BANK OF ENGLAND

Speech

Institutions for macroprudential regulation: the UK and the US

Speech given by

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At the Kennedy School of Government, Harvard University

17 April 2014

The US and the world economy still haven't fully recovered from the global financial crisis that provoked the worst recession since the Great Depression. Nonetheless, a lot of effort already has gone into reducing the risk that we put the world through something like this again. In the US and elsewhere we've renovated our regulatory and supervisory structures in charge of making the financial system more resilient. We've made progress, but - at least in the US - my view is that the job isn't done yet. In particular, I'll be concentrating on the institutions we've created to deal with risk to the entire financial system - so-called macroprudential regulation. And I'll be contrasting the systems put in place in the UK, where I have been privileged to become a member of the macroprudential regulator - the Financial Policy Committee (FPC) - and the US where the Dodd-Frank law created the Financial Stability Oversight Council (FSOC). And I'll be making some suggestions for improving the FSOC's chances for success.

Many failures in the private and public sectors contributed to the buildup of risks in the financial market and institutions that led to the financial crisis. But one was that no entity had a clear mandate to look at the financial system as a whole and the authority to act to mitigate the risks it saw developing; no one was responsible for identifying and taking steps to protect against the dangerous elements of procyclicality in the buildup of leverage, maturity transformation and complex interdependencies and interconnections in good times that left risk higher and more concentrated than private entities realized. Moreover, the resulting exposures to rare tail events - like a national decline in housing prices - left the economy and many innocent parties subject to externalities, or effects beyond those that could be priced into the market by private parties even with more complete knowledge and understanding.

To be sure, a number of central banks issued thoughtful financial stability reports, but these central banks often had little or no authority to act on weaknesses they identified. In the US, the Federal Reserve came closest to being seen as responsible for overall financial stability, but that objective was more implicit than explicit, its powers were limited and focused on banks and bank holding companies, and any regulatory action it wanted to take even in that sphere had to be agreed and coordinated among a plethora of other regulatory agencies. Furthermore, the Federal Reserve and other regulatory agencies in the US and abroad were lured into complacency by a relatively tranquil economic and financial environment over a number of years and came to rely too much on the private sector to police itself, with less governmental oversight.

Among the many responses to the crisis has been the establishment of groups to monitor systemic risk in the financial system and to do something to build resilience of that system to problems that might develop - macroprudential regulation. In US, the Financial Stability Oversight Council, FSOC, is a committee of microprudential regulators under the Chairmanship of the Secretary of the Treasury. In the UK, the Financial Policy Committee is a new committee established as part of a comprehensive restructuring of regulation. I am an external member of the FPC, that is, a member without a formal relationship to the Bank of England or to the microprudential regulators on the committee.

Strong macroprudential structures are important for many reasons. One is the interaction of macroprudential and monetary policy. Among the issues that have gained prominence after the crisis have been the relative roles of monetary and macroprudential polices in preserving financial stability. The optimal mix of these two policies to preserve financial and economic stability depends on a lot of factors - including where the risks are coming from and how far from price stability and full employment the economy is; but crucially, the mix will also depend upon the robustness of the macroprudential framework - the stronger the framework, the less pressure on monetary policy to steer away from its objectives for price stability and full employment over the next year or two in order to preserve the resilience of the financial sector and protect the economy over the longer run.[1] The better macroprudential policies work, the less likely that the central bank will have to consider raising interest rates higher than the medium term outlook for employment and inflation warrant.

<u>What do we want from macroprudential authorities[2]</u>

We want those authorities to be able to:

Identify legitimate risks to financial stability. This requires analytical capability and access to information. Where the information is not immediately available, the authorities need to have the ability to get it from other agencies and from the private sector. One challenge is identifying tail risks - very rare outcomes that are possibly very consequential, but not fully priced into most financial markets. Another is identifying externalities - in which potential costs and benefits to society exceed those to individual market participants.

Opportunities for misidentification abound. Our metrics for identifying threats to stability are immature. For a while now there will be a tendency to see problems that need to be corrected, many of them genuine weaknesses, but care must be taken not to impose unnecessary costs on productive activities of the financial sector. Over time, a challenge will be differentiating innovations that have genuine value-added and price adjustments that represent shifts in underlying tastes or productivity from those that result primarily from regulatory arbitrage or speculative excess.

