funds, where they are invested in reverse repo from the Fed. But growing money market funds doesn't seem like a lasting

structural solution for the problem, and to the extent some of those extra inflows are invested in Treasuries or commercial paper as well as reverse repo, the case I'm about to address for addressing weaknesses in MMFs and in Treasury markets is strengthened.

The Fed recognized this problem in exempting reserves and Treasuries from the SLR denominator at the height of market dysfunction, but this exemption expired in March. To increase dealer market making capacity, the SLR should be restored to a backstop function for risk-based capital—by exempting reserves or some other way—and other regulations also should be examined to see whether they could be adjusted to remove impediments to market making in Treasuries without reducing the resilience of the banking system. Of course, the hard part is in that last phrase, and I imagine that's what holding up the suggestions on SLR that in March the Federal Reserve promised were coming “soon.”

My second suggestion on banks—not part of the Task Force report—is for the Federal Reserve to move to more active use of the countercyclical capital buffer (CCyB). It should be at a positive rate in a normal, standard risk environment, raised from that when leverage or liquidity transformation has reached more dangerous levels among borrowers or lenders and cut when stress events occur. I'm drawing on my experience with the Bank of England, where we are putting the CCyB at 2% in standard risk environments and we cut it twice—once after Brexit referendum and again with COVID. Strengthening risk-based capital requirements with a CCyB will provide assurance that easing the risk-insensitive SLR will not put the banking system at risk.

My thinking on the CCyB has been reinforced by two recent observations. First, the staff memo to the board on the adoption of the stress capital buffer (SCB) early this year characterized the SCB as pro-cyclical—that is calling for less capital protection as the economy improved. This is not an acceptable macroprudential outcome; the ability of the financial system to deliver services in bad times as well as good, will be enhanced when capital is built up in those good times so it can be safely drawn down when adverse developments hit. I wasn't surprised by the staff's characterization; the paper Nellie

Liang and I wrote on the stress tests showed very limited countercyclicality in the stress capital buffer, and what there was came from the requirement to prefund eight quarters of profit distribution, a requirement that has been considerably trimmed.⁶ That pro-cyclicality needs to be turned into countercyclicality, and the CCyB seems the way to do it.

Second is the issue of buffer usability—the willingness of banks to continue to lend if doing so might cause capital ratios to fall into their regulatory buffers, risking adverse market reactions, supervisory feedback and restrictions on distributions. In a recent working paper, Berrospide and co-authors show that U.S. banks that were at risk of having their capital fall into buffers reduced lending commitments to SMEs (small to medium enterprises) in the pandemic by more than banks with ample headroom over buffers, and buffer-constrained banks were more likely to terminate lending relationships.⁷ The beauty of CCyB is that when it's released, that capital is no longer part of a buffer and can be drawn down to support lending without risking adverse feedbacks.⁸

In sum, exempting reserves from the denominator of the SLR and raising risk-based capital slightly on average over the cycle by adding a CCyB on top of the SCB would enhance the resilience of several key sectors of the U.S. financial markets.

Nonbank Finance

Credit has increasingly shifted to nonbank channels, responding to innovation and to regulatory arbitrage as bank regulation tightened. But elements in nonbank finance share the leverage and maturity and liquidity transformation characteristics of banks, making them also vulnerable to runs and fire sales that tighten credit and amplify business cycles. In many respects, however, vulnerabilities in nonbank finance are harder to deal with than they are with banks. They are spread over many types of institutions and markets, subject to multiple regulators—and some parts are very lightly regulated, if at all. Market-based finance is global, facilitating arbitrage across borders and necessitating a globally agreed approach to regulation. And rapid

technological change produces a constantly evolving set of instruments and players.⁹

Runs and fire sales threaten when a surge in demand for liquidity—both funding and market— can't readily be met by supply from the private sector.

Nowhere is it more important to improve the balance and make smooth market functioning more reliable than in the market for U.S. Treasury securities. Treasuries provide a pricing benchmark for riskier securities; they are widely used to manage and diversify risk; and by practice and regulation Treasury securities are a key source of liquidity—a source that both users and regulators count on, especially in adverse states of the world. None of those systemically important functions will be adequately performed if prices in that market behave in unexpected and counterintuitive ways, as they have periodically, most seriously in March 2020.

The demand for liquifying Treasuries can come from many sources, as it did in the March 2020 “dash for cash.”

