

Independence for Monetary Policy vs. Financial Regulation and Supervision

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Central Bank Independence in Practice
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Integration Pros and Cons

❑ Pros

- ✗ ○ “Holistic view”
- ✗ ○ Independence shields from politics
- ✓ ○ Coordinated/faster during crisis

❑ Cons

- ✓ ○ Conflated Monetary Policy → Financial Stability constrains Monetary Policy
- ✓ ○ Reputation spillovers: “Independent”?



Dented Credibility?



“Net interest income used to be the bellwether of whether [a] bank is doing well or not,” said Kim Forrest, chief investment officer at [...]. “Investors have comprehended that they’ll make money in good times and bad.”

LOLR → LOIR → TBTF

Governance 101



❑ Dented Credibility → Governance

- ✓ Accountability
- ✓ Accountability
- ✓ Accountability

Governance 101



❑ “Credibility Governance”

- ✓ Accountability
- ✓ Accountability
- ✓ Accountability

LOLR (not LOIR)

- Solvency versus Liquidity
 - Reinterpret “solvency” as “liquidity”
 - A Paradox
 - Neither defined Nor measured
 - Slow...Fast...Sudden...

Governance 101



❑ “Credibility Governance”

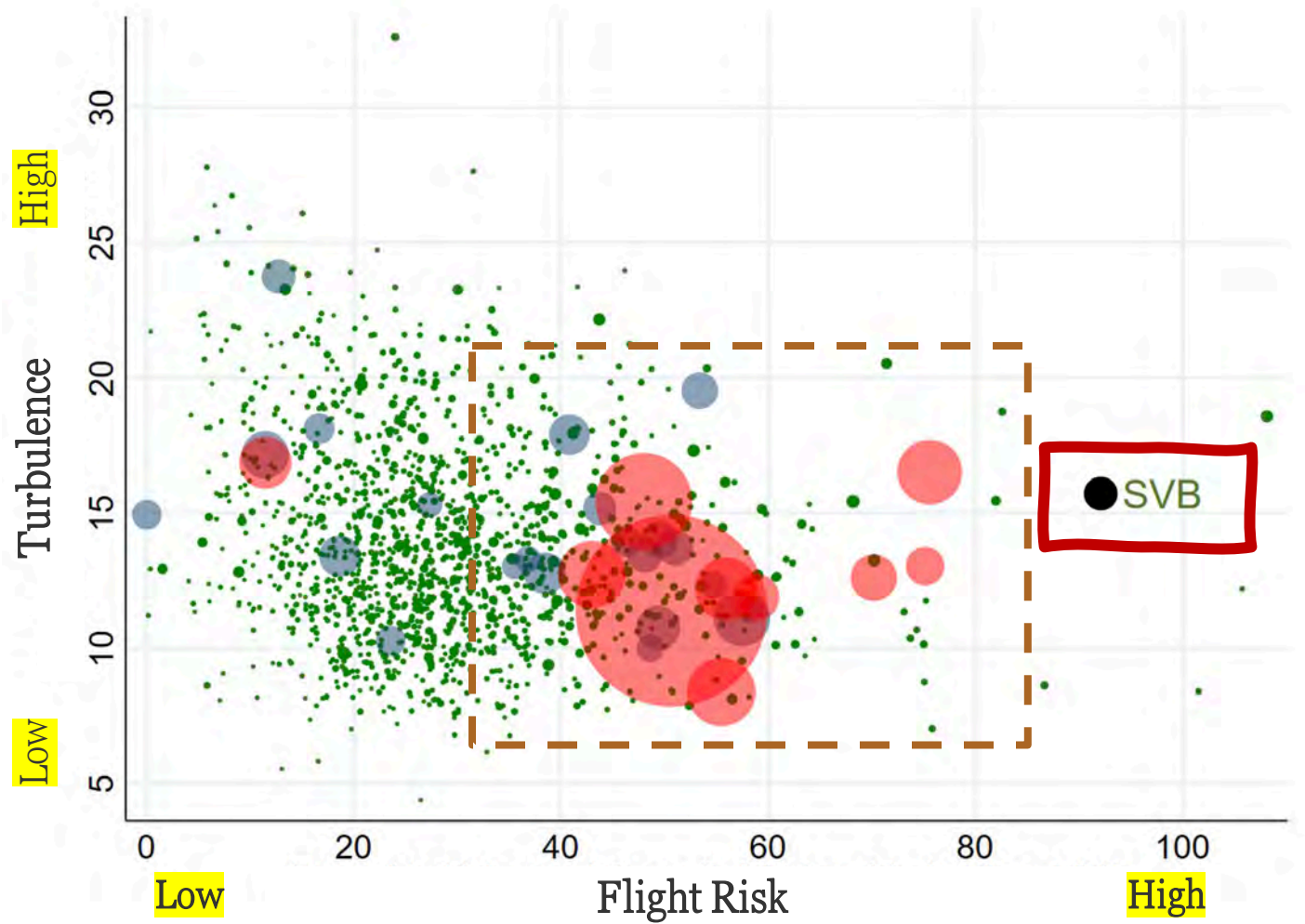
- ✓ Accountability
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LOLR (not LOIR)