Be willing and able to act on the risks they identify in a timely way. Such actions might be in the form of direct instructions to financial institutions or supervisors; or they might be in the form of recommendations to microprudential supervisors. In the latter case, it's important that regulatory structures allow the recommendations to be accepted or rejected quickly and implemented expeditiously. Complex regulatory structures with overlapping authorities who must be convinced of problems and whose responses need to be coordinated may be too slow to head off problems; corrective actions risk coming into effect after the bubble has burst or imbalances have begun to be corrected, exacerbating the downward momentum.

[1] For earlier reflections on macropru and monetary policy see Kohn http://www.bankofengland.co.uk/publications/Pages/speeches/2013/692.aspx
[2] The IMF has written extensively on macroprudential regulation, and my remarks are informed by these studies. See for example, Macroprudential Policy: An Organizing Framework http://www.imf.org/external/np/pp/eng/2011/031411.pdf

Actions or recommendations can be aimed at strengthening the structure of the system, the ability of institutions and markets to withstand the unexpected and to behave in less procyclical ways, that is, less prone to exacerbate the ups and downs of the economy. Macroprudential authorities should also have the ability and willingness to take countercyclical actions, to tighten when good times tend to lead to added risk and to ease when downturns threaten the supply of credit. Countercyclical actions on the upside may not themselves be very effective at damping building asset bubbles or growing imbalances, but they should make the financial system more resilient to the inevitable turnaround.

And we want the authorities to take responsibility for patrolling the regulatory perimeter - for identifying potential risks that can't be dealt with under the existing legal structure and to make recommendations to the executive and legislative bodies for new legislation to fill the gaps. This is likely to become increasingly important as incentives grow for activities to migrate away from the most highly regulated institutions - those subject to greater oversight, tighter activity restrictions, and higher capital and liquidity requirements.

Acting on risks will require a considerable degree of independence from short-term political pressures, including those exercised by regulated firms themselves directly on the regulators and indirectly through their influence on elected representatives. Good macroprudential regulation will entail taking steps that impinge at least on the short-term profitability of regulated firms - beyond the steps required to keep them individually safe and sound. It will also entail an element of "taking away the punch bowl" in good times. Neither of these types of actions will be popular. The degree and modalities of independence and associated accountability need not be the same as for monetary policy. Different issues are at play, and accountability will be more difficult as "financial stability" is much harder to measure (except after it collapses) than are the goals of monetary policy - price stability and growth or employment. But the macroprudential authority must have a clear mandate to protect financial stability and the scope to pursue that objective when it might be unpopular.

Be able to interact productively with the microprudential and monetary policy authorities. For the most part, macroprudential policies will involve using the microprudential tools - like capital and liquidity requirements - but with a macroprudential overlay that takes account of the entire system. As such, those tools generally will be implemented by the microprudential authorities, who need to understand and buy into the financial stability objective. The cooperation of those authorities will also be necessary for analyzing the strengths and weaknesses of the system and for getting data and other information to deepen that analysis where necessary.

The conduct of macroprudential and monetary policies each may have important effects on meeting the objectives of the other. In the current circumstances, there are concerns that prolonged periods of very easy monetary policy can induce behaviors that might threaten financial stability when monetary policy is reversed; and that more rigorous macroprudential policy following a period of instability can restrict credit supply and work against recovery. The macroprudential and monetary policy authorities each need to understand the strategies the other is pursuing and how they might evolve. And under some circumstances they may want to work in tandem, with explicit understandings about the circumstances under which reliance on macroprudential tools to protect financial stability will be paramount and the circumstances under which monetary policy may need to be adjusted, perhaps because macroprudential tools are not adequate to address building risks.

Weigh the costs and benefits of proposed actions appropriately. Precise, quantitative cost benefit analysis is unlikely to be possible for proposed macroprudential actions, but, as in all economic decisions, a cost-benefit mindset is required to enhance public welfare. There are considerable benefits from avoiding another crisis and collateral damage to the economy, from avoiding the need for taxpayer support to limit any such damage and from reducing the moral hazard of public support and erosion of market discipline. But there are potential costs as well, including the greater costs of intermediation in the form of lower returns on saving and higher costs or reduced availability of credit for the public, possibly higher costs or reduced availability of other services from the financial sector like market liquidity and risk management products, and compliance costs for the private sector. The macroprudential authority should be able to justify its actions clearly and show that it has considered the full range of costs and benefits.

