

It's Broke, Let's Fix It: Rethinking Financial Regulation*

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This paper considers a wide range of financial reform issues, focusing on macroprudential regulation and on the recent reforms in the United States—although the principles apply globally. It emphasizes such issues as the needs for a systemic risk regulator and an orderly resolution mechanism for systemically important financial institutions, the risks posed by proprietary trading and skewed compensation incentives, and the design of new capital and liquidity requirements for banks. Throughout, an attempt is made to relate concrete regulatory proposals to the abstract principles that should govern financial regulation.

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1. Why Regulate Finance?

The whole world is now grappling with how to redesign the financial regulatory system, which is widely perceived to have failed on a massive scale and with catastrophic consequences.¹ In June 2009, the U.S. Treasury (2009a) released a lengthy white paper with a long, comprehensive list of reform proposals. Naturally, that document became the focal point of the discussion in the United States. The

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¹This is not to imply that regulatory failures were the *only* cause of the financial crisis of 2007–09. But they were certainly among the causes.

Treasury subsequently supplemented it with a sixteen-part draft bill and a variety of other documents. In December 2009, the House of Representatives passed a bill which was similar but not identical to the Treasury's proposal, and after many months in the congressional sausage grinder the Senate followed suit in July 2010. The Dodd-Frank Act is now the law of the land in the United States, though thousands of pages of detailed regulations are yet to be written.

Before you set out to do something—such as revamping the entire financial system—it is always a good idea to figure out *why* you are doing it and *what* you are trying to accomplish. According to the standard economic canon, government intervention into private business affairs normally is justified under one of the following five rubrics:

1. to create and enforce rules of the game and keep the system honest;
2. to guard against undue concentration, thus keeping markets competitive;
3. to redistribute income, e.g., through the tax-and-transfer system;
4. to correct externalities or other market failures, e.g., those due to asymmetric information;
5. to protect the interests of taxpayers, e.g., in cases in which public money is being spent or put at risk.

Income redistribution is of only marginal concern in the context of the financial crisis.² But the other four are all quite apposite and will be given substantial attention here. Rules were inadequately enforced or, in some cases, never made. Emergency rescue operations have increased concentration in the banking industry, and the too-big-to-fail (TBTF) doctrine may have been abused by many once-illustrious financial companies. A variety of miscreants imposed enormous costs on innocent bystanders by dragging the world's economies down. And taxpayers around the world have been forced to shoulder a variety of huge actual and potential bills. All

²The main issue was that many low-income people were victimized in the sub-prime lending markets.

this suggests the need for some fundamental rethinking of the rules and regulations that govern the financial system.

One other generic distinction is relevant before getting down to specifics. Economists typically draw a sharp distinction between regulation of prices, quantities, and entry, on the one hand, and regulations designed to promote health and safety and to protect consumers, on the other. Call these “price” and “safety” regulations for short. The prototypical attitude among many economists is deep skepticism about price regulations, which are normally designed to fleece someone, but open-mindedness about safety regulations. Pertinent questions must be asked on a case-by-case basis, of course. Does a regulatory proposal really advance the cause it purports to advance? Does it do so fairly and efficiently? Is a better alternative available? But if the answers are yes, yes, and no, the proposed regulation may be worth supporting. My discussion will focus on financial safety regulation. If you are looking for someone who wants to bring back Glass-Steagall or Regulation Q, you’ll have to look elsewhere.

Within that general framework, I suggest the following four main reasons for (different kinds of) financial regulations, all of which play major roles in this paper:

1. *Consumer protection*: To protect customers from anti-competitive behavior (and hence from excessively high prices), from fraud, from deceptive practices, and perhaps even—though this is far more controversial—from their own foolishness and gullibility.
2. *Taxpayer protection*: To limit the costs to taxpayers of the government’s safety net for financial institutions. The huge bailout costs that taxpayers in many countries are now bearing are spectacular examples. Ex ante taxpayer protection often involves guarding against or limiting moral hazard. Ex post taxpayer protection involves, inter alia, such things as least-cost resolution.
3. *Financial stability*: To protect the financial system against various sorts of systemic risks that might be triggered by contagious runs, breakdowns of the “financial plumbing,” or failures of large institutions that are either too big or too interconnected with others to fail—or, rather, to fail messily.

4. *Macroeconomic stability*: To limit the adverse spillover effects of financial shocks on the real economy and/or to limit the financial propagation and magnification of shocks that originate outside the financial sector—in short, to mitigate booms and busts.

Notice that safe and sound operation of banks and other financial institutions contributes to each of these objectives. Sound institutions do not fleece their customers. Safe institutions do not hand taxpayers large bills. Safe and sound institutions contribute to, rather than undermine, financial and macroeconomic stability. It's no wonder that when you wake a bank supervisor up from a deep sleep, the first words out of his or her mouth are liable to be "safety and soundness." That attitude pervades this paper.

2. Principles of Sound Regulation

I have already enunciated and emphasized two principles of sound regulation, whether financial or not:

1. Regulation should be designed to mitigate some well-articulated problem.
2. Regulations should concentrate on "safety" issues rather than on "price" issues.

