

The Case for Simpler Financial Regulation

The Philadelphia Fed Policy Forum
Policy Lessons from the Economic and Financial Crisis

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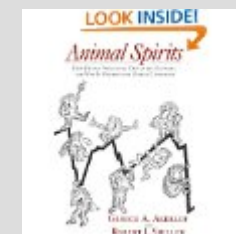
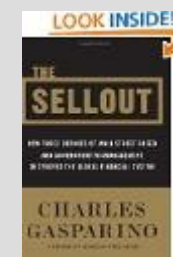
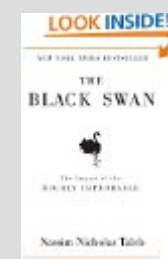
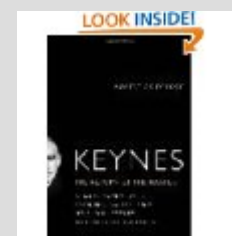
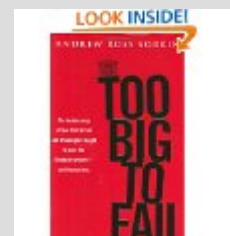


Roadmap

- Origin of the problem
- A missed opportunity
- An alternative path
- Whither the Fed?

Book lists are chocked full of answers,

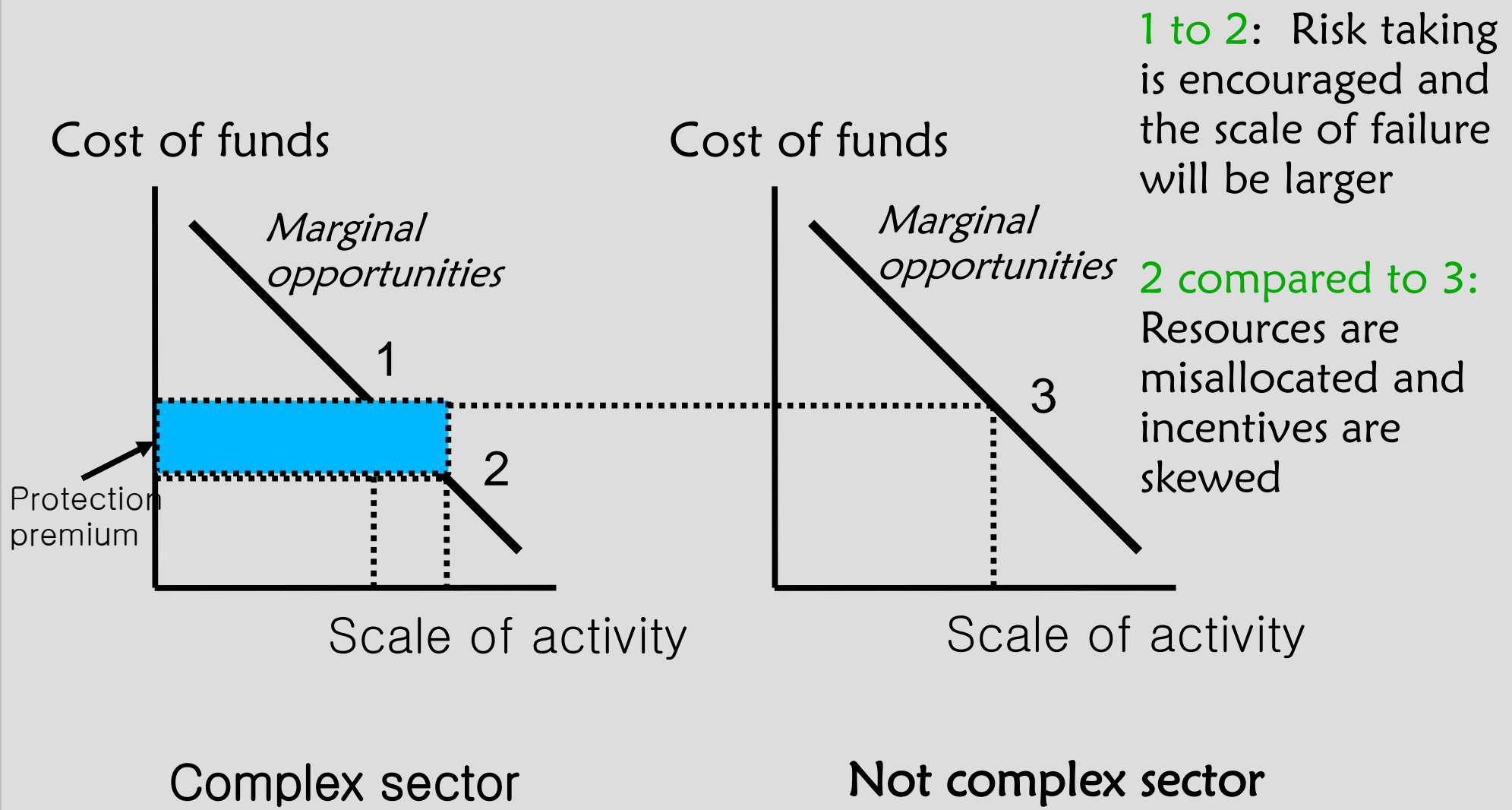
- Including,
 - Greed
 - Forgetfulness
 - Nature of uncertainty
 - Incompleteness of markets
- If these are the answers,
 - We have to consider fundamental reforms that **limit** and **discipline** private behavior