Macroprudential regulation in the United Kingdom: The Financial Policy Committee

The UK approached building an institution to meet these challenges for macroprudential policy as an element in a root and branch restructuring of the whole financial regulatory structure. The system is built around three new entities. The FPC; the Financial Conduct Authority (FCA), with responsibility for consumer protection, market functioning and the supervision of some financial firms, such as asset managers; and the Prudential Regulatory Authority (PRA), the microprudential regulator and supervisor for banks, other depository institutions, insurance companies, and major investment firms. In addition, the Bank of England plays a major role in financial stability in the UK, housing and staffing the FPC and PRA, but also with broad responsibility for analysis and policy to promote stability. Although they are within the BoE, the FPC and PRA have separate boards or committees ultimately responsible for the policies to meet their objectives, each with external members, like myself. Our job is to bring our expertise to bear in formulating policies but crucially also to bring diverse views to the table. Those views are informed by the information and analysis we get from the Bank and the PRA and FPC staff and management, but they embody our own perspectives, and can be independent of the views of the central bank as we have no long-term connection to the institution.

The Financial Policy Committee has 10 members: the Governor of the Bank of England, the chief executives of the PRA and FCA, three others from the Bank, and four external members. A Treasury observer attends FPC meetings. Our primary objective is to identify, monitor, and take action to remove or reduce systemic risks with a view to protecting and enhancing the resilience of the UK financial system. The FPC has a secondary objective to support the economic policy of the government, including for growth. To achieve these objectives we can make recommendations to just about anyone - other regulators, the Treasury, private industry associations.

Recommendations to supervisory agencies can be on a “comply or explain” basis. Implementing any recommended changes in regulation would be subject to the usual public comment period and be ultimately under the control of the agency or organization. But we also have “powers of direction” - direct orders we can give for certain defined changes in regulation. To date, those powers encompass the countercyclical capital buffer under Basel III and sectoral capital requirements pertaining to categories of real estate lending. We also asked for direction powers over the leverage ratio and have noted that we will consider whether to ask for such powers for bank liquidity requirements and for margin requirements in securities financing markets once international standards have been agreed.

The UK system appears to be well-designed to meet the objectives outlined above. Each of the Financial Policy Committee, the two supervisory agencies and the Monetary Policy Committee with its inflation objective has a well-defined primary objective related to aspects of the overall objective of macroeconomic and financial stability. Each is populated in large part by personnel with relevant expertise. Overlap among committee membership enhances communication and understanding of policy interactions, while external members guard against group think. The microprudential regulators on the FPC embrace the financial stability mandate of the committee and they have been able to help shape the macroprudential overlay to their own requirements.

And each Committee has tools adapted to its objective. For the FPC we are required to say how we are planning to use our direction powers - under what circumstances and to what effect - in short, to define our reaction function. Given the lack of experience with these tools, this is a very preliminary and tentative description, but it is the beginning of enhancing ours and the public’s understanding of our potential actions. And we are required to keep the costs of our recommendations or directions proportionate to their benefits - to consider and weigh both.

In practice, the FPC has concentrated on a few issues. First and foremost has been to encourage the rebuilding of the capital of the UK banking system, replenishing it after the crisis and holding the system to a higher, more resilient standard than the one that had proven so inadequate in 2007 and 2008. Working with the microprudential regulators, we required banks to build up capital to ensure it was adequate against a more forward looking recognition of losses than required by accounting standards, a more realistic assessment of costs for conduct redress and a more prudent approach to risk weighting. Currently we are working with the PRA to initiate simultaneous stress tests of bank capital built around a macroeconomic stress scenario. Cooperation with the PRA has involved a joint meeting of the FPC as a committee with the PRA board, as well as the usual back and forth about specific proposals.

A second major thrust has been around information. The FPC has made requests to the PRA and FCA for added information that would help us judge systemic risks. And we have worked with the microprudential regulators and the British Bankers Association to increase the amount and usefulness of information released publically so that markets can better judge financial health, raising the odds on market discipline reinforcing financial stability. Our focus on transparency has been mainly on capital, involving publication of the leverage ratio, pillar three capital disclosures, and the implementation of the recommendations of the Enhanced Disclosure Task Force of the Financial Stability Board.