But these are not the only relevant principles. There is a third:

3. Regulation should not stifle valuable innovation.

Stated thus, as an abstract principle, no one would object. But, perhaps especially in the financial sphere, the application of this principle to concrete cases is rife with ambiguities and judgment calls. Which innovations are "valuable"? In most areas of human endeavor, progress is unidirectional: Technology gets unambiguously better, albeit at variable rates; it never deteriorates. In finance, as in academia, I am less sure. For example, simple interest rate swaps and plain-vanilla asset-backed securities (ABS) appear to be clear technological advances. So are credit default swaps (CDS) used to hedge credit risk. But I am loath to defend the social utility of CDO²s

or “naked” CDS used for gambling (or to assist in bear raids)³—not to mention exotic mortgages or credit cards with terms that seem designed to victimize naïve consumers. Others, however, hold different views.⁴

Next, I have already mentioned the following:

4. Regulation should be efficient.

To me, this means two main things. One is that regulations should not impose *unnecessary* costs on businesses or consumers. The necessary costs are, well, necessary. This simple principle is, of course, familiar from business applications, and the rationale for it is exactly the same. Just as firms strive to produce any given level of output at the lowest possible cost, regulators should strive to achieve their goals at the lowest possible cost—including, especially, the costs imposed on others. The second important efficiency principle is that regulations should be designed to work *with* incentives rather than to fight them. Wherever possible, we want the invisible hand to assist the visible hand—and vice versa.

But in the public domain, the efficiency principle has an important companion that is far less salient in, and far less understood by, the private sector:

5. Regulation should be, and be seen to be, fair.

This principle includes due process, of course. Good regulation follows the law and is not arbitrary or capricious. To the maximum extent possible (which will never be 100 percent), regulators' actions should be predictable and understood by the regulated. Notice also the phrase “and be seen to be.” In democratic governments, where officials serve and are accountable to the public, the *appearance* of fairness is almost as important as the reality. Without it, political legitimacy is thrown into question.

³A CDO is a collateralized debt obligation, which pools a variety of debt instruments and tranches them. A CDO² is a CDO of CDOs.

⁴For example, many people argue—with some validity—that naked CDS help provide liquidity to the CDS market. But maybe this market got too liquid! In any case, these positions should always be properly collateralized.

6. The regulatory system should not leave large gaps, whereby important activities that should be regulated escape regulation.

The financial industry is teeming with highly innovative, even ingenious people. That ought to benefit society. But when their prodigious talents are turned toward escaping regulation, the commonweal is put in jeopardy. For example, in the United States, the absence of a federal mortgage regulator and *any* effective regulator of either derivatives or asset-backed securities played major roles in allowing a house-price bubble to turn into one of the biggest and most pervasive financial crashes in history.

That said:

7. Regulatory overlap should not leave firms confused or needing to satisfy one regulator at the expense of another.

Anyone who has ever been involved in financial regulation knows that some degree of overlap is inevitable. For example, within a U.S. bank holding company regulated by the Federal Reserve, the bank itself may be regulated by the Office of the Controller of the Currency (OCC) while the broker-dealer subsidiary is regulated by the Securities and Exchange Commission (SEC). It is a good principle to try to minimize, rather than maximize, such regulatory overlap. But perhaps even more important, a company should not get conflicting guidance or instructions from regulator A and regulator B. Anyone who has ever lived in the regulatory world knows that this sometimes happens, too.

There is an eighth principle, which is much in dispute. So I will offer both versions:

- 8a. Regulation should be *by function or instrument*; that is, the same activity should be regulated by the same regulator, regardless of the type of institution that performs it.
- 8b. Regulation should be *by institution*; that is, all of the potentially disparate activities of a single financial institution should be regulated by the same regulator.

Both principles are appealing. But obviously, in a world of multifunction firms, no regulatory system can satisfy both. So which version should take precedence?

I must admit to a certain ambivalence on this question, since neither pure model quite fits.⁵ Strict functional regulation can founder on close inter-relationships across functions (e.g., sound mortgage underwriting standards and consumer protection) and may leave significant gaps in the regulatory system (e.g., who was supposed to regulate credit default swaps?), especially since executives of complex financial giants try to manage them as single enterprises.⁶ But strict regulation by institution requires the regulator of a large, complex institution to have a tremendous range of in-house expertise, lest it find itself overwhelmed (e.g., the Office of Thrift Supervision trying to regulate AIG Financial Products). It is presumably this conundrum that led several countries to create a single, all-purpose financial regulator with authority over substantially all financial institutions and markets—e.g., the UK's Financial Services Authority (FSA). But that innovation is not noteworthy for uniform success across countries, and bank regulation in Britain, in particular, is now being returned to the Bank of England.

3. When the Tide Goes Out, You See the Rocks

The rolling financial crisis of 2007–09 revealed a number of weaknesses in the financial regulatory structure, some of which were not apparent before—though perhaps they should have been—and some of which were. There seems to be no natural way to order the items on what is by now a long list of needed regulatory reforms, and many of the items overlap in complicated ways. So I will simply proceed in a top-down fashion, starting with systemic risk and working my way down to the supervision of individual companies, and finally to

⁵Reflecting its usual lack of ambivalence, the *Financial Times* entitled an editorial (May 26, 2009) “Regulation Time: Authority Must Be Assigned by Function, Not Product.” But as Saunders, Smith, and Walter (2009, p. 154), who generally favor regulation by function, note, “regulation by function is not enough in the case of LCFIs” (large, complex financial institutions). I agree.

⁶Cf. Tarullo (2009, p. 8), who says that the Gramm-Leach-Bliley Act of 1999 “elevated the concept of ‘functional regulation’ to the potential detriment of a more effective consolidated supervision.”

consumer protection.⁷ In each case, my focus will be on what failed, why, and what might be done to fix it. As I proceed down the list, I will discuss many, but certainly not all, of the recently enacted U.S. reforms.