An alternative possibility is that the financial system has gotten too complex

- Multiple federal and state regulators
- Multiple charters
- Elaborate, overlapping, and sometimes contradictory regulation
- Intricate tax system in various jurisdictions
- Varying litigation risks
- Byzantine accounting rules

Perhaps the greatest incentive to complexity is TBTF or TCTF

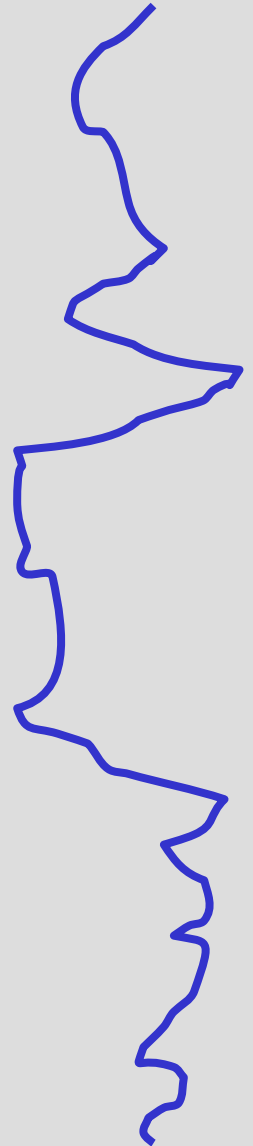


The protection premium does not all go to owners

- **Rent seeking** as firms spend resources to keep their special status by
 - Going slow on industry initiatives that limit risk
 - Netting of swaps, central clearing houses
 - Weaving systemically important activities into the firm's structure
 - Clearing banks
 - Resisting regulation that would make closure easier
 - Uniform insured depositor list
- Making their balance sheets more intricate and their instruments more complicated

A geometric intuition is that:

- The government created an intricate frontier of opportunities, encouraging
 - Tax and regulatory arbitrage
 - Shopping for supervisors
- Over time, institutions became better at exploiting these opportunities
 - Financial engineering
 - Balance-sheet splintering (SIVs as horcruxes)



As a result of this complexity, large institutions

- Cannot be **supervised** effectively
 - Basel II was already an admission of failure
- Cannot be **disciplined** by markets
 - Creditors looked to the family name
 - Equity owners did not look past CEOs
 - A hint comes from the lack hostile takeovers in finance
- Cannot be **managed**
 - Managers did not understanding risk-taking of employees
 - Suitability abuses
 - Compensation misalignments
 - Short-termism

2. The Administration's proposal (as codified by the HFSC)

- Is not the right way forward
- Makes the system more, not less, complicated
 - Adds boxes to the supervisory org chart
 - Enshrines TCTF
 - The government's ability to price that protection is suspect
- Does not lower, and may raise, the probability of future crises