Finally, the FPC has been called on to bring its perspective to bear on certain policies of other entities, with the potential for inducing modifications of those policies where they might pose threats to financial stability. For example, in 2013 the UK government initiated special programs to stimulate housing construction and to help first time home buyers. Using its judgment on the effect of these programs on financial stability, the FPC is expected to opine periodically on whether changes in the terms of these programs would be desirable, and it is expected to give its views on the overall impact of the programs on financial stability when it is time to consider renewing them after three years.

Perhaps of even greater interest is how the intersection of "low for long" interest rates to achieve monetary policy goals and financial stability is being handled in the UK. When the MPC initiated its forward guidance about the persistence of very low interest rates, it gave a financial stability "knock out" to the FPC. The MPC said it would hold interest rates at current very low levels at least until the unemployment rate fell below 7 percent; however, if the FPC found that the low rates threatened financial stability and it had unsuccessfully tried to deal with these risks with available macroprudential approaches, it would notify the MPC and that notification would "knock out" the promise to wait until the unemployment rate had at least slipped below 7 percent. Such a notification would not automatically entail a rise in the bank rate, but it would sharpen the discussion about the relative costs and benefits of the stance of monetary policy.

What's appealing about this use of the FPC is that it brings an independent view on the effects of a given policy on financial stability from a specialist group - and one that does not have an ownership interest in the policy itself. In addition, the communication between the FPC and the Treasury and MPC is open and transparent. Everyone will know what our concerns might be - and they would know as those concerns were building because we will be issuing reports on financial stability and taking actions to deal with escalating problems before we exercise our knock out.

I don't want to hold up the UK institutional arrangement as ideal for all countries in all circumstances. It vests a lot of authority in one institution - the Bank of England, which has a good deal of independence. This raises questions around effective accountability, already a difficult issue for financial stability, given the problems of measuring the objective - the fact that failure to preserve stability could become known with a considerable lag, and that the effects of over-regulation on credit supply can be inferred only indirectly. And it will be challenging to be assured that alternative perspectives are being brought to bear on difficult issues when so much is in the Bank of England. It is early days; I'm optimistic, but we don't know how this will work out over time.

Other jurisdictions have faced different histories and constraints as they construct their institutions for macroprudential regulation. I will spend the remainder of my talk reflecting on the US institutions for macroprudential regulation.

Macroprudential regulation in the US: the Financial Stability Oversight Council.

Overview

FSOC has the same objectives as the FPC: identify systemic risks and find ways to mitigate them through action or through recommendations to regulatory agencies or to the Congress and the administration. But unlike in the UK, the Congress, in Dodd-Frank, left the current regulatory structure in place and grafted the macroprudential authority on top of it. Moreover, it's a very fragmented regulatory structure in which multiple agencies have responsibilities for the same or closely related entities and markets. There had been discussion before the crisis of streamlining the regulatory structure, and the debate around Dodd-Frank included proposals for regulatory reform. But the resistance of the agencies and of the various Congressional committees having jurisdiction over the agencies doomed those discussions. In the end, one small agency, the Office of Thrift Supervision, was abolished and its functions distributed to other supervisors of depository institutions; and one agency, the Consumer Financial Protection Bureau, was created to assume an expanded version of the consumer protection oriented authorities of the Federal Reserve.

Changes were made to the mandates of a number of existing agencies to take care of problems identified as having contributed to the build up to the crisis or as potential weaknesses in the financial system - for example in the derivative markets. But for the system as a whole, of the existing agencies, only the Federal Reserve was given broad new responsibility, and even that was focused mainly on systemically important bank holding companies (and financial market utilities), with the addition of, so far a few, nonbank companies designated as systemically important by the FSOC and therefore subject to special oversight.

So monitoring and devising actions to deal with systemic risk rests importantly with FSOC. FSOC has ten voting members: eight regulatory agency heads, one independent member with expertise in insurance, and the Secretary of the Treasury, who chairs the Council. Importantly, these are the heads of the agencies, not the agencies themselves and the heads can't always speak for the whole agency when it is run by a board. FSOC also has 5 nonvoting members, including two more from the insurance sector.