3.1 *The Need for a Systemic Risk Regulator*

The term “systemic risk” connotes risks that threaten the entire (or at least a large portion of the) financial *system* and thus, by inference, threaten the entire economy. Even cataclysmic events, such as the bursting of the tech stock bubble after 2000, may not pose systemic risks if they can be confined to a single market⁸—although a big enough crash may undermine many institutions, and perhaps other markets. Similarly, the failure of a single large institution need not, but could, pose a systemic risk. That worry, for example, is the origin of the old “too big to fail” (TBTF) doctrine, its younger cousin the “too interconnected to fail” (TITF) doctrine, and shining the regulatory spotlight on systemically important financial institutions.

Between the summer of 2007 and the spring of 2009, the United States and other nations experienced a frightening cascade of financial ructions the likes of which the world had not seen since the Great Depression—when finance was far simpler. This searing experience seems to have created, among other things, a widespread agreement that we need a macroprudential or “systemic” risk regulator (really a systemic risk *supervisor*, but I’ll stick to standard nomenclature) with a broad view over the entire financial landscape—an agreement reflected in the Treasury’s proposal, the law enacted by the U.S. Congress, and reform efforts in many other nations. But what would such a regulator do—and how?

Presumably, its main task would be to serve as an early warning-and-prevention system, constantly on the prowl for looming risks

⁷While lengthy, my list is not encyclopedic. Several important issues are not taken up here—for example, accounting standards, money market mutual funds, insurance regulation, and what to do with Fannie Mae and Freddie Mac. For the most part, the Dodd-Frank Act punted on these, too.

⁸This will normally require, among other things, that it’s an equity market with little debt involved.

that extend across markets and/or across different classes of institutions and that are growing large enough to have systemic consequences if troubles arise. Easier said than done. Recognizing systemic risk *ex ante* calls to mind former U.S. Supreme Court Justice Potter Stewart's famous test for recognizing pornography: "You know it when you see it." But the question, just as with pornography, is: Do you? Different people see things differently.

That said, the task of identifying systemic risks while they are still bubbling up may not be impossible, as long as our performance standards are appropriately modest. For example, Borio and Drehmann (2009) have developed a statistical indicator of bubbles based on the simultaneous occurrence of rapid increases in asset prices (of stocks or houses) *and* rapid growth of credit. Huang, Zhou, and Zhu (2009) propose a way to estimate the systemic risk of specific institutions by looking at their CDS spreads and stock prices. Barrell et al. (2009) predict banking crises in OECD countries with data on capital adequacy, liquidity ratios, and property prices. There are others. But all this research is new, and probably none of it is ready for prime time. That said, the ideas hold promise and merit further study.

Here is a counterfactual case study meant to illustrate what a systemic risk regulator in the United States might have seen, had one been in place in 2005–06. It might have noticed that a variety of banks *and* non-banks were granting a very large volume of dubious sub-prime mortgage loans, *and* that a correspondingly large volume of fixed-income securities (some of them quite opaque) were being built on these shaky foundations, *and* that many systemically important institutions were acquiring extremely large positions in these very loans and securities, *and* that a truly colossal volume of derivatives (e.g., CDS) were being written on these securities without much capital behind them.

That was a long sentence, but its most important words are the four uses of the conjunction "and." The essence of the systemic risk regulator's job is to look *across* markets and *across* types of businesses. The lending practices of U.S. banks were, in fact, supervised by four federal banking agencies and fifty state agencies—albeit poorly, as it turned out. However, no one had a good window on the lending activities of non-bank mortgage lenders, which accounted for most of the sub-prime mortgages, including an

inordinate share of the worst ones.⁹ Thus no regulator kept a watchful eye on the mortgage market *as a whole* even as the volume of sub-prime lending skyrocketed.¹⁰ While many government bureaus (e.g., the SEC and the banking agencies) had some peripheral involvement with asset-backed securities, no regulator was responsible for overseeing the gigantic ABS markets—which, in many cases, buried their products in off-balance-sheet structured investment vehicles (SIVs) and conduits.¹¹ In addition, regulators either did not know how many of these ill-fated assets were on (and off) their institutions' balance sheets or, what would have been even worse, allowed unconscionable risk concentrations to build up anyway.¹² Finally, the U.S. government made fateful decisions in 1998 (when Commodity Futures Trading Commission [CTFC] head Brooksley Born was overruled) and again in 2000 (when the Commodity Futures Modernization Act protected derivatives from regulation) to turn a blind eye toward derivatives. This deliberate neglect left, for example, the oversight of AIG's credit default swaps business in the hands of the badly overmatched Office of Thrift Supervision (OTS).¹³

How might things have been different if a systemic risk regulator had been in place then? The residential mortgage market, plus the mortgage-backed securities (MBS), CDOs, CDS, and other instruments built on these mortgages, constituted the largest financial market in the world. So you might have thought the systemic risk regulator would have kept a watchful eye on it. If it had, it would

⁹According to Chomsisengphet and Pennington-Cross (2006, p. 38), “subprime loans were originated mostly by non-depository and monoline finance companies.”

¹⁰According to Morgenson (2008), the value of newly issued sub-prime mortgages rose 159 percent from 2002 to 2006.

¹¹This practice was, in turn, largely motivated by avoiding capital charges. More on that below.

¹²For example, the SEC's Inspector General later reported (U.S. SEC 2008) that the Commission knew Bear Stearns was dangerously overconcentrated in sub-prime securities and yet did nothing about it. Bank managements and boards failed, too. For example, the *New York Times* reported that Citigroup's CEO first learned of the company's \$43 billion in mortgage-related assets in 2006. See Dash and Creswell (2008).