An aside on the political economy

- The lack of ambition in the Administration's proposal is not evidence of its intent to protect the Fed
- In all areas of economic policy making, the Administration's first offers initiatives within its perceived political and market constraint
 - Conservative in its estimate of the location of the constraint
 - Unwilling to expend political capital to shift it out
- The Administration has been receptive to expanding the government's role *if* the constraint shifts out by the effort of others

3. An alternative way forward



Ole Kirk Christiansen's modular solution

- The whole of a financial holding company can be made of parts that can be disconnected and reassembled
 - LEGO is formed from the Danish words "LEg GOdt" meaning "play well"
- Any part of the firm that is systemically important can be protected in bankruptcy
 - With haircuts in the event and
 - Infrastructure developed over time to limit the perimeter of systemically important activities
- But the rest can be turned over to the market

Playing well also involves

- **Reducing** the number of corporate charters and agencies
- **Enforcing** consolidation of balance sheets
- **Placing** guard rails on the consolidated entity in terms of
 - Capital requirements
 - Leverage restrictions

Playing well

- Over time should
 - Make pre-packaged bankruptcy a viable option for any large financial entity
 - Increase discipline on management because hostile takeovers are more likely when entities can be carved up
 - Improve monitoring within a firm
- Facilitates international cooperation
 - Because the module in a foreign country can be supervised by the host (consider the Turner Report)
- Works overall to improve economic efficiency

Another geometric intuition about limiting alternatives

- Remember the **four-color theorem**
 - given any separation of a map into contiguous regions, the regions can be colored using at most four colors
- A limited number of charters and standardization of instruments can be consistent with a rich and varied financial landscape
 - And it is not an injunction about size or scope of activities

I have no illusions

- *Playing well* would
 - Be costly and take time to implement
 - Be resisted by industry because it
 - Takes money off the table
 - Put more pressure on management
 - Lowers the return on equity in finance
- But so will other, more burdensome and more likely regulatory alternatives
- Change is coming
 - We should at least get some efficiency gains from it