- SVB, First Republic,...Republic First
 - Liquidity (Fed: 300+ in the report)
 - Liquidity (FDIC)
 - ...
- Lots of “liquidity” infusion...
 - ...yet banks kept failing
 - Reality: SVB/ others insolvent → restructuring/equity

Flight Risk & Turbulence

Solvency NOT
Liquidity



Source: Jiang, Matvos, Piskorski, Seru (2023): “Monetary Tightening, MTM losses”...

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LOLR (not LOIR)

- Solvency versus Liquidity
 - Reinterpret “solvency” as “liquidity”
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 - Slow...Fast...Sudden...
- Restructure or raise capital

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Discretion

- Benefits: Information
- Costs: Too much Discretion?
 - Reinterpret rules if no guardrails
 - Dents accountability

Too much
Discretion?

Discretion AND
Rules

C: Capital Adequacy (1-5)

A: Asset Quality (1-5)

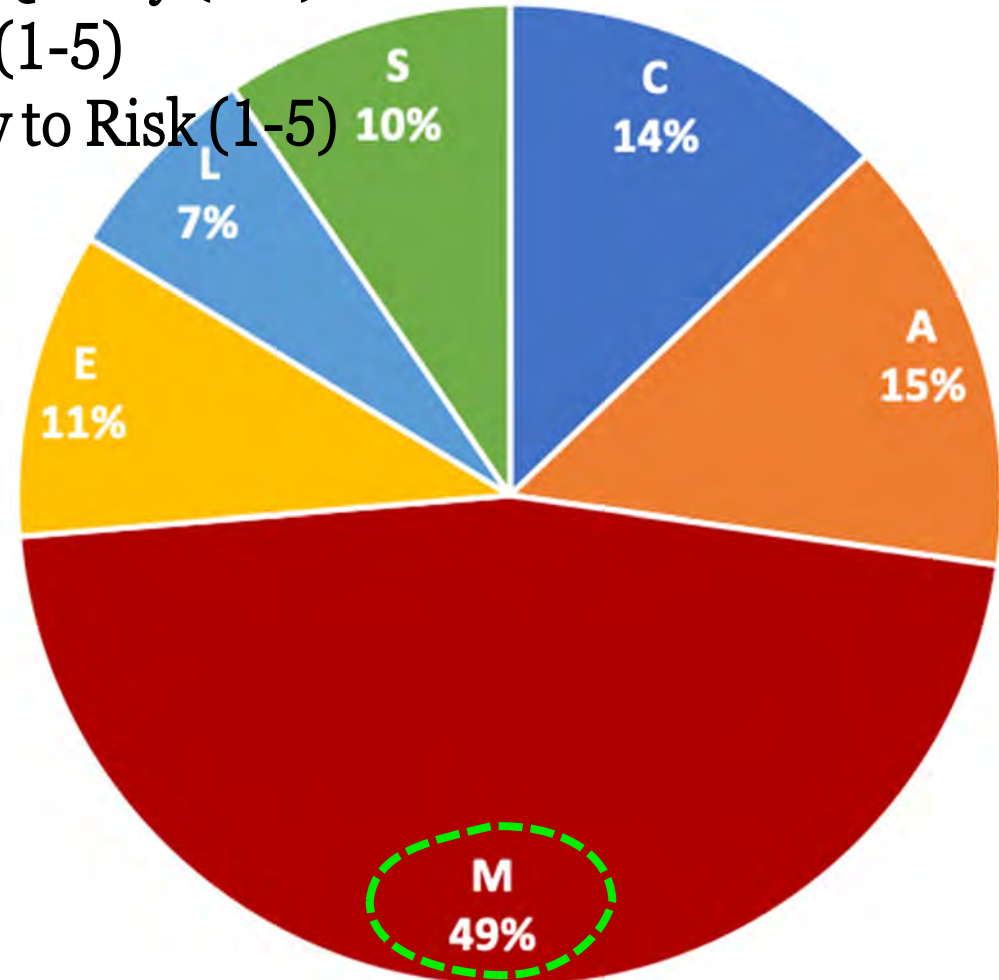
M: Management Quality (1-5)

E: Earnings Quality (1-5)

L: Liquidity (1-5)

S: Sensitivity to Risk (1-5)

Composite CAMELS Score: (1-5)



Source: Agarwal, Morais, Seru and Shue (2024): “Noisy Experts...”