¹³AIG purchased a small savings bank in 1999, presumably to qualify as a thrift holding company under the Gramm-Leach-Bliley Act of 1999, and thus to be regulated by the OTS, which has now been abolished. I have heard it claimed that AIG and others fashioned these contracts as swaps, rather than as insurance policies, to avoid insurance regulation and capital requirements.

have seen what the banking agencies apparently missed: a lot of dodgy mortgages being granted by non-bank lenders with no federal regulator.¹⁴ It might then have been natural for the systemic risk regulator to look into the solidity of the securities that were being manufactured from these mortgages. That investigation *might have* turned up the questionable AAA ratings that the rating agencies were showering on these securities, but it certainly *would have* uncovered the huge risk concentrations both on and off banks' balance sheets. And, unless it was totally incompetent, it would have been alarmed to learn that a single insurance company (AIG) was on the sell side of an inordinate share of all the CDS that had been issued—and that the company did not have nearly enough capital to back them. Hmm. That counterfactual really does suggest that history might have turned out much better.

Some people would end the role of the systemic risk regulator right there—as an investigative body and whistle blower whose job is to alert other agencies to mounting hazards. Maybe such a limited role is appropriate. But if systemic problems and weaknesses are discovered, *someone* should presumably take steps to remedy them—or at least to safeguard the rest of the system. Whom?

Under one model, the systemic risk regulator would act like the family doctor, taking a holistic view of the patient, making a general diagnosis, and then referring patients to appropriate specialists for treatment: to the SEC for securities problems, to the banking agencies for safety and soundness issues, to the _____ for potential problems with derivatives, etc. (We really do need to fill in that blank, don't we?¹⁵)

There is a problem here, of course. If several different agencies are involved in the solution, the process will work much better if their actions are well coordinated. Anyone who has been involved in a bureaucratic turf war knows that achieving coordination is harder

¹⁴Journalists were calling attention to the dangers inherent in the rapid growth of sub-prime mortgages as early as June 2004. For example, the *New York Times'* Edmund Andrews (2004) wrote that “problems may be just over the horizon, especially in markets where housing prices have risen far faster than personal income.” In that same year, Federal Reserve Governor Edward Gramlich (2004) gave a prescient speech calling attention to some of the “challenges” posed by sub-prime mortgage lending.

¹⁵The Dodd-Frank Act shares this authority between the SEC and the CFTC.

than it sounds. Hence one key question is: Would the systemic risk regulator turn out to be the field marshal of a well-coordinated army, or find itself herding cats? I guess the soon-to-be-established Financial Stability Oversight Council (FSOC)—consisting of (count 'em) the heads of the Treasury, the Federal Reserve, the OCC, the Federal Deposit Insurance Corporation (FDIC), the SEC, the CFTC, the Federal Housing Finance Agency (FHFA), the National Credit Union Administration, the new Consumer Financial Protection Bureau, and an independent presidential appointee “having insurance expertise”—is supposed to solve that problem. I wonder.

An alternative model would work more like a full-service HMO, where the internist/gatekeeper refers patients to in-house specialists for treatment as necessary. Establishing a comprehensive systemic risk regulator like that would mean giving it a much broader grant of authority—not only to *diagnose* problems but to *fix* them. It would also require a tremendous range of in-house financial expertise, in both depth and breadth. This is, roughly speaking, the FSA model, which failed in practice in the United Kingdom but succeeded in Canada.

But that leaves one big unresolved problem. When problems of truly systemic proportions blow up, or threaten to, a lender of last resort is likely to be crucial to the solution—at least to the immediate rescue phase thereof. And only the central bank can serve this function. So this more expansive view of the role of the systemic risk regulator points straight to the central bank. In fact, it is the main reason why I see this question *of principle* as being open and shut *in practice*. At least in the United States, if there is to be a systemic risk regulator, it must be the Federal Reserve. Like Secretary Timothy Geithner, “I do not believe there is a plausible alternative,”¹⁶ for at least five reasons.

First, if the systemic risk regulator is to take strong actions (as I think it should), rather than just flag problems, then it really must have—among other things—lender-of-last-resort powers.

Second, systemic risk regulation is a natural first cousin (if not a sister) of monetary policy. Both are *macroprudential* functions. Every central bank sees itself as the nation's principal guardian of

¹⁶Secretary Geithner was quoted on a variety of financial wires on June 17, 2009.

financial stability, whether or not its explicit legal mandate says so. Since synergies between monetary policy and financial stability abound, it is unnatural, inefficient, and probably even dysfunctional to separate them.¹⁷

Third, and implicit in what I just said, the central banks of most countries—unlike any other agency—would not be starting from scratch in monitoring and thinking about systemic risk. Most of them already have the eyes and ears (though not enough of them) to do this job, and the broad view (though, again, not broad enough) of the entire financial landscape.¹⁸ It must have these things in order to do monetary policy properly. So the Federal Reserve and many other central banks, unlike *de novo* agencies, would hit the ground running.

Fourth, the nature of the job requires an effective systemic risk regulator to be fiercely independent of politics. Probably no other agency of government has as much independence as the central bank—even where, as in the United States, that independence is more a matter of tradition than law.¹⁹ Perhaps an equivalent degree of independence might be developed, eventually, in a systemic risk regulator other than the central bank. But doing so would certainly take time, probably a lot of it.

Fifth, I am deeply skeptical that the job can be done well by a consortium or committee of regulators, such as the above-mentioned FSOC. Creating a hydra-headed systemic risk regulator, as some have proposed, invites delays, disagreements, and turf wars. It also dilutes accountability. So the U.S. financial reform sensibly made the Federal Reserve the operating arm of the systemic risk regulation apparatus, with the FSOC serving more as a policymaking body and board of directors. That said, if the systemic risk

¹⁷See, for example, Peek, Rosengren, and Tootell (2009) or Blinder (2010).