4. Whither the Fed?

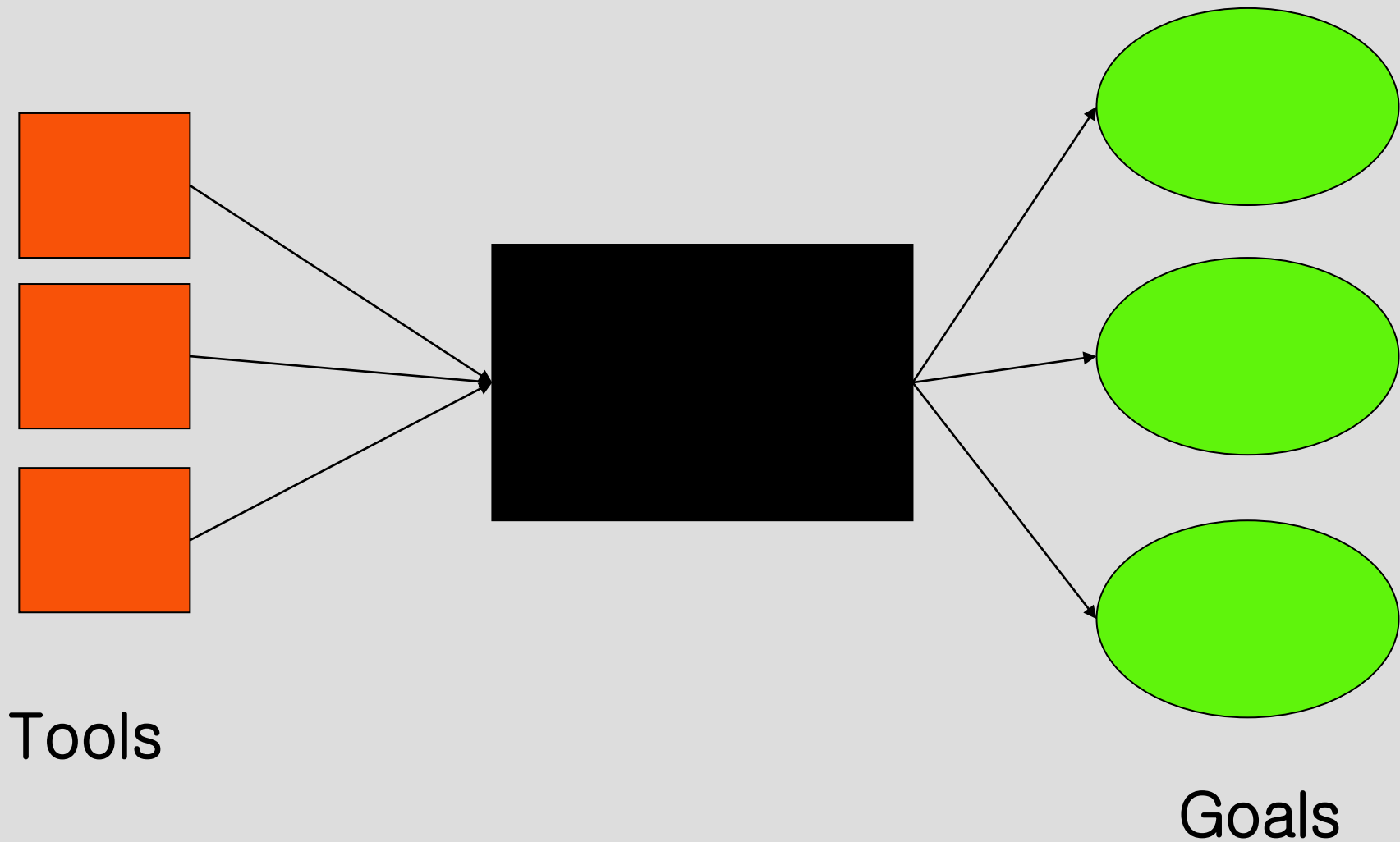
Two currents in open legislative initiatives

- Rep. Paul would open monetary policy to GAO audit
- The legislation would
 - Lower the hurdle to second-guess the Fed
 - Potentially force more FOMC records into the public sooner
- Sen. Dodd would narrow the Fed's focus
- The legislation would
 - Consolidate supervision
 - Limit the Fed' role to monetary policy making

Why does the Congress create an independent agency?

- To protect decision-making that should have a long-term focus from short-term political pressures
- The Paul-Grayson amendment runs counter to this
- To assign issues outside its competence to technicians
- The Dodd legislation assumes monetary policy technicians perform better with a single focus

