Chapter 1

Public Policy and Financial Economics: Comments to Honor George G. Kaufman

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When I was first informed about this conference, I was very pleased to have the Chicago Fed co-sponsor the event. When I was asked to also participate and give some opening comments, I gladly accepted the invitation. George has been a fixture at the Federal Reserve Bank of Chicago since I first arrived, and obviously he was quite influential long before my arrival.

The conference organizers told me that when putting the program together, George had stressed to them that he had in mind a high-quality, policy-oriented research conference. He had no interest in this being simply a run-of-the-mill retirement party. Tying a quality agenda to his retirement celebration was fine, as long as the ultimate goal was kept in mind. In looking over the program and the list of participants, I believe the program coordinators have achieved that goal.

But before we dive into that program, I would be remiss if I did not speak at least a little about George's early accomplishments and affiliation

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with the Chicago Fed, where he spent the first 10 years of his professional life as a full-time research economist. I want to mention his research agenda and the influence it has had on the profession. Time constraints require that I exclude much of his research output, but I want to at least highlight a few of his many accomplishments. Perhaps during your breaks, you can discuss some of his other major achievements.

Although most of us associate George with his analysis of financial regulation, his early research was quite eclectic. In his dissertation, written at the University of Iowa while on a Ph.D fellowship financed by the Chicago Fed, George wrote about the influence of Federal Reserve monetary policy operations on commercial bank behavior. He modeled adjustments in bank balance sheets as the central bank used different policy tools and as economic conditions varied. The research was quite influential, and over the years many others used a similar methodology to evaluate banks' responses to various regulatory constraints, such as how lending changed with changes in capital requirements or capital risk-weights.

Also early in his career, George explored the determinants of both the demand for and the supply of money. As perhaps the most cutting-edge research at the time, his work focused on the interest elasticity of demand for money and the ability of the central bank to control the level of, or the rate of change in, the monetary aggregates. His work also encouraged others within the Federal Reserve System to initiate research in the area. In large part as a result of George's leadership, a group developed at the Chicago Fed that was quite prolific in publishing in this area — particularly in developing and modeling reserve regimes that permitted the central bank to better control the monetary aggregates (Kaufman, 1972).

George is also well known for his work on measuring and managing bank risk, particularly interest rate risk. In the late 1970s and early 1980s, interest rates both increased sharply and became more volatile. These movements increased the risk of depository institutions, particularly thrift institutions that largely borrowed short-term and lent long-term at fixed rates. His work at the time on the concept of duration led to the development of more accurate measures of interest rate risk exposure that were

aggressively adopted by the industry. Although he discussed alternative means for institutions to predict future interest rates and to manage interest rate risk, the major emphasis of his work was to develop a straightforward means of *measuring* a firm's risk exposure and enabling it to shift capital to protect the firm against future rate volatility (see Kaufman, 1984; Bierwag and Kaufman, 1985).

Additionally, George made significant and practical contributions to the underwriting and operation of the primary market for municipal bonds. He found that most state and local governments were using an auctioning technique to price their bond offerings that ignored the time value of money. By taking the time pattern of coupon payments into account in evaluating the interest cost of the bonds, George and his colleagues were able to show that local governments were incentivizing bidders to create bonds that both returned some of the tax-exemption benefit that the federal government granted these issuers and were not viewed favorably by investors. He stressed the advantages of using more rigorous techniques in pricing the bonds.

This is interesting because I do not think of George as an exceptionally tech-savvy person. Even today, he puts pencil to paper when drafting his research instead of using a computer. But George was telling local governments that it was well worth their while to develop internally, or to hire the technical skills externally, to lower the computed interest rates on the new bond issues. The local municipalities responded, which resulted in improvement in the efficiency of the market and significant cost savings for local governments (for background, see Hopewell and Kaufman, 1974a, 1974b; Goldstein and Kaufman, 1975).

As I said originally, when I think of George's research, I typically think of public policy work in the financial services sector. Since early in his career, George has been a firm believer in bringing research theory and findings to the public policy debate. A classic example of this was when the principles underlying Prompt Corrective Action (PCA) and Least Cost Resolution, which he largely developed with his coauthor George Benston, were incorporated into the FDIC Improvement Act of 1991 (for background, see Benston and Kaufman, 1993, 1997a, 1997b).

George was instrumental in working with congressional staff and other non-academics to introduce these concepts, with a goal of discouraging or precluding high-risk behavior by banks as they approached insolvency. His previous work on moral hazard and the increasing value of the “put” option resulting from deposit insurance and limited liability as a firm approaches insolvency convinced him that PCA would be a means of both limiting bank failures and reducing losses when failures do occur. Others in the Federal Reserve System picked up on these ideas and conducted subsequent work to figure out how best to construct regulatory triggers that could be used to effectively initiate PCA (see, for example, Evanoff and Wall, 2001, 2002).