¹⁸Part of the “not enough” in the United States is that the Gramm-Leach-Bliley Act (1999) made the Federal Reserve only the “umbrella” supervisor of financial holding companies. In practice, that meant that the Federal Reserve did not pay enough attention to what went on *inside* subsidiaries whose primary regulator was some other agency—indeed, it was not authorized to do so. See Bernanke (2009) and Tarullo (2009). The Dodd-Frank Act is supposed to end this practice for large financial holding companies.

¹⁹Congress can override any Federal Reserve decision by a simple majority vote. But it never does.

regulator is to have authority to shut down dangerous institutions, it probably should require consent from *someone*. Under the new U.S. system, that someone is the Secretary of the Treasury—subject to the approval of the courts. That seems like a sensible choice to me. After all, life-or-death decisions on individual companies are inherently political and may commit taxpayer money. So it is appropriate for someone with political legitimacy to make such decisions. The Secretary of the Treasury, the country's CFO, is the President's designated agent.²⁰

In fact, the absence of such a political check was one major source of unease about the Federal Reserve's extensive use of section 13(3) powers during the crisis. That once-dormant but now-controversial provision of the Federal Reserve Act allows the Board, "in unusual and exigent circumstances," to "discount for any individual, partnership, or corporation, notes, drafts, and bills of exchange" as long as they are "secured to the satisfaction of the Federal Reserve bank" and the Federal Reserve has "evidence that such individual, partnership, or corporation is unable to secure adequate credit accommodations from other banking institutions." In short, in an emergency, the Federal Reserve was authorized to lend to *virtually anyone* against *virtually any collateral*.

That broad grant of authority, obviously, was neither checked nor balanced. Perhaps the Federal Reserve should have been required to seek permission *ex ante* from the Secretary of the Treasury, at least in cases involving individual companies,²¹ and then to report *ex post* to Congress on why its use of section 13(3) powers was justified. The new Dodd-Frank Act requires such reporting (and auditing) and also *prohibits* section 13(3) lending to individual companies, which may prove to be a step too far.

Returning to the choice between the family doctor and HMO models, it is, of course, possible to envision hybrids. For example, even if the central bank takes on the more-limited family doctor role, it will probably be among the specialists that get called in to

²⁰Once the company is designated to be shut down, the actual job of receivership is done by the FDIC.

²¹Section 13(3) cases that deal with *markets*, rather than with *companies*, sit much closer to monetary policy proper; so perhaps the Secretary's permission should not be required.

affect a cure. Alternatively, if the central bank takes on the more-powerful HMO role, the government might want to limit some of its other powers, lest the central bank become too monolithically powerful. The U.S. Treasury and Congress debated this issue at length in 2009–10, but in the end took away only the Federal Reserve's authority over consumer protection.²²

3.2 The Need for an Orderly Resolution Mechanism for Financial Giants

The too-big-to-fail and too-interconnected-to-fail doctrines have been roundly criticized in recent years, largely because of the moral hazards they create, but also on fairness grounds and because they expose taxpayers to potentially huge liabilities. All three criticisms are valid. Living under the government's protective umbrella gives financial giants an unfair competitive advantage (e.g., access to cheaper funding), puts taxpayers on the hook, and may encourage excessive risk taking.

But let's not forget the (valid) rationale for having a TBTF doctrine in the first place: It is very risky to let a giant financial institution—which will, of course, have thousands of counterparties and probably a global reach—go bankrupt. Lehman Brothers demonstrated that fact painfully in September 2008. Within days, the entire global financial system was melting down at a frightening pace. Within weeks, officials in numerous countries were all but declaring that no other large financial firm would be allowed to fail, and backing that pledge with piles of taxpayer money.

Yet the aforementioned objections to the status quo ante are both powerful and valid. So it's no wonder that recent experience with TBTF and TITF, though "successful" (e.g., the financial melt-down was halted), seems to have left no one happy—not regulators, not legislators, and certainly not ordinary citizens. What to do? There are several options.

First, we could try to jettison the two doctrines, replacing them by "sink or swim," presumably coupled with a heavy dose of caveat

²²As a political compromise, Congress housed the new Consumer Financial Protection Bureau at the Federal Reserve but made it independent of the Federal Reserve. If that sounds strange, it is.

emptor. In my view, this option is attractive mainly in *laissez-fairey* tales. In the real world, it is probably neither possible nor advisable. Not possible because genies are not easily put back into bottles; the precedents already set would undermine the credibility of any future proclamation of “never again.” Not advisable because, as just noted, there really is a good reason to have some sort of TBTF doctrine, even though business failures are inherent in capitalism. Yes, it feels right to punish miscreants. But it doesn’t feel right to see millions of innocent bystanders dragged down with them. Recent experience also suggests that market discipline was highly overrated, some might even say oxymoronic. Where was the market discipline—until the very last minute—of Bear Stearns, Lehman Brothers, AIG, and others?

Second, we could adjust our regulatory and anti-trust policies to make it difficult or impossible for any financial institution to be too big to fail in the first place, as suggested by Bank of England Governor Mervyn King (2009), among others. Frankly, I think it is probably a good idea to impart some greater anti-bigness tilt to regulatory policies once the crisis is over.²³ But our expectations should be realistic, which in this case means modest. Specifically, we are not going to create an environment in which no U.S. financial institution is TBTF or TITF—and I think the same is true in many other countries. Think about it. The United States is a huge country. Its biggest firms are extremely large in just about every industry. Why should finance be different? And modern finance is all about interconnections. Furthermore, the United States is and likely will remain the global financial leader. Globalization itself involves some minimum scale and scope that depends, *inter alia*, on developments in other countries. So international competitive considerations suggest that both the size and scope of America’s largest financial institutions will at least approximate those of other major nations. The same holds, *ipso facto*, for other major countries.²⁴

²³For example, crisis-induced mergers and acquisitions have left the United States with a banking system that is too concentrated according to the Riegle-Neal Interstate Banking and Branching Efficiency Act (1994).

