

# An Enhanced Objective—**Financial Stability**



## KEY POINTS

The financial system has grown much more sophisticated over the past century, as has the Federal Reserve's approach to keeping it safe.

Financial stability became a more prominent objective of the Federal Reserve in the aftermath of the financial crisis.

The decisions and rules being hammered out today will determine whether the new systemic view will be enough to prevent future crises.

Before the Civil War, bank panics were an all-too-common occurrence across young America. In response, the National Banking Acts of 1863 and 1864 introduced two new safeguards: a directive that US government bonds backstop banknotes and the creation of the Office of the Comptroller of the Currency to supervise the banks.

Both reforms had their merits but quickly proved lacking as first conceived. Market developments soon enough outpaced market regulators—an age-old pattern that prevailed right up to the financial crisis of 2008.

Bank regulation has always been the Federal Reserve's responsibility, and recently the Federal Reserve has been given additional authority to safeguard the stability of the entire financial system. A look back at 150 years of bank panics and full-blown financial crises helps explain how America's central bank grew into its new role.

### **Crisis, Response, Repeat**

The Panic of 1873, which destroyed some 18,000 businesses and pushed unemployment above 14 percent, showed that the Banking Acts were not adequate solutions, partly because deposits, rather than banknotes, had become the dominant form of money. A series of severe panics, culminating in the disastrous Panic of 1907, drove

this point home, and a new solution emerged: a currency that could expand to meet the demands of depositors throughout the year, whenever they needed it—that is, an "elastic currency." The Federal Reserve Act of 1913 intended to provide just that, along with "a more effective supervision of banking in the United States."

Problem solved? Not quite. The Great Depression opened with a series of too-familiar banking crises. It took the nationwide bank shutdown in March 1933 to restore calm and set the stage for a new round of regulatory response.

The resulting New Deal reforms—including federal deposit insurance, separation of commercial from investment banking, and interest rate caps on deposit accounts—ushered in nearly three-quarters of a century without a major banking panic. Deposit insurance helped solve the problem of bank runs by giving depositors confidence that their money would be protected, even if their bank got into trouble. And separating commercial from investment banking seemingly prevented banks from engaging in risky high-finance activities. But just as before, the economy was changing, and the old solutions became less effective.

High inflation during the early 1980s made interest rate ceilings, designed in part to keep banks from trying to outdo each other in a risky pursuit of depositors,



*The Great Financial Panic of 1873, as depicted in Frank Leslie's illustrated newspaper, October 4, 1873; the collapse of stock market values following the global economic crisis from the front page of the Financial Times, September 30, 2008.*

particularly painful. Depositors began looking for other, “safe” investment vehicles to earn money, and markets delivered with the invention of money market funds. A domino effect ensued: Commercial banks lost market share to investment banks. At the same time, a series of regulatory changes, culminating in the Graham–Leach–Bliley Act, allowed commercial banks to take on investment banking activities. A shadow banking system arose beyond the control of existing regulators. By 2008, the world was in the grip of a full-blown financial crisis.

## The Financial Stability Mandate

In the aftermath of the most recent episode, the crisis-response script played out as usual, with one exception; unlike previous crises, which resulted in the formation of major new financial regulators—the Comptroller of the Currency, the Federal Reserve, the Federal Deposit Insurance Corporation, and the Securities and Exchange Commission—the financial crisis of 2008 mostly brought a reorientation and redefinition of responsibilities.

These principles were laid out in the Dodd–Frank Wall Street Reform and Consumer Protection Act of 2009, which gave the Federal Reserve and other financial market regulators more explicit responsibility for

promoting financial stability. It did not stipulate most of the details necessary for accomplishing this target. Instead, it provided a goal and established systemic risk as a major consideration in the formation of policy.

The remaining open question is whether elevating “financial stability” as a regulatory ambition will be enough to prevent crises like that of 2008. The Dodd–Frank Act did spell out some clear instructions, including stronger capital buffers for the largest financial firms and new regulatory oversight of the shadow banking system. But much of the “how” was not specified. For all its 800-plus pages, the most important directive in Dodd–Frank may be the establishment of “systemic risk” as a standard of practice. The crisis reinforced the lesson that a bank’s failure affects not only its depositors and investors but other banks and businesses as well. That is why the shift is sometimes described as a change from “microprudential” regulation, concentrating on the safety of individual banks, to “macroprudential” supervision, focused on the safety of the financial system.

Systemic risk is a sort of pollution: A risky bank can upset the financial system, just as a coal plant can dirty a neighborhood. So from now on, in considering measures such as adequate capital buffers, regulators are thinking not only about how to keep a bank safe, but also about how to minimize the impact of its possible failure on the



*The Federal Reserve System is a decentralized central bank. It consists of 12 Federal Reserve Bank districts around the country, each with its own president, plus a seven-member Board of Governors in Washington, DC. Here, the Marriner S. Eccles Federal Reserve Board Building, named after a former Chairman of the Federal Reserve, under construction in 1937.*

“[The Federal Reserve] is one of the finest research institutions, both at Washington and at the Reserve Banks, of any institution in the United States. It managed over 100 years to never have a corruption scandal, which is quite an achievement. It has a real esprit de corps; as an institution, it’s really a very good institution.