Among the nonvoting members is the director of the Office of Financial Research within Treasury. OFR was established to support the work of FSOC, in part by identifying and filling data gaps, but it also is to provide independent research and analysis of financial stability issues. OFR is a promising construct, but in many respects it is just now getting off the ground and its effectiveness has yet to be established.

FSOC can and has identified a variety of risks to financial stability in its annual report. It has some powers to act on those risks. It can identify systemically important financial institutions for regulation by the Federal Reserve; it can make recommendations, and when it recommends more stringent regulation and heightened safeguards to regulatory agencies it can do so on a comply or explain basis; it can make recommendations to the Congress on problems it sees with the perimeter or reach of regulation. But it does not have the authority to act on its own - except for the SIFI designation. For example the countercyclical capital buffer is under control of the Federal Reserve for bank holding companies and of the Comptroller of the Currency for national banks.

Without question, FSOC is a step forward in the US in dealing with systemic issues in the financial markets. Most macroprudential tools work by tweaking microprudential tools, and FSOC has all the heads of all the microprudential regulators sitting on it for discussions of systemic issues and how they might be dealt with. This should foster understanding of how each agency's actions can affect stability. Moreover, by all reports, FSOC has helped to foster coordination and cooperation among these regulators - much more so than existed in the past. However, the early years of FSOC have also revealed structural issues and shortfalls in its ability to accomplish the objectives we identified for macroprudential regulation.[3]

Issues

First, it is composed of many independent regulators, each of whom has mandates focused on particular institutions or markets. The legislation for each agency limits its objectives and the reach of its regulations. For example, the Securities and Exchange Commission is tasked with to protecting investors and maintaining fair, orderly, and efficient securities markets, with a focus on getting adequate information to all investors at the same time. Achieving its objectives may well be necessary for financial stability, but they are not sufficient for the system, even in the areas under its jurisdiction. No agency has an explicit objective for maintaining financial stability - for taking into account the macroprudential add-on to microprudential oversight. The Federal Reserve comes closest to having a broad mandate and powers, reflecting the reasons for its founding in the wake of financial instability in the early 20th century, its responsibility as lender of last resort when the financial system seizes up, as well as its regulatory and supervisory responsibilities, which have been enhanced by Dodd-Frank. But as I already noted, even these are focused mostly on banking organizations. Macroprudential regulation will require cooperation and coordination across many agencies in the context of shared goals for the system.

FSOC has made progress but isn't yet as effective as it needs to be in the balkanized US regulatory system. The money market fund episode is a good illustration of some of the issues. FSOC had reached the conclusion that the reforms of money market funds in 2010 were not sufficient to address the systemic risk of these funds that became very evident in the wake of the failure of Lehman Brothers, and recommended further action to better assure financial stability. The fact that FSOC had to make a recommendation on a comply or explain basis - that discussions in the committee weren't enough to trigger a response at the SEC to correct perceived systemic risks - is indicative of difficulties. And the recommendation itself was resisted by current and former SEC commissioners on the grounds that the recommendation impinged on SEC independence, that only the SEC had the procedures

[3] Among others to point out limitations of FSOC see Tucker, Regulatory Reform, Stability, and Central Banking. http://www.brookings.edu/~/media/research/files/papers/2014/01/16%20regulatory%20reform%20stability%20central%20banking%20tucker/16%20regulatory%20reform%20stability%20central%20banking%20tucker.pdf

and expertise to judge what was best for securities markets, and that the chair of the SEC on the FSOC could not and should not undermine the SEC's regular procedures involving all commissioners.

Second, there are gaps in regulation among FSOC and its regulators that could interfere with efforts to reduce systemic risk. For example, some types of asset managers are regulated in their interface with the public - mutual funds - but not so much in their practices that might potentially undermine systemic resilience. Other asset managers might have some reporting requirements - hedge funds - but no real regulation. Many mortgage brokers and servicers are pretty much exempt from federal oversight. Pieces of the shadow banking system - the chain of securitization vehicles, securities financing and short-term funding through commercial paper and repurchase agreements outside the commercial banking sector - can be regulated as they come in contact with the regulated sector, but not on their own. So leverage and maturity mismatch can build, perhaps in new and opaque ways, before the risk becomes evident and well before any legislative action is possible.