²⁴That said, two-trillion-dollar balance sheets are probably not necessary to, and may be inimical to, business success. Here, the “too big to manage” doctrine may hold sway.

Third, we could recognize the inevitability of having some TBTF institutions, and charge them for the privilege. I think that is, in Sherlock Holmes's words, a capital idea (pun intended) to which I will return.

Fourth, we could develop a new resolution mechanism, perhaps patterned on what the FDIC now does with small banks (often *before* the bank's net worth goes negative), that would enable the authorities to wind down a systemically important financial institution (including a non-bank) in an orderly fashion—rather than just throwing it to the Chapter 11 wolves. This last idea is the one Congress adopted, after much debate. Among its presumed virtues are the following:

- The TBTF doctrine would morph into “too big to be put into Chapter 11,” but not “too big to be seized and its management thrown out.” That change alone should go a long way toward reducing moral hazard.
- Taxpayers would be mostly relieved of the burdens of costly bailouts. I say “mostly” because even least-cost resolution often imposes costs on taxpayers, and because the “systemic risk exception” (discussed below) explicitly recognizes that costs are justified if they mitigate systemic damage.
- Regulators would no longer have to keep large “zombie banks” (and non-banks) on life support for fear of the systemic consequences of shutting them down.

As in many aspects of financial reform, the details matter. Many of the most important issues are lawyers' questions, regarding which I have no comparative advantage. But let me make a few points about good design—beginning with this question: What do we want the new resolution authority to accomplish that present arrangements do not? I would list six objectives. To the extent possible, it should:

1. maintain the continuity of the payments and settlements systems, which might mean continuing the core operations of some firms;
2. create resolution procedures that are both well defined (though legal certainty may be unattainable) and expeditious;

3. reduce, or in the limit eliminate, contagion to other institutions;
4. minimize the threat and/or the severity of disruptive runs prior to resolution;
5. minimize costs to taxpayers; and
6. as part of objective 5, *not* make all liability holders whole (in contrast to recent bailout practice).

Notice, however, that some of these objectives conflict with others. For example, if the resolution procedure imposes (even well-defined and predictable) losses on debt holders (objective 6), as a way to minimize taxpayer burdens (objective 5), debt holders will have incentives to run whenever they smell trouble (thus contradicting objective 4 and maybe even objectives 1 and 3). Perfection is not achievable—and we should keep that in mind when appraising concrete proposals.

To me, there are two basic approaches, each with advantages and disadvantages.

The first would be to establish a special resolution authority to do for systemically important financial institutions something like what the FDIC does so well for failing (small) banks: make the resolution process orderly, predictable, and fast. This is roughly what the U.S. Congress just did. But notice at least three critical differences. First, resolving a multi-function financial giant goes way beyond what the FDIC is accustomed to doing over a weekend. The job is so different, both quantitatively and qualitatively, that closing on Friday afternoon and reopening on Monday morning is out of the question. So “fast” may be an unattainable goal. Second, such a resolution authority must keep systemic risk and financial stability in mind, rather than be narrowly legalistic like a bankruptcy court. Doing so would no doubt push decisions out of the legal realm and into the realm of political economy—which has both costs (possible political interference) and benefits (political legitimacy and attentiveness to broader economic concerns). But it is necessary, if systemic risk is to be contained. One critical focus of a special resolution authority would be to limit externalities, which bankruptcy is *not* designed to do. Third, a special resolution authority would presumably be allowed to impose something akin to prompt corrective action *before*

insolvency, again in stark contrast to what a bankruptcy proceeding does.²⁵

Since other countries need to grapple with this issue too, it is worth replaying parts of the U.S. debate. The Treasury's original white paper modeled its proposed resolution procedure "on the 'systemic risk exception' contained within the existing FDIC resolution regime" and reserved it "only for extraordinary times" in which an actual or impending default by a systemically important institution "would have serious adverse effects on the financial system or the economy."²⁶ The Secretary of the Treasury, after consulting with the President and obtaining approvals from the relevant regulators, would "generally" appoint the FDIC as the conservator or receiver with "broad powers to take action."²⁷

As Congress debated the idea, two of the biggest issues were the role of the courts and whether "bailouts" should be allowed. The compromises in the House and Senate did a little of each. As mentioned earlier, if the company objects, the Secretary of the Treasury needs court approval in order to proceed with special resolution under Dodd-Frank. More important, the Act eliminates the conservatorship option, which I would have preferred to keep, mandating receivership instead. It also requires that management be dismissed and that unsecured creditors bear some losses, two features that, I think, will help reduce moral hazard.

The second approach to special resolution would be to enact a new "Chapter 16" of the bankruptcy code,²⁸ designed to remedy the defects of Chapter 11 in cases of systemic risk—defects that were painfully obvious when Lehman collapsed. For example, Chapter 16 would maintain the continuity of payment and settlements

²⁵On these points and others, see Cohen and Goldstein (2009).

²⁶These words almost precisely mimic the words in FDICIA Section 13(c)(4)(G): "serious adverse effects on economic conditions or financial stability." It is noteworthy that the systemic risk *exception* is an exception to the principle of least-cost resolution. It thus recognizes that avoiding systemic risk can justify the expenditure of public money, as noted above.