Governance 101



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Discretion

- Benefits: Information ✓
- Costs: Too much Discretion? ✓
 - Reinterpret rules if no guardrails
 - Dents accountability

→ Need Discretion AND Rules

Governance 101



□ “Credibility Governance”

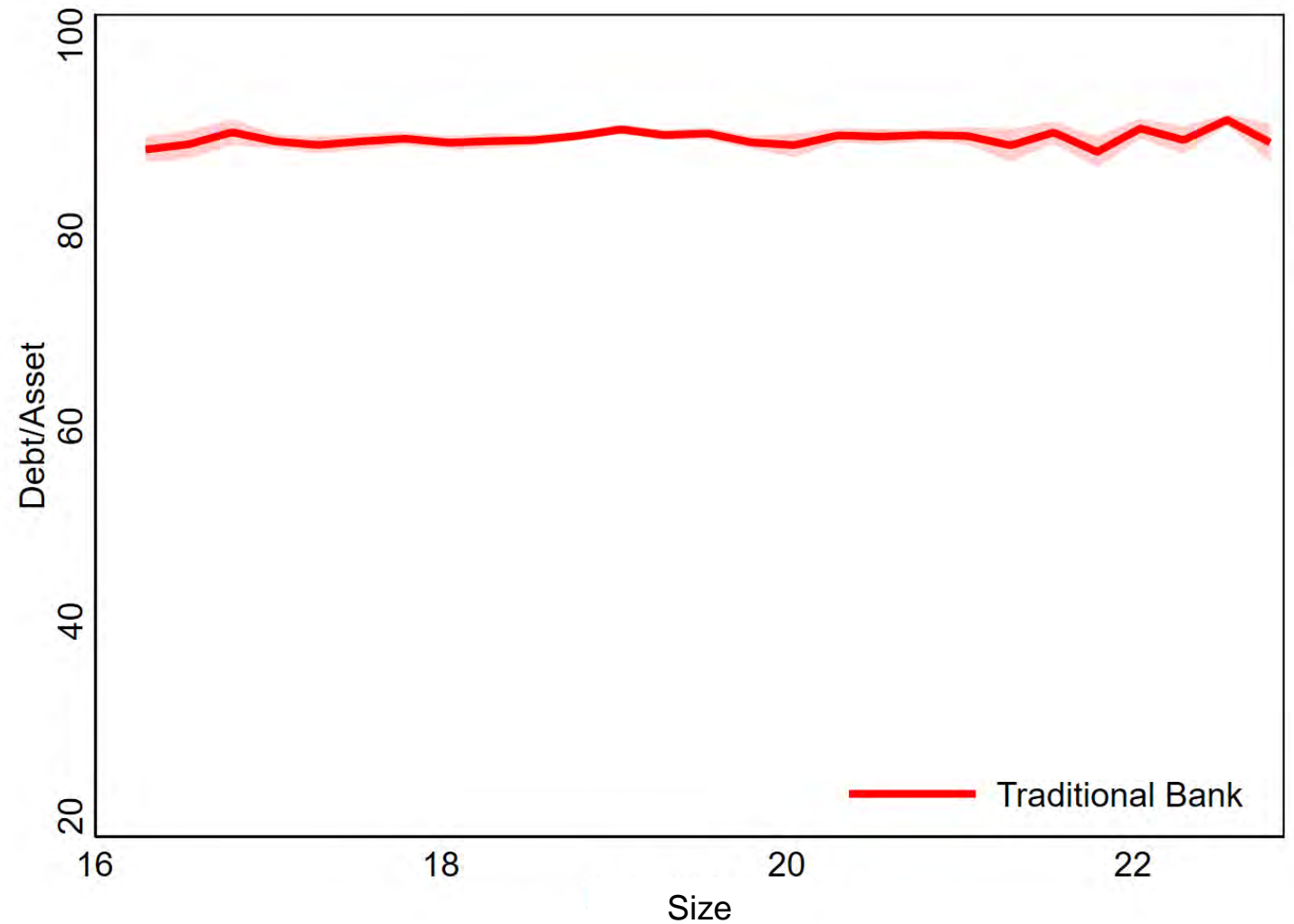
- ✓ Accountability
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Reputation (Tough Decisions)

- Highly Levered system
 - Equity to absorb shocks
 - But more equity → lower lending?

Too Much Leverage?