I'm not arguing that these parts of the financial system necessarily need more regulation - that remains to be determined. And in many respects every jurisdiction faces similar problems of patrolling the regulatory perimeter - including the UK. But I do wonder whether the fragmented US system, with each agency protecting its prerogatives and listening to its regulated industry, won't have more problems spotting and making recommendations for change than other regulatory structures. The incentives for transactions to migrate from sectors like commercial banking where regulatory requirements are increasing in cost to less heavily regulated sectors will only grow over time. FSOC needs to focus on this.

Third, a consequence of regulatory fragmentation is the difficulty of obtaining and using data from a variety of agencies, cutting across institutions and markets. Data sharing is hard and complex, requiring strong protections for confidentiality of information obtained by a particular agency for supervisory purposes. But sharing data will help to spot problems developing, help inform the oversight of closely related agencies, and assist in identifying data gaps or inconsistencies. This isn't happening now to the extent that it should.

Fourth, FSOC is likely to face particularly difficult challenges in the area of countercyclical macroprudential policy. The institutional makeup of FSOC and its focus on systemically important institutions and on broad weaknesses in markets and institutions seem better suited to building through-the-cycle resilience than to leaning against developing asset mispricing and growing leverage and maturity mismatch in the expansionary phase of a cycle. One can be skeptical of the ability of most macroprudential policies to actually damp the cycles themselves, while still believing, as I do, that those efforts still are likely to be worthwhile. But they may have some marginally positive effects on the incentives for financial institutions to be more careful about taking on risks in boom times. And, requiring higher capital and liquidity or lower loan-to-value ratios as asset prices rise and credit expands will build the resilience of the financial sector to the inevitable downturn - making it much less likely that financial sector distress and fire sales intensify the adverse economic consequences of the unwinding.

Highlighting the cyclical risk and recommending raising capital or liquidity requirements in good times are not going to win any political popularity contests. Banks and other lenders will deny the risk, and will point to the fact that they are already well capitalized and enjoying good profits. Households and businesses will be resistant to higher costs or nonprice constraints on borrowing as they seek to finance increases in housing, consumer durables and business capital as incomes and sales rise. The Federal Reserve and other banking agencies met fierce Congressional and industry resistance when, in the years before the onset of the crisis, the regulators drew attention to the risks of commercial real estate concentrations at small and regional banks. Some degree of independence from short-term political pressures will be required to try to calm the party down and reduce the severity of the hangover when the party is over. Yet, the FSOC is chaired by the Secretary of the Treasury who represents the administration in power. The two- and four-year election cycles will be very much on the minds of the administration and the members of the president's party in the Congress.

The interaction of countercyclical macroprudential policy and monetary policy is particularly difficult under the current institutional structure. As I emphasized in my opening remarks, the stronger the macroprudential regime, the easier for monetary policy to focus on the medium term inflation and output objectives Congress has given it, and the less pressure on monetary policy to steer away from these objectives to guard against longer-term financial stability risks. But it's hard to see FSOC playing an active role in this very delicate interaction between macroprudential and monetary policies. The presence of all those regulatory agencies and in particular the chairmanship of the Secretary would seem to hold potential for unwelcome political influence on monetary policy. The Federal Reserve would quite justifiably be reluctant to give the FSOC a say in policy action as the Monetary Policy Committee did with the FPC in the UK. Under the current structure, the mix of monetary and macroprudential policies will be determined entirely within the Federal Reserve, which itself has limited macroprudential tools to apply outside the banking system.

Fifth, FSOC itself has very limited tools to deal with structural or countercyclical macroprudential risks, and recommendations to other regulatory agencies might take considerable time to be implemented, coming into effect when they could be ineffective or even procyclical.

Recommendations to make FSOC more effective

Against the backdrop of what we want macroprudential authorities to do and of the weaknesses just identified, here's how I would modify FSOC and its agencies. I have taken the current fragmented structure of regulation and supervision as given, but tried to think of ways of making the whole structure - FSOC and its constituent agencies - more effective macroprudential authorities. These changes would require legislation, and that's not going happen any time soon in our contentious political environment. But it can't hurt to start a conversation that might bear fruit at some future date.

1. Give every agency on FSOC a financial stability objective - in carrying out its primary missions it should give weight to any risks posed by the institutions and markets it oversees to the overall stability of the US financial

system. This would make financial stability an objective for the agency, not just for the agency head sitting on FSOC. It would, at a minimum, make it harder for an agency to reject or tone down a recommendation that FSOC viewed as important to reduce systemic risks.