²⁷All the quotations in this paragraph come from pages 77–78 of the white paper.

²⁸The present U.S. bankruptcy code has fifteen chapters.

systems,²⁹ provide for uniform treatment across different types of businesses (e.g., banks, insurance companies, securities firms, etc.), and work relatively smoothly across national borders. As compared with the Treasury's recommended approach, Chapter 16 would presumably be less political/economic and more legalistic. It would thus engender greater legal certainty, and perhaps harsher penalties for failure, at the cost of less flexibility in dealing with "unusual and exigent circumstances." It would almost certainly be far less attentive to macroprudential aspects and externalities on other firms, perhaps excluding them altogether. And it would probably also be slower. For example, it is hard to imagine how a Chapter 16 proceeding could be brought *before* the institution failed to make payments. These last two drawbacks strike me as particularly significant. Perhaps they struck Congress the same way.

In either case, prompt resolution will be assisted by "living wills," a novel regulatory requirement first proposed by Brunnermeier et al. (2009) that Treasury also proposed in its white paper. Under Dodd-Frank, each systemically important firm would be required to report "resolution plans" to the Federal Reserve, the FDIC, and the FSOC, and to keep them up to date. Like seemingly everyone, I find this idea attractive. But I wonder how practical it would be. For example, how often would the plan have to be updated? Every time a new division was created, spun off, or amalgamated? Every time the firm's balance sheet changed in a major way? If living wills are both detailed and updated frequently, which might be necessary if they are to serve their regulatory purpose, they might impose large burdens on firms. More likely, banks will find ways to make compliance a cookie-cutter, check-the-box exercise that does not consume much time or energy.

Whichever approach is selected, there is a serious human resources concern that seems to have been ignored. Special resolutions of systemically important financial institutions will presumably be rare events, perhaps occurring only once every several decades,

²⁹Chapter 11 goes some way in this direction already, by exempting repos and derivatives from the usual automatic stay in bankruptcy, that is, by allowing payments to continue to be made. While these provisions do maintain continuity, questions have been raised about why such contracts (after netting, which clearly makes sense) should be put at the head of the payments queue in case of bankruptcy.

and requiring the skills of possibly hundreds of attorneys, accountants, bank examiners, etc. How could the FDIC, or anyone else, keep such a large, highly skilled resolution force at the ready, prepared to descend en masse on a failing institution on short notice, without even knowing in advance whether the main problems would lie in banking, securities, trading, or insurance? Presumably, personnel would have to be seconded from several federal agencies. Analogously, where on the federal bench would we find a judge prepared to take on a massive Chapter 16 case, when he or she had probably never seen one in his entire judicial career? In this respect, at least, Chapter 16 seems to have one advantage: In a bankruptcy proceeding, the burden of working out the details of the financial restructuring falls on the company and its creditors, not on the court.

3.3 The Roster of Financial Regulators

America's crazy-quilt of banking and financial regulators, which has been substantially unchanged for a long time, has come in for a great deal of criticism of late—much of it well justified. I think it is safe to say that, starting from scratch, no one would ever design the current U.S. system. And, indeed, it is hard to find anything like it elsewhere in the world. The organization chart is a management consultant's nightmare, with overlaps and gaps galore. I'll divide this broad issue into parts, starting with the one that may be the most delicate politically.

3.3.1 Rearranging the Regulatory Deck Chairs

Unlike many other aspects of its proposal, where it was bold, the U.S. Treasury proposal was timid when it came to trimming the number of regulators and rationalizing their functions. And after a flirtation with major deck chair rearrangements in the Senate, Congress settled on essentially the same approach. Only one of the four current federal banking agencies will be merged out of existence (the OTS). Thus, many banks will still be able to shop around for a friendlier federal regulator; their choices will just be trimmed from four to three.³⁰ Furthermore, despite the similarities in their

³⁰But large banks will not be able to avoid the Federal Reserve.

functions (how different are futures and options, really?), and the potential dysfunction inherent in their traditional (and sometimes bitter) rivalry, the SEC and the CFTC are not slated to be merged. A twenty-five-year-old management consultant could have done better.

Why such timidity? One reason might be the presumed (by some) virtues of competition among regulators. But I believe the main reasons are grounded in *realpolitik*. Tidying up the organizational chart by eliminating the CFTC and collapsing all four banking agencies into one makes good sense in the abstract. It's what I'd want my students to recommend in a classroom exercise. But either proposed reorganization would likely trigger fierce bureaucratic and congressional turf wars that reformers might lose. So I'm willing to forgive Treasury and the two banking committees for their decision to husband their political capital for more important, and more winnable, fights. Furthermore, tidying up the organizational chart is almost certainly *less* important than getting the regulators—all of them—to improve their performance. After all, regulatory failure on a grand scale was one major cause of the mess.

Still, since this paper is about *principles* for regulatory reform, I feel obliged to state the obvious: Having two regulators rather than six would be better, as most of the rest of the world recognizes.

3.3.2 *Filling Regulatory Gaps*

The unhappy history that started to unfold in the United States in the summer of 2007 highlighted at least five major regulatory gaps. First, the United States had no federal mortgage regulator. Second, we had no effective regulation of derivatives. Third, we didn't even have much knowledge about, much less regulatory authority over, the activities of hedge funds. Fourth, regulators, and perhaps even top executives, had inadequate understanding of what was going on in off-balance-sheet entities such as conduits and SIVs. Fifth, no one was effectively regulating the gigantic ABS markets. The last four of these five failings were not limited to the United States. They were and remain common across the globe.