For example, several types of open-end funds faced very large redemptions in March, including both money market funds and corporate bond and loan funds. To meet those demands, funds turned in part to selling the Treasuries they held for liquidity purposes. The scale of the redemptions is not surprising, and the financial stability risks from OEFs is one the Financial Policy Committee at the Bank of England has been highlighting for several years. Many mutual funds offer their investors much greater liquidity—an ability to redeem by tomorrow at tonight's closing price—than the liquidity of the underlying securities they hold, which often trade in illiquid markets or simply don't trade at all, like commercial paper. This mismatch creates a first-mover advantage—an incentive to get out while the fund has Treasuries to sell—before redemptions by other investors force fire sales of less liquid assets depressing prices. Financial stability requires greatly reducing, if not eliminating this first-mover advantage. Our task force had a variety of recommendations to this end: swing pricing to reflect the effect of heightened redemptions, which forces early redeemers to pay the price of the liquidity they are

getting; reducing the threat of gates on MMFs; and other techniques to better align liquidity offered investors with the liquidity under stress of the assets held.¹⁰

Another source of demand for liquidity arose from initial margining at central counterparties in derivative and securities markets. Users cited a lack of transparency and predictability about margining methodologies as contributing to unexpected demands for cash during the “dash for cash.” And margins should be made less pro-cyclical with more through-the-cycle methodologies.

To increase the supply of market liquidity, the regulators should take a hard look at the SLR and other regulations that might be impeding private market making, as I’ve already discussed. They should examine the costs and benefits of mandating central clearing for Treasuries and repos, which might free up dealer capital that would be available to be used for market making.¹¹ And they need to gather and publish more complete data on market transactions to help both regulators and market participants better understand and anticipate market dynamics.¹²

Even with greater private-sector market making, circumstances could arise in which the Federal Reserve would need to step in to preserve well-functioning Treasury securities markets. To that end, backstop standing repo facilities for foreign official holders of Treasuries and for a wide variety of private market participants would put structures in place that could fill that role in a well-anticipated and transparent fashion. In that regard, the Federal Reserve’s recent announcement of two such facilities was welcome. Foreign official institutions were an important source of Treasury sales in March 2020, and the standing facility aimed at these holders will give them away of liquefying their holdings without putting downward pressure on Treasury security prices.

The announcement notes that the facilities will “support the effective implementation of monetary policy and smooth market functioning.” But the repo facility for private parties is limited to the primary dealers and, over time, depository institutions.¹³ If “smooth market functioning” is to encompass the Treasury market more

broadly, that may well not be enough. To better guarantee Treasury market functioning, the repo facility probably needs to be available to other large participants, like hedge funds and other leveraged investors that are playing an increasingly important role in the market. Such an extension would raise issues of counterparty risk and distortions to risk-taking incentives among lightly regulated entities; the Task Force suggested dealing with those through varying haircuts and by imposing a small ex-ante fee on lightly-regulated entities with access to the facility, but other approaches may also work.

So, my ask here is that the Federal Reserve explicitly define “smooth market functioning” to encompass the whole Treasury securities market; and that as it implements SLR relief and considers central clearing, that it also considers whether a limited repo facility will be enough to do the trick. In my view, the public good that flows from a well-functioning Treasury market is so material, that appropriate risk management implies leaning on the side of doing too much, however complicated that might be, rather than too little.

One such complication will be getting many banks and a broader set of counterparties to actually use the repo facility. Too often potential users of Federal Reserve liquidity facilities perceive a stigma attached to borrowing that impedes these facilities from performing their intended functions—and this applies to bank borrowing at the discount window as well as use of 13(3) facilities and likely a repo window with extended counterparty access. Stigma has many deep roots, including in Federal Reserve history of how the window has been administered, in the attitude of bank supervisors, and in the perspective of the Congress and the public that too often characterizes borrowing at a penalty rate against good collateral as a “bail out” and reinforces reluctance by mandating transparency about individual loans.¹⁴

When, on March 15, 2020, the Federal Reserve reduced the penalty on discount window loans and extended their maturity it said “the discount window supports the smooth flow of credit to households and businesses. Providing liquidity in this way is one of the original purposes of the Federal Reserve System and other central banks around the world.”¹⁵ Exactly. In the U.K., the public distrust

of bankers seems no less intense than it is in the U.S., but there also seems to be a recognition that use of central bank liquidity facilities under stress is in the public interest. Making the discount window and similar liquidity facilities more usable in the U.S.—more effective macroprudential tools—would make a substantial contribution to preserving financial stability. That will take an extended and focused education effort by the Federal Reserve at its highest levels, backed by action—for example as it considers how or even whether to unwind the steps it took in March 2020 to fulfill the discount window’s historic mandate.

Regulatory Structure and Process

Protecting financial stability requires constant adaptation of regulations to the dynamic evolution of the financial system. That adaptation is most likely to take place when the regulators have a clear financial stability mandate and have in place processes and procedures to check the stability of the system to spot oncoming problems and take concrete steps to deal with them. And the incentive to protect financial stability must be reinforced by holding the regulators accountable for their actions—or lack thereof.