From the Congress's perspective an independent agency is a black box



Multiple goals

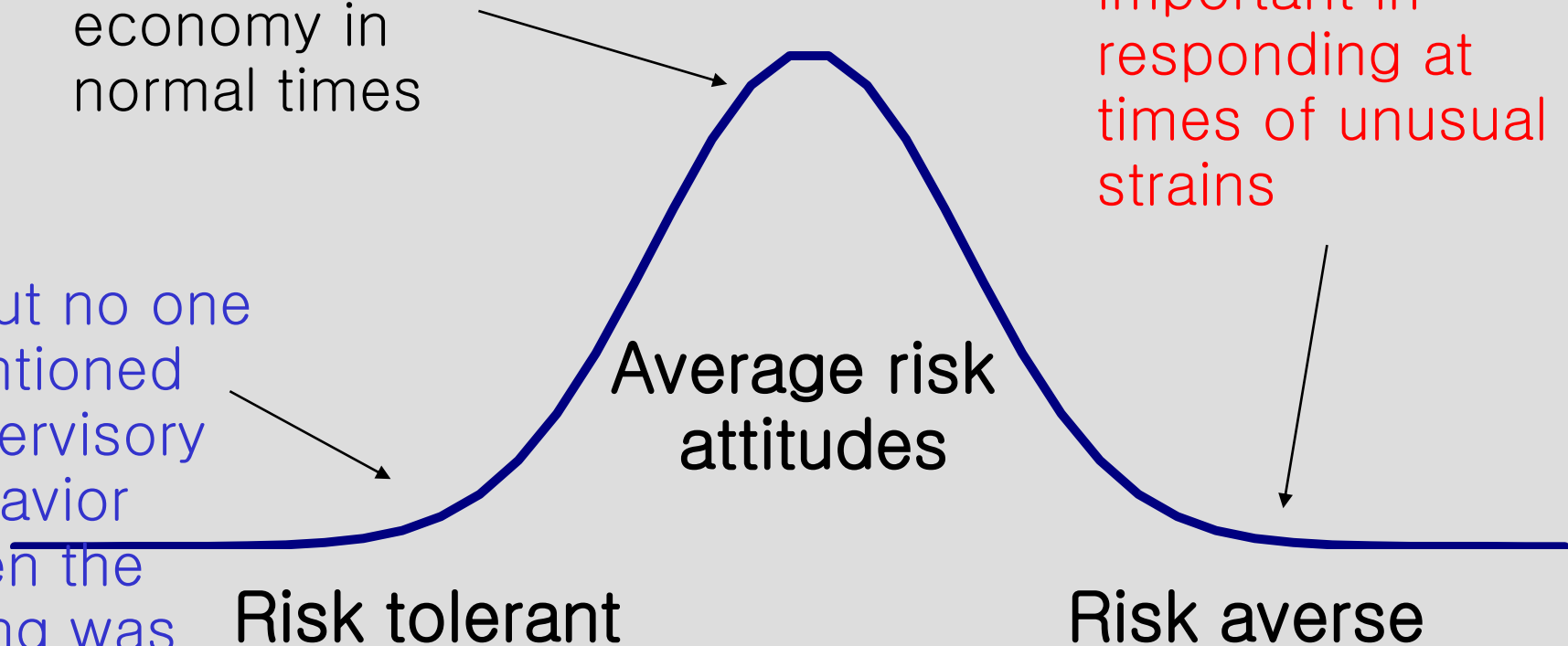
- Might be reinforcing if the information and competence needs are correlated
- Invite tradeoffs among goals
 - That are not necessarily understood by principals
 - That do not necessarily satisfy the legislated mission
- Require the agent be evaluated across its performance relative to all the goals

The argument is made that industry information ...

