

# A Better Way to Regulate Financial Markets: Asset Based Reserve Requirements

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*Abstract: Asset based reserve requirements (ABRR), which would extend margin requirements to a wide array of assets held by financial institutions, provide a better way to regulate financial markets. ABRR are easy to implement, use the tried and tested approach of reserve requirements, are compatible with existing regulation (including capital standards), and would fill a hole regarding adequacy of financial policy instruments. Moreover, by increasing demand for reserves, ABRR can help central banks exit the current period of quantitative easing. By gradually raising asset reserve requirements central banks can implement a form of reverse quantitative easing that smoothly transitions the financial system to a new sounder regime.*

There is widespread recognition that the financial crisis which triggered the Great Recession was significantly due to financial excess, particularly related to real estate. Now, policymakers are looking to reform financial systems in hope of avoiding future crises. But like the drunk who looks for his keys under the lamp post because that is where the light is, policymakers remain fixated on capital standards because that is what is already in place.

There is a better way to regulate financial markets through asset based reserve requirements (ABRR) which would extend margin requirements to a wide array of assets held by financial institutions. ABRR are easy to implement, use the tried and tested approach of reserve requirements, are compatible with existing regulation (including capital standards), and would fill a hole regarding adequacy of financial policy instruments.

The toleration of periodic bouts of financial excess over the past two decades reflects profound intellectual failure among central bankers and economists who believed inflation targeting was a complete and sufficient policy framework. It also reflects lack of policy instruments for directly targeting financial market excess. With central banks relying on the single instrument of short term interest rates, this supported the argument using interest rates to target asset prices would be like using a blunderbuss that inflicts massive collateral damage on the rest of the economy. ABRR offer a simple solution to this problem by providing a new set of policy instruments that can target financial market excess, leaving interest rate policy free to manage the overall macroeconomic situation.

ABRR require financial firms to hold reserves against different classes of assets, with the regulatory authority setting adjustable reserve requirements on the basis of its concerns with each asset class. One concern may be an asset class is too risky; another may be an asset class is expanding too fast and producing inflated asset prices.

By obliging financial firms to hold reserves, the system requires they retain some of their funds as non-interest-bearing deposits with the central bank. The implicit cost of forgone interest must be charged against investing in a particular asset category, reducing its return. Financial firms will therefore reduce holdings of assets with higher reserve requirements, and shift funds into other relatively more profitable asset categories.

The effectiveness of this approach requires system-wide application. If applied only to banks, ABRR would simply encourage lending to shift outside the banking sector. To succeed, reserve requirements must be set by asset type, not by who holds the asset.

A system of ABRR that covers all financial firms can increase the efficacy of monetary policy. Most importantly, it enables central banks to target sector imbalances without recourse to the blunderbuss of interest rate increases. For example, if a monetary authority was concerned about a house price bubble generating excessive risk exposure, it could impose reserve requirements on new mortgages. This would force mortgage lenders to hold some cash to support their new loans, raising the cost of such loans and cooling the market.

A similar logic holds for stock market bubbles. If a monetary authority wanted to prevent stock market inflation from generating excessive consumption, it could impose reserve requirements on equity holdings. This would force financial firms to hold some cash to back their equity holdings, lowering the return on equities and discouraging such investments.

ABRR also act as automatic stabilizers. When asset values rise or when the financial sector creates new assets, ABRR generate an automatic monetary restraint by requiring the financial sector come up with additional reserves. Conversely, when asset values fall or financial assets are extinguished, ABRR generate an automatic monetary easing by releasing reserves previously held against assets. In all of this, ABRR remain fully consistent with the existing system of monetary control as exercised through central bank provision of liquidity at a given interest rate.

At the microeconomic level, ABRR can be used to allocate funds to public purposes such as inner city revitalization or environmental protection. By setting low (or no) reserve requirements on such investments, monetary authorities could channel funds into priority areas, much as government subsidized credit and guarantee programs and government-sponsored secondary markets have expanded education and home ownership opportunities and promoted regional development. Conversely, ABRR can be used to discourage asset allocations that are deemed socially counterproductive.

ABRR also have other significant policy benefits. First, ABRR increase the demand for reserves which should prove helpful as central banks seek to exit the current period of quantitative easing to avoid future inflation. By introducing and gradually raising asset reserve requirements central banks can implement a form of reverse quantitative easing that smoothly transitions the financial system to a new sounder regime. Second, by increasing the demand for reserves ABRR will increase seignorage revenue for governments at a time of fiscal squeeze. To the extent that required reserves constitute a tax on financial institutions, that tax is economically efficient given the costs of financial crises.

In the late 1990s, US policymakers completed the repeal of America's "New Deal" segmented system of financial regulation but they created no framework of matching comprehensiveness. That failure created a regulatory vacuum, particularly regarding the activities of the secondary banking system, and was a major contributing factor to the financial excesses that caused the crisis. Applied uniformly to all domestic financial firms – GE Capital as well as Citigroup, Prudential as well as Charles Schwab – a system of ABRR can help fill this vacuum.

For the euro zone, ABRR are additionally attractive because they can help address the instrument gap created by the euro's introduction. The euro's establishment represents an important step in the creation of an integrated European economy. Over time it should yield dividends as increased competition and lower transaction costs generate increased efficiency. However, member countries have had to give up their own exchange rates and interest rates, which have created problems for economic management by reducing the number of policy instruments. ABRR can fill this policy instrument gap because they can be implemented on a geographic basis by national central banks.

Property lending, which has been a major focus of concern, is particularly suited to this. If Euroland is suffering excessive house price inflation, the ECB could raise reserve requirements on mortgage loans secured by property. However, national central banks should have the power to set reserve requirements above (but not below) the rate established by the ECB. Thus, if Spain or Ireland is suffering excessive house price inflation, their national central banks could raise reserve requirements on mortgage loans secured by property in those countries. That would raise mortgage loan rates in Spain and Ireland without raising rates in other countries.

Nationally contingent ABRR will create incentives to shop for credit across countries. That means ABRR will work best when linked to geographically specific assets that cannot evade the regulatory net. This includes mortgage lending that is secured by collateralized property, and shares for which legal title is registered where companies are incorporated. But jurisdictional shopping is expensive, and that cost enables ABRR to create cross-country interest rate differentials for wide categories of assets. Finally, jurisdictional shopping would tend to promote cross-country financial integration, which is a long-term goal of the euro project. So even here there is an upside.

### Further Reading

Palley, T. I., "Asset Based Reserve Requirements: Reasserting Domestic Monetary Control in an Era of Financial Innovation and Instability," Review of Political Economy, 16 (January 2004), 43 – 58.

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*This paper has been prepared for a forthcoming book, After the crisis - towards a sustainable growth model, being prepared by the European Trade Union Institute, Brussels, Belgium.*