My complaints are not on the subject of how it operates but what it does, and I think it’s made major mistakes along the way. The Great Depression. The Great Inflation, a lot of business cycles, and I think its policy now is heading us toward disaster.” ►

*Allan Meltzer, Carnegie Mellon University*

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“In the decades prior to the financial crisis, financial stability policy tended to be overshadowed by monetary policy, which had come to be viewed as the principle function of central banks. In the aftermath of the crisis, however, financial stability policy has taken on greater prominence and is now generally considered to stand on an equal footing with monetary policy as a critical responsibility of central banks.”

*Chairman Ben Bernanke, April 9, 2012*

rest of the system. For example, a bank merger that would give the public more branches but would create a dangerously large, risky bank now faces more scrutiny. That is, Dodd–Frank represents a shift in perspective as much as a collection of new rules.

Taking a systemic view of financial stability also means greater coordination of regulatory policy. To a large extent, the worst financial crises are best described as exits from bank debt. People try to move to a “safer” form of money. In the 1800s, people caused a run on the bank by exchanging their banknotes for gold; in the Great Depression, they caused a run on the bank by exchanging their deposits for cash; and in 2008, some caused a run on their money market fund by exchanging their shares for bank deposits.

Resolving, and ultimately preventing, these crises involve both banking and monetary policy. This supports a role for the central bank, which controls the money supply, to wield extensive supervisory authority. With such authority, the central bank, as lender of last resort, has direct access to the best and most up-to-date information about the banks and non-bank financial institutions it lends to.

## A Durable Solution?

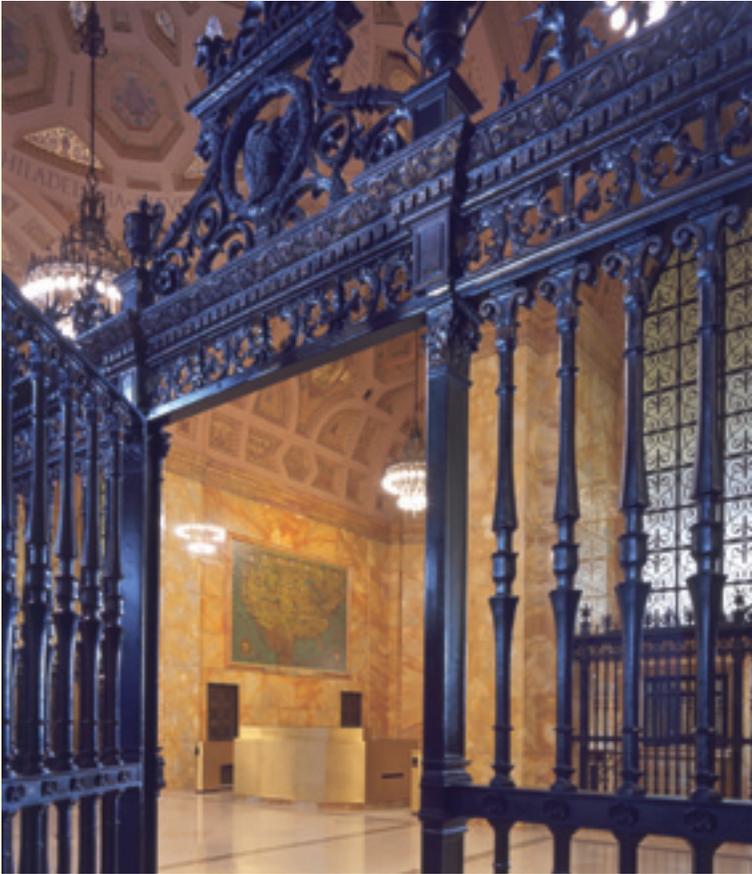
But the most important question is whether an enhanced mandate for financial stability will translate into significantly less economic damage from the next crisis, if it does not prevent it entirely. Not to dodge the question, but it is too early to say. Although many of the rules that Dodd–Frank requires have been completed, some new rules are either in development or still under debate. As of March 2013, no non-bank financial institutions had been designated as systemically important. Even the nation’s largest banks, which are automatically designated by Dodd–Frank as being systemically important, have yet to learn of the enhanced supervisory standards they may be subject to.

Exactly what other restrictions such institutions might eventually be subject to had not yet been established, either. For example, it’s unclear how much effect higher capital requirements will have or in what cases mergers will be cancelled or activities banned. Moreover, regulators may also have to weigh the benefits of limiting the actions of systemically important firms against the possible loss of economic growth.

Those are just a few of the question marks. The idea of the Federal Reserve playing a prominent role in financial stability is not new. Nevertheless, some might say that providing the Federal Reserve with additional tools to achieve that goal is long overdue. In any case, we are in the thick of it today. Historians of the future will be looking closely at the actions now being taken to explain why we failed or succeeded.



► Watch the video at [www.clevelandfed.org/annualreport](http://www.clevelandfed.org/annualreport).



*The Cleveland Federal Reserve Bank building has been restored to its original beauty, while its spaces have evolved to meet the needs of the future. See this report's "Operations Evolution" on page 33 for a closer look at how the Federal Reserve Bank of Cleveland is evolving.*

"... the Federal Reserve System that we know today has changed a lot over the last 100 years. Some of those changes came from the lessons of experience learned inside the organization; some came from changes in economic thought; and some changes resulted from Congressional legislation. There is no such thing as 'the Fed for all time.' The institution has evolved and will continue to evolve, shaped by the same forces that have changed it in the past." ►

*Mark Sniderman, Federal Reserve Bank of Cleveland*