...helps in assessing the economy in normal times

...is especially important in responding at times of unusual strains

...but no one mentioned supervisory behavior when the going was good



However, information about financial firms in normal times

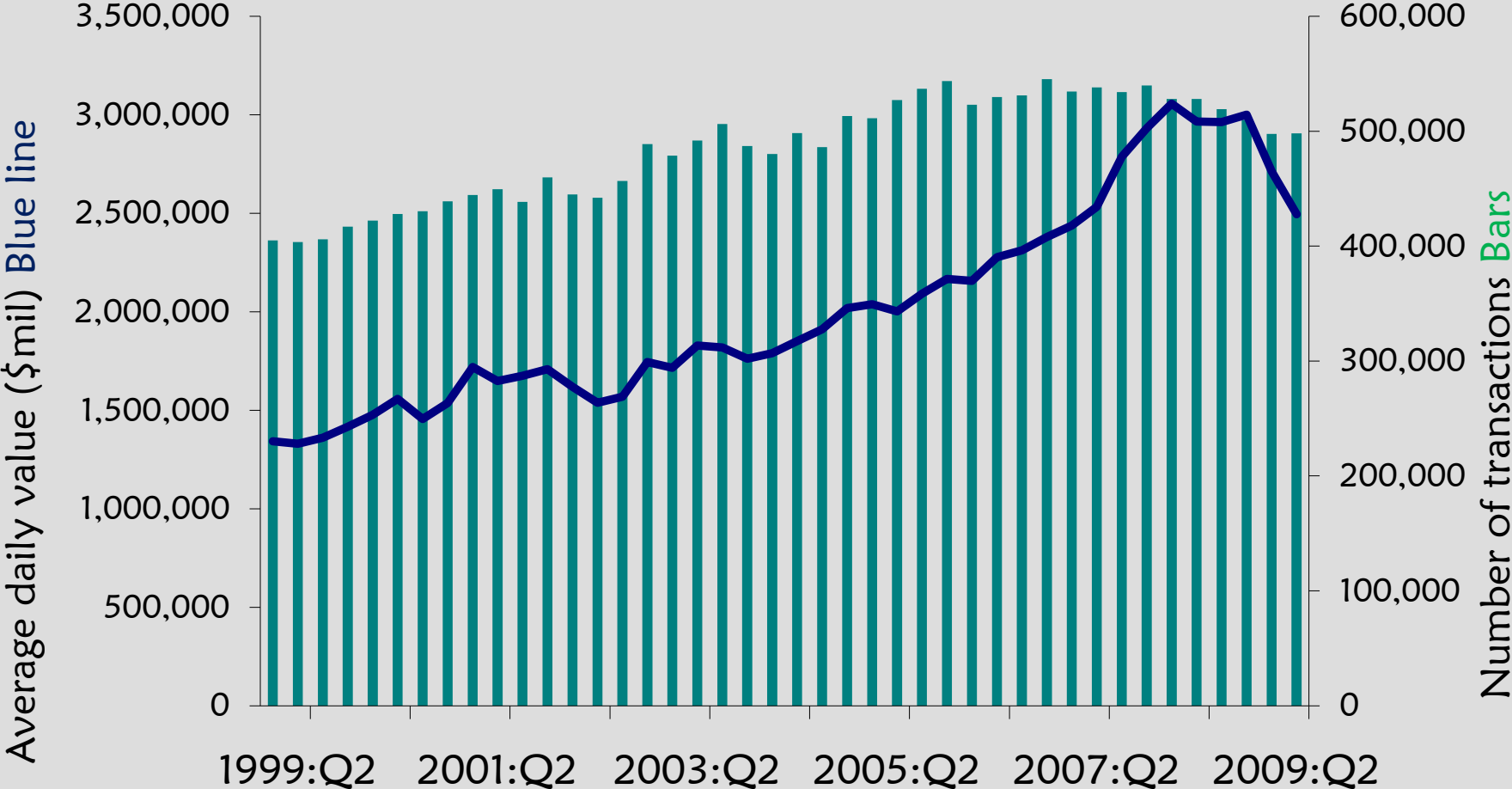
- Mostly comes from regular data collection efforts, such as
 - The Beige book
 - The Senior Loan Officer Survey
 - The monetary and credit aggregates
- That are collected outside of the supervisory process (intentionally so)
- And can continue to be collected even if the Fed was not a supervisor