The goal was largely to minimize, if not avoid altogether, supervisory forbearance — something that we had just experienced excessively in the 1980s — by leaving the closure decision to supervisory subjectivity. Those efforts continue today as economists evaluate the potential for contingent convertible bonds (Co-Co bonds), with a trigger that forces action before losses are incurred to enable more efficient failure resolutions (see, for example, Calomiris and Herring, 2012, 2013; Flannery, 2014, 2015). This would avoid costly deadweight bankruptcy and resolution costs and enhance financial market stability.

On another policy front, George was instrumental in founding the U.S. Shadow Financial Regulatory Committee in the mid-1980s to have a formal platform to bring research to the public policy debate and evaluate and critique financial policy recommendations, such as new capital requirements or PCA guidelines. The Committee met regularly and developed some 360 policy recommendations, or “policy statements,” to address issues that were being considered at the time by financial regulators. The goal was to raise the quality of the public debate on important financial policy issues. Shadow Committee membership turned over occasionally as members, many of whom are in this room today, moved on to other areas of research or on to regulatory positions, which created a potential conflict of interest. However, from its inception until its dissolution in 2015, the one stable force on the Committee was George as co-chair. It was the type of position he loved, as it allowed him to interact with other members who brought significant expertise to the policy

debate. It also gave him a platform to make recommendations on the most important financial issues of the day.¹

Because George's research and policy impact have been so significant, we at the Chicago Fed are pleased to have had a lengthy and productive relationship with him. George joined the Chicago Fed in 1959 as a research fellowship student and was instrumental in developing its Economic Research Department and setting the research agenda. For example, George played a major role in setting up our initial research working paper series and, to show leadership, he authored the first Chicago Fed working paper entitled, "Time lags between money and income: Friedman and Meiselman revisited" (Kaufman, 1967). It was an impressive beginning to the research series as a revised version of the paper later became George's first *American Economic Review* publication (Kaufman, 1969).

Additionally, while George was completing spinoff pieces from his dissertation, a federal judge ruled on a bank merger that would change the bank antitrust environment both within the industry and within the Federal Reserve System. In the 1963 Philadelphia National Bank decision, the judge ruled that banks were subject to the antitrust provisions of the Sherman and Clayton Acts and that financial regulators, as well as the Department of Justice, needed to evaluate the potential impact of bank mergers on market competition and bank safety (see United States, 1963). This was a new responsibility for financial regulators, including the Federal Reserve.

Given there was no experience in this area within the Federal Reserve System, there was a major push to determine how such a competitive analysis should be undertaken and how best to develop System policy and procedures. George was a major player in bringing together active researchers from within and outside the System to study the methodology used in other industries to review and evaluate the evidence on market structure and competition issues. The Chicago Fed, including George, conducted much research and analysis of bank merger activity, including sponsoring the annual Bank Structure Conference, which ran for 50 years and spotlighted the sharp increase in this field of research. The Bank was

¹For a history of the Shadow Regulatory Committee including its purpose, goals, and output, see Litan (2016). For additional background information, see Kaufman (1992, 1997).

widely considered a System leader in the early years of this new activity.

During the 1970s, George went on a West Coast tour, serving in faculty and research positions at Southern California, Cal-Berkeley, Stanford, Oregon, and the Federal Reserve Bank of San Francisco.² When he returned to Chicago with his Loyola University appointment, we were pleased to formally renew the relationship and have him serve as a consultant at the Bank. Since that time, he has been involved with our Antitrust Division, our Financial Research staff, our Payments Group, and our Supervision and Regulation Department. He has frequently been tapped as a valued resource and colleague. It has been a very productive working relationship that I hope has been mutually beneficial. I know it has been beneficial to us at the Fed.

George is held in such high esteem that when the system was developing activities to commemorate the centennial of the Federal Reserve Act in 2013, he was asked to serve on the System's Centennial Advisory Council. In that capacity, he worked with past Federal Reserve Chairs Paul Volcker, Alan Greenspan, and Ben Bernanke, as well as other financial regulatory leaders, to help plan the activities. The resulting celebration was something the Fed was very proud of.

To close, let me say that George has been an institution within the Chicago Fed. We are pleased to be part of this conference aimed at identifying and analyzing some of the issues that he has evaluated in the past. Again, the program looks quite impressive.

When looking over an earlier version of the agenda, I saw a number of topics that I associate with George and on which I know that he has conducted research. But one stood out as being different; it was titled: "Financial regulation over the past 50 years." Admittedly, that is one topic that George has not researched. Rather, he's *lived* it. I wish you the very best over the next two days, and again, I want to emphasize that we are very pleased to be part of this event.

Congratulations, George!

²He also served in Washington, DC, during the decade as deputy to assistant secretary of the U.S. Department of the Treasury and as the acting director of research at the Office of the Comptroller of the Currency.

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