Dodd-Frank, by creating the FSOC and an Office of Financial Research (OFR), moved in this direction, but I think most would agree that performance by these new entities has been spotty. Our Task Force had a number of recommendations to better adapt regulatory structure and process to protecting financial stability. Some of them dealt with the makeup and processes of FSOC, for example to enhance the role of the annual report, revive consideration of systemic designation, and mandate an analysis of instruments and institutions that had been growing especially rapidly. Another set of recommendations addressed filling data gaps and achieving better cooperation on data issues across agencies, and we assigned a newly focused and empowered OFR to that.

I want to delve a little more deeply into a set of recommendations that I think are critical to preserving stability in our fragmented regulatory system. First, Congress should give each agency serving on FSOC an explicit financial stability objective to pursue alongside its existing

goals for say, investor or consumer protection. Right now, systemic risk is not something they are required to take into account as they carry out their missions. They should be required to broaden their perspective to consider the systemic implications of their actions and of the activities and firms they oversee and be held accountable or doing this. Second, to help them meet this new objective, each agency should also be required to open an office or division of financial stability to inform the decision-making of the board or commission. This office would help the agency meet the requirement to assess how a proposed rule or other action might affect financial stability. The agency would also be mandated to look back five years after a rule or action to see how well its predictions fared.

Taken together, these reforms would embed financial stability firmly into agency decision-making, would improve the quality of the analysis provided decisionmakers, and would facilitate holding the agencies accountable for the reasoning behind and the consequences of their decisions. Agencies can take some steps in this direction without congressional action, and as I noted at the outset, I believe that in this highly uncertain economic and financial environment it is imperative to escalate our attention to financial stability risks *now*.

We will have failed our public trust if the Kansas City Fed has an opportunity to focus Jackson Hole 2026 or 2031 on a financial crisis that we can now be taking steps to avoid.

Endnotes

¹<https://www.brookings.edu/research/report-of-the-task-force-on-financial-stability/>

²<https://www.federalreserve.gov/mediacenter/files/FOMCpresconf20210728.pdf>

³<https://www.federalreserve.gov/newsevents/pressreleases/monetary20210818a.htm>

⁴<https://www.ft.com/content/32a57864-d983-46b0-bbfa-85fd2d2361e5>

⁵A recent Bank of England working paper shows that interactions among the nonlinearities of the ELB, inadequate capital of lenders and the demand side response of overleveraged borrowers imply a need for higher capital requirements when the ELB is near. <https://www.bankofengland.co.uk/working-paper/2021/a-tail-of-three-occasionally-binding-constraints-a-modelling-approach-to-gdp-at-risk>

⁶<https://www.brookings.edu/research/understanding-the-effects-of-the-u-s-stress-tests/>

⁷<https://www.federalreserve.gov/econres/feds/un-used-bank-capital-buffers-credit-supply-shocks-at-SMEs-during-the-pandemic.htm>

⁸A recent study by the Basel Committee on Bank Supervision “Early Lessons from the COVID-19 Pandemic on the Basel Reforms” looking across jurisdictions also found that banks with less headroom over buffers tended to lend less through the pandemic than banks with more headroom. The study also found evidence that capital release, including through lowering the CCyB, tended to have a positive effect on lending. <https://www.bis.org/bcbs/publ/d521.pdf>

⁹A recent example are so-called stablecoins; these are neither stable nor coins, but instead threaten financial stability by growing what are, in effect, prime money market funds with a fixed dollar redemption price.

¹⁰Kashyup, Kohn and Wessel explain swing pricing at <https://www.brookings.edu/blog/up-front/2021/08/03/what-is-swing-pricing/>

¹¹Darrel Duffie highlighted the potential for central clearing to economize on dealer capital. <https://www.brookings.edu/research/still-the-worlds-safe-haven/>

¹²Notably, the recommendations of the G-30 group on Treasury market functioning are broadly aligned with our own on the supply side of the market. <https://group30.org/publications/detail/4950>

¹³See the Federal Reserve’s “Statement regarding Repurchase Agreement Arrangements.” <https://www.federalreserve.gov/newsevents/pressreleases/monetary20210728b.htm>

¹⁴Bill Nelson delves into the history and origins of stigma at <https://www.bpi.com/discount-window-stigma-we-have-met-the-enemy-and-he-is-us/>

¹⁵[https://www.federalreserve.gov/newsevents/pressreleases/monetary 20200315b.htm](https://www.federalreserve.gov/newsevents/pressreleases/monetary%20200315b.htm)