2. Require agencies to share data in response to a request from another agency, FSOC, or the Office of Financial Research, and require the agencies to respond to properly supported requests to collect additional information that FSOC views as essential to determining the existence or extent of a threat to financial stability. We are just beginning to develop ways to discover and monitor systemic risks; it will help to make the data available among agencies to bring new perspectives to bear on these difficult problems. And data sharing will enable FSOC and the OFR to analyze market events or other threats to financial stability promptly after they occur, informing any recommendations for changes in regulation or legislation.
3. Require FSOC to include in its annual report to the Congress an assessment of the regulatory perimeter - where risks are developing outside the most heavily regulated sectors - and whether laws need to be adjusted to bring more oversight to bear on these areas. FSOC already has a responsibility to monitor this possibility, and it has raised some broad issues in its annual report, but requiring such an assessment in the annual report would help to focus attention in the attendant hearings and begin to build a case for any changes.
4. Change the structure of FSOC to enhance its independence and its ability to take unpopular stands, especially on countercyclical macroprudential policy. I see two important elements here. One is to substitute for the secretary of the Treasury a new independent chair appointed by the president and confirmed by the Senate for a fixed term. FSOC might remain in the Treasury department, but with considerable independence on the model of the Comptroller of the Currency - or it could be set up separately. Two, the Committee should have its own staff and funding source; this could be accomplished by folding the Office of Financial Research into FSOC. The Secretary should remain a member of the Committee, and any time the public purse might be involved the Treasury must be in the lead. But over time, effective macroprudential policy, including as it interacts with monetary policy, is likely to require a more arms-length relationship to the political process than can be provided by a Treasury-led committee.
5. Require the FSOC to consider the costs and benefits of any action it takes or recommends. The costs of financial instability are high and very vivid right now as we slowly emerge from a deep recession, so the benefits of strengthening the system are correspondingly large in part as such actions better align private and social costs. But it is possible to go too far - to increase the costs of intermediation, or market making, of risk redistribution, of innovation by more than is justified on stability grounds. Precise quantification of costs and benefits is likely to be a chimera, but FSOC should be able to demonstrate that it has considered the costs and well as benefits of its recommendations and be required to justify its actions in that context. And the constituent agencies should face the same requirement when they act on systemic issues. One aspect of considering costs as well as benefits might be to tilt macroprudential regulation toward a more systematic exercise of powers. Discretion will always be necessary, but the more the actions of the macroprudential regulator can be predicted, the less costly is it likely to be for the private sector to adapt.
6. Give the more independent FSOC tools it can use more expeditiously to address potential systemic risks. One tool might be to give FSOC more say in the countercyclical capital buffer - the countercyclical tool envisioned under the Basel III capital accord - and to spread it more widely than banking organizations. That is, FSOC

should be expected to make recommendations to the Federal Reserve and banking agencies on the countercyclical capital buffers on a regular basis - at least annually. And, if it saw a reason for change it would make that recommendation on a comply or explain basis. It should also make recommendations about levels of capital say in broker-dealers or futures market participants based on its concerns about building risks outside the banking sector. In addition, when circumstances call for timely action, the FSOC should be able to fast track its recommendations on any subject by bypassing its own comment period for comply or explain recommendations and by requiring that the resulting proposed agency rules be issued within 30 days for public comment.

An FSOC reshaped along these lines would have better odds of fostering the resilience of the financial sector. It would: have access to data to be better able to identify and asses risks; be better able to force timely action against those risks by being able to fast track recommendations; by being more independent it would be more likely to identify risks and take unpopular stands; and be more likely to have cooperative and understanding partners among the regulatory community once each had financial stability added explicitly to its mandate.

Macroprudential policy in highly developed, globally integrated, economies is just now being implemented. Institutional structures must adapt to particular circumstances of history and politics. If we get this right, we minimize the risks of another wrenching financial crisis. If we don't, we're more likely to stumble into another financial crisis, and we'll be repeating the conversation about "strengthening financial regulation" and "improving macroprudential policies" when we could be devoting our energies to addressing more fundamental economic challenges of escaping from recession and building sustained rises in living standards.