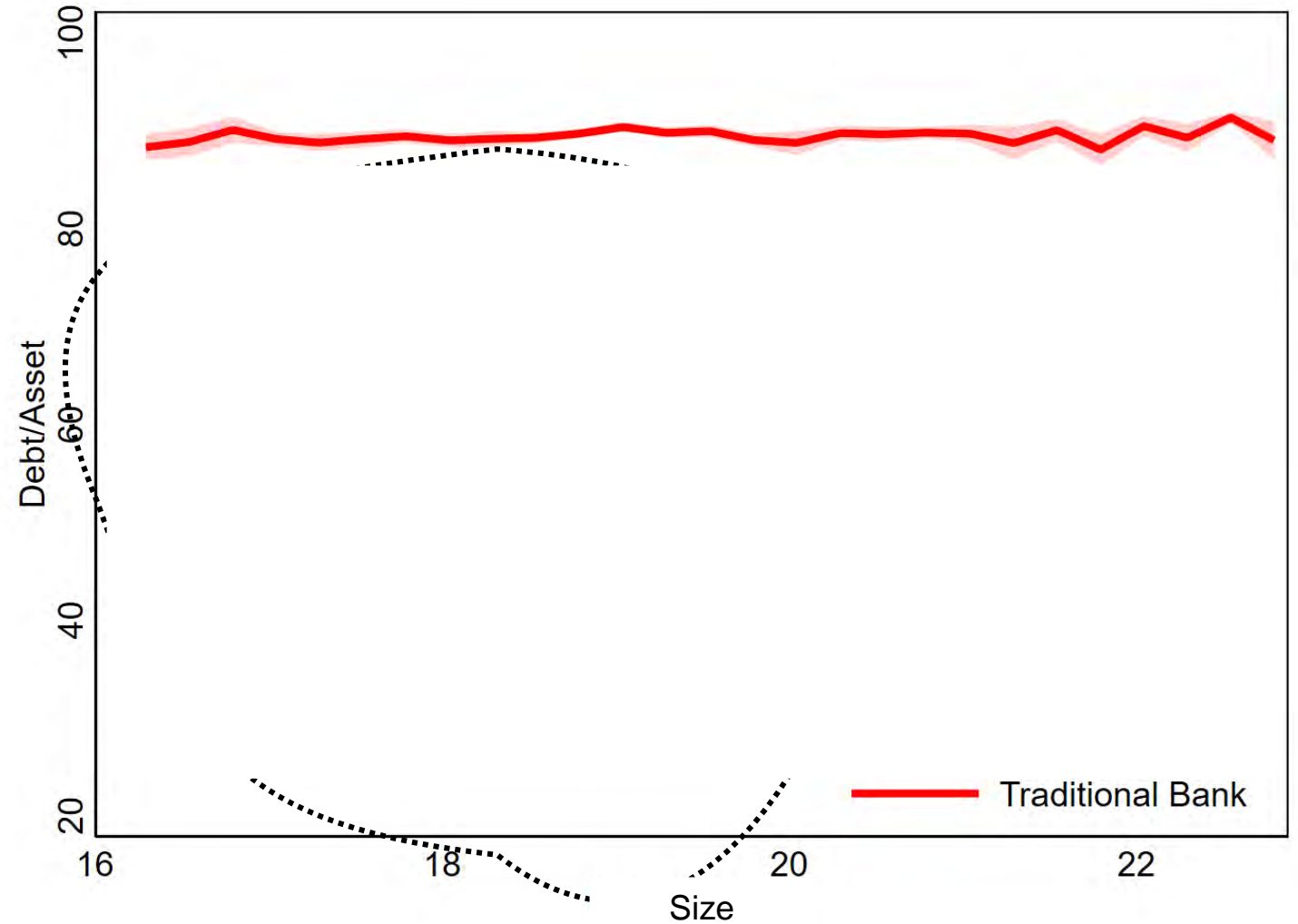
Will to Act Tough...



Source: Jiang, Matvos, Piskorski, Seru (2020): "Banking without Deposits"...

Too Much Leverage?

Will to Act Tough...



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Governance 101



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Reputation

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 - Equity to absorb shocks
 - But more equity → lower lending?
- Losses to risktakers not taxpayers

Integration Pros and Cons

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LOIR + Discretion w/o Rules + Will to Act Tough

→ TBTF (Mission creep)

Spillovers?

Credibility for being Independent

“Some industry representatives claim that inadequate capital had nothing to do with those bank failures,” the Federal Reserve’s vice-chair for supervision said

How Wall Street won ‘capitulation’ from the Federal Reserve on new bank rules

Fed vice-chair says he learnt ‘lesson of humility’ when he had to revise capital requirements plan

Spillovers?