One Fed example about a time of stress is definitely right

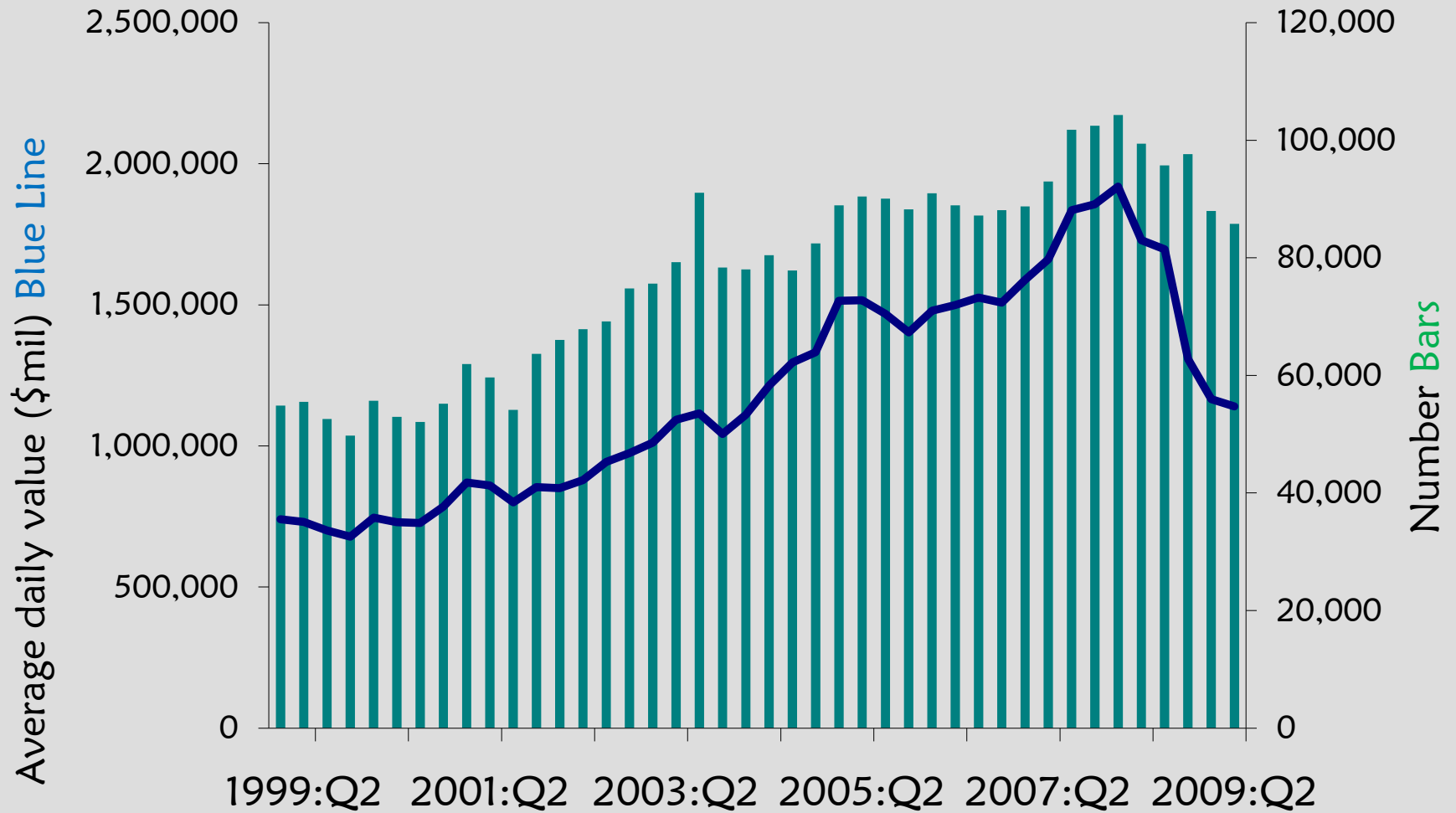
- Knowing the market operations of intermediaries was critical on 9/11/01
- Fed staff were able to help institutions with impaired infrastructure
- That knowledge helped to inform initial communications and subsequent action

But this was not about supervisory information, it was about expertise gained from running the payment system

Fedwire funds services



Fedwire securities services



Another Fed example is confusing

- If knowledge coming from supervision is critical in controlling risk to the lender of last resort,
- Why does the lender of last resort keep harping on **Bagehot's dictum**?
 - The sole test is proof of solvency, which requires an attestation from the lead regulator, and
 - Collateral contains risk

Ultimately, correlation is an empirical matter

- The FOMC has scrupulously kept **transcripts** of its meetings over the decades
 - After a lag of five years, this record is released to the public
- If the FOMC made materially better decisions because of the Fed's role in supervision, there should be instances of informed discussion of the linkages
- Anyone making the case for beneficial spillovers should be asked to produce numerous relevant excerpts from that resource

Tossing a lifeline: Don't defend the status quo

- **Concede** that monetary policy should be the sole focus of the Federal Reserve
 - Require robust information-sharing protocols from the supervisory agency
- **Protect** the independence of monetary policy
- **Strengthen** data collection
- **Use** the Fed's role as a provider of payment services to
 - Deepen understanding of markets and institutions
 - Force industry efforts to limit systemic risk

