Bernanke Charts New Mission for the Fed: Financial Stability

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WASHINGTON -- While by law the Federal Reserve Board must worry about price stability and unemployment, Chairman Ben Bernanke appears to have charted a third mandate for the central bank: financial stability.

In his speeches, lectures and testimony, Bernanke has steadily elevated the importance of the issue as his agency's responsibilities have swelled under Dodd-Frank.

"It's become the unofficial third goal," said Margaret Tahyar, a partner at Davis Polk & Wardwell. "It's happening very, very slowly, and it's interesting that there is a lot of messaging going on about it right now. Until recently, they've been doing it on little cat's paws quietly, quietly."

The new duty appears born out of necessity after Dodd-Frank tasked the central bank with regulating all systemically important banks and nonbanks. The regulatory reform law also required the Fed to write new rules on a range of topics under the auspices of financial stability, including living wills, capital and liquidity requirements.

But Bernanke has also encouraged the Fed to embrace its new role

"It's a new piece of the Chairman's legacy," said Karen Shaw Petrou, a managing partner at Federal Financial Analytics Inc.

Bernanke, who like his predecessor is seeking to use monetary policy to stabilize the economy, is "going to be judged not only on that, but whether in fact he does leave a legacy of financial regulation that promotes stability.

"That's never been the case before. That's never been a criterion for judging the central bank," she added.

Observers said that the central bank could promote financial stability in one of two ways. Either it can try to avoid any external shocks as seen with the burst of the housing bubble or strengthen the financial system enough so that it could withstand such shocks. The Fed, so far, has heavily leaned toward option two, although it is just getting started, observers said.

"The Fed's clearly the first among equals," said Tahyar. "They've clearly been given major responsibilities, but the deadlines when enhanced prudential regulations were to be put into place were all much later than things like derivatives or the Durbin amendment. It's really just now starting to circle in. But it is one of the deeper changes."

The Fed and Bernanke have also had to take stock of just how deeply integrated the global financial system was during the crisis.

"Chairman Bernanke's comments really reflect not so much a change in mission, despite all the new powers it has in Dodd-Frank, but rather a real wake-up call of what happens macro-economically when the financial system goes off the rails," said Petrou.

"They really learned, as did we all, an awesomely hard lesson in 2008. They didn't understand this fundamental linkage between macroeconomics and financial stability and now they do, and that's really what I think is behind Bernanke's comments in recent weeks and years."

To be sure, this is not the first time the Fed has contemplated the concept of financial stability, but it has returned to the forefront of the central bank's mission.

"It's not that it wasn't there before, but going through the experience of the crisis emphasized its importance," said Robin Lumsdaine, a former Federal Reserve Board official and now a professor at American University. "The crisis has led all of us to a greater focus on financial stability."

Even so, there is broad acknowledgment that the way regulators discussed financial stability now pales in comparison to earlier days.

"I don't think we talked about it much before the crisis," said Hal Scott, Nomura Professor and Director of the Program on International Financial Systems at Harvard Law School. "The crisis made us more acutely aware of the fragility of the financial system."

That is now changing. In recent weeks, Bernanke has repeatedly emphasized the issue, saying financial stability should be a top priority for the central bank commensurate with its monetary policy efforts.

"Going forward, for the Federal Reserve as well as other central banks, the promotion of financial stability must be on an equal footing with the management of monetary policy as the most critical policy priorities," Bernanke said in a speech this month.

His focus has caught the attention of numerous Fed watchers.

"Given the number of speeches, the Fed clearly has embarked on a program to convince the powers that be what they should be doing in trying to maintain financial stability," said Gil Schwartz, a partner at Schwartz and Ballen and a former attorney for the Fed.

Financial stability has been largely overshadowed by fiscal policy, which has been widely considered the core purpose of central banks prior to the recent crisis.

"We've had other crises... and I think it's fair to say that none of those created the panicky fear that this crisis did," said Scott. "It's not surprising that the country and the world are more concerned with stability."

Aside from beefing up the financial system to withstand any unforeseen shocks, the Fed is also weighing how its monetary policy actions may impact financial stability. For the first time, observers say, Fed officials are connecting financial market theory with monetary policy -- sometimes in wide disagreement.

"Dissent from the Federal Reserve Banks about the role of big banks... is the biggest change," said Petrou. "That's never happened before. The most interesting aspect of this debate in terms of the [Federal Reserve Bank of Dallas President] Richard Fisher view is that the continued presence of 'too big to fail' banks not only has financial market stability implications, but impedes monetary policy."

Fischer and other Fed officials have called for the break up of too-big-to-fail banks, a battle cry that Bernanke has not taken up.

Lawrence Goodman, president of the Center for Financial Stability, suggested the central bank's role in monitoring financial stability as two-fold when it comes to monetary policy.

Each central bank, he said, has to determine whether or not its monetary policy "is setting the seeds for the growth of financial problems, and secondarily, an analysis of assets throughout the financial system, whether they are being developed in the institutional sector, the banking sector, the private sector, or whether there is a proliferation of these assets that are leading to risks."

Another challenge comes from the information regulators are able to cull to make risk assessments.

"Industry data limitations still present challenges," said Lumsdaine. "One's ability to assess the financial institution or financial stability hinges critically on the quantity, quality, and timeliness of data that's available."

How regulators are able to press ahead in developing the necessary tools will depend on the kind of cooperation or pushback from the industry.

"If you get a recognition on the side of the industry that financial stability is important for each individual firm's bottom line, then things could evolve rapidly," said Lumsdaine.

But even Bernanke acknowledges the early start of the process, while noting that it is a return to the Fed's original mission. Established by Congress in 1913, the central bank was intended to reduce the panics that risked crippling the financial system.

"Based on the crisis and what happened and the effects that we are still feeling, it's now clear maintaining financial stability is just as important [of a] responsibility as monetary and economic stability," Bernanke said in a recent lecture to business students at George Washington University. "And indeed very much a return to where the Fed came from in the beginning. Financial stability was the original goal of the creation of the Fed. So now we sort of [have] come full circle."