Credibility for being Independent

- Innovation in Financial Sector
 - Fintech, payments, crypto, private credit...
 - ...

Banks push back against CBDC

The nation's biggest bank and bank trade groups stressed the risks of creating a central bank digital currency in comments to the Fed.

Powell says Fed not "remotely close" to a central bank digital currency

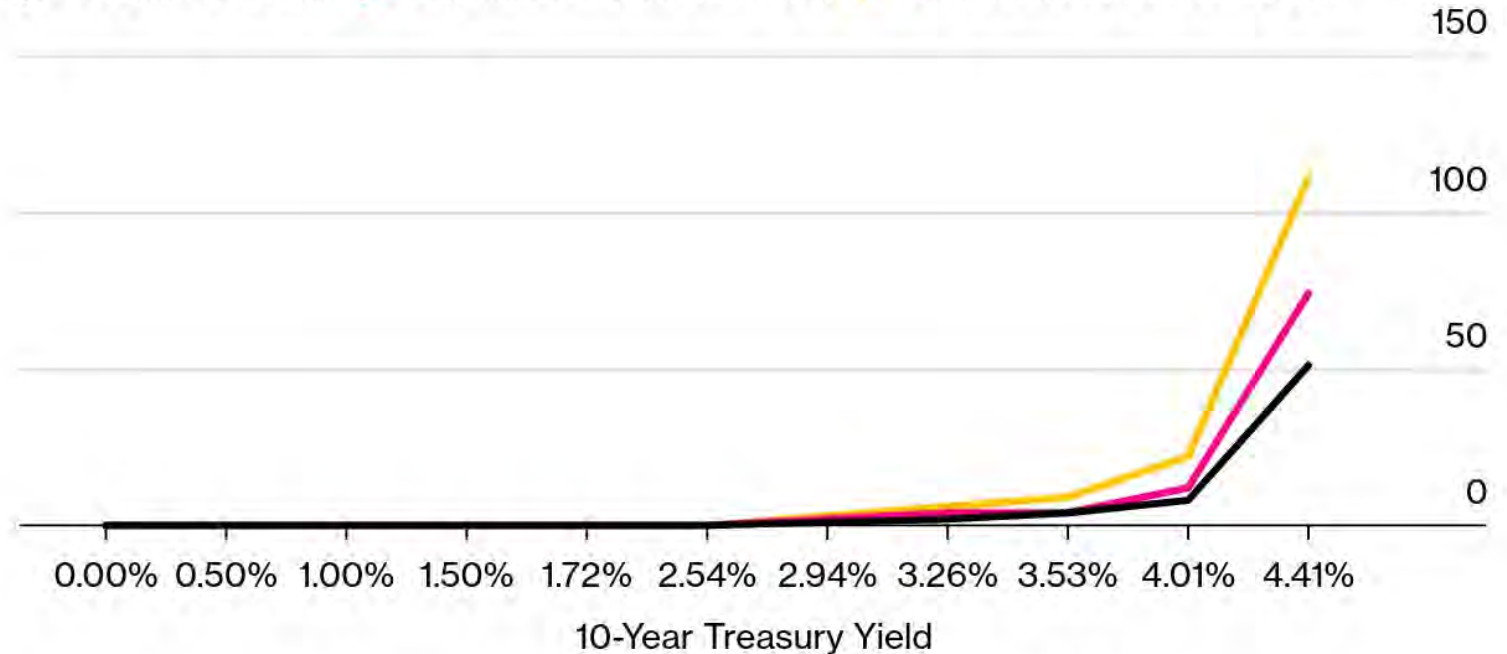
Spillovers?

Credibility for being Independent

Number of Banks at Risk of Insolvency

The 10-year Treasury yield is a key factor in lender fragility

— No CRE distress — CRE distress rate hits 10% — CRE distress rate hits 20%



Source: "Monetary Tightening, Commercial Real Estate Distress, and US Bank Fragility" by Erica Jiang, Gregor Matvos, Tomasz Piskorski and Amit Seru

Note: Data assumes a 50% uninsured deposits' run. CRE distress scenario is based on the default rate and assumes a 30% loss.

Bloomberg



Conclusion

- Credibility Dented
 - ✓ LOIR
 - ✓ Discretion
 - ✓ Reputation for acting Tough
- “Credibility Governance”
 - ✓ Accountability
 - ✓ Accountability
 - ✓ Accountability
- Partial separation; supervision made accountable
 - ✓ Financial Policy Committee (inside Fed), separate from FOMC
 - ✓ Sunlight: doctrine + pre and post-mortems + red team memos...