Remember, one of the main regulatory principles mentioned earlier was that large gaps in the regulatory structure should be avoided. The status quo ante failed miserably on that criterion. And while nature may abhor a vacuum, financial market participants will rush

to fill one—as they did. Banks certainly played a key role in the sub-prime lending debacle, but the problems really burgeoned out of control in America's unregulated, non-bank sector. Securitization ran wild. No regulator understood what AIG was up to in the CDS market. To this day, I think no one really understands the role hedge funds played in the drama. And a vast profusion of conduits and SIVs were used to hide assets from prying regulatory eyes. The new U.S. law proposes to fill all five gaps. Let's hope it succeeds.

Mortgages. All residential mortgages (and many other consumer products) will fall under the jurisdiction of the new Consumer Financial Protection Bureau (CFPB). This agency could, among other things, mandate that mortgage lenders (whether banks or not) provide simple, clear disclosures (a one-pager would be nice). An even better idea—to offer consumers “plain vanilla” mortgage options whose standardized terms would be intelligible and facilitate comparison shopping—was dropped in the House. I would have liked to have had that. I also preferred a true federal mortgage regulator with authority over both banks and non-banks.³¹ But the CFPB is clearly a step in the right direction. Similarly, to protect consumers, I had hoped that all mortgage lenders would be forced to abide by a suitability standard, like the one that now applies to financial advisers. Instead, the new law imposes only a “duty of care” on all mortgage originators and bans “unfair, deceptive, or abusive” lending practices.³²

Since a free-standing consumer protection agency proved to be a major bone of contention between liberals and conservatives, the Act placed the new agency—physically and budgetarily—at the Federal Reserve Board, even though its head is to be an independent presidential appointee who does *not* report to the Chairman of the Federal Reserve. I have no idea how this will work in practice.

Derivatives. While the regulation of derivatives is fraught with peril, it is not hard to improve upon what the world has now—which is practically nothing. I have argued for years that the most

³¹Brunnermeier et al. (2009) seem also to take this view.

³²In tort law, a *duty of care* requires a party to an agreement to adhere to a standard of reasonable care in exercising its responsibilities. A suitability standard goes further. It makes it a violation (of ethics or law) to sell someone a financial product that requires greater sophistication or ability to absorb losses than he or she possesses.

important step the world's governments could take would be to push as much derivatives trading as possible onto organized exchanges—whether by cajoling, regulatory incentives, or regulatory coercion. Cajoling might mean, for example, letting banks know that their regulators view over-the-counter (OTC) derivatives as far riskier than exchange-traded derivatives. Arched eyebrows often work. Incentives might mean, for example, higher capital charges on OTC derivatives than on exchange-traded derivatives. Under such a regime, regulatory arbitrage might actually enhance rather than undermine safety and soundness. Coercion might mean, for example, banning certain types of institutions (e.g., insured depositories) from trading in OTC derivatives, except perhaps for unambiguous hedging and/or market-making purposes.³³ I have long advocated the middle approach: providing strong regulatory incentives to move trading onto organized exchanges.

Once again, purity should not be the goal. There are cases in which customized derivatives really are appropriate, and such arrangements will never be sufficiently standardized to trade on exchanges. Furthermore, any financial contract whose payoffs depend on any other financial price can be considered a “derivative,” and the government certainly does not want to prevent two companies from making a one-off financial deal that is in both parties' interests—as long as the deal poses no systemic risk. Moreover, genuinely customized derivative contracts, by their very nature, should not be of systemic importance. If and as they outgrow that status, they should become standardized and forced onto exchanges where, among other things, sufficient capital and collateral would be required.

The regulation of derivatives proved to be a major battle ground in the U.S. financial reform process. The Treasury white paper (p. 48) proposed to subject OTC derivatives to a “robust regime” of regulation that included “conservative capital requirements,” margins, reporting requirements, and “business conduct standards.” The subsequent draft legislation allowed for either clearinghouses or exchanges to accomplish that. What's the difference? An exchange will presumably clear its trades through a clearinghouse. So either mechanism offers the advantages of central clearing, multilateral

³³This would be a piece of the so-called Volcker Rule.

netting, greater transparency, and the interposition of a third (and very creditworthy) counterparty between buyer and seller—which would substantially reduce (and in most cases eliminate) counterparty risk. The main additional step taken by an exchange, as opposed to just a clearinghouse, seems to be the public reporting of price and volume data. Since such reporting seems desirable both for public policy and market efficiency reasons, I have always favored exchanges. But the major gains from a systemic-risk standpoint come from moving from the status quo to central clearinghouses. The further step from clearinghouses to exchanges would be icing on the cake.

The bill that emerged from Congress favors standardization and exchange trading. Its main problem is the large number of exceptions it allows. How this will work in practice remains to be seen.

Hedge Funds. The supervision and regulation of hedge funds is the dark continent of financial regulation; we have virtually no experience with it. Complexities abound in this domain for many reasons, not the least of which is that the term “hedge fund” connotes a form of legal organization, not a type of financial activity. The truth is that hedge funds do almost everything. Some are risky, others are safe. Some use a great deal of leverage, others use little. Some specialize in large directional bets, others shun them. And so on. Furthermore, aside from some presumed involvement in bear raids, hedge funds do not appear to have played major roles in the crisis.

Recognizing that maintaining the secrecy of their investment strategies is often a key component of a hedge fund's business model, I have long thought that most of the answer is to require “regulatory transparency,” meaning that funds should keep regulators—but not the public—informed about their portfolios and exposures, almost in real time. That seemed, more or less, to be the Treasury's attitude as well.³⁴ The white paper (p. 12) proposed that all funds above “some modest [size] threshold” register with the SEC and disclose information that is “sufficient to assess whether” it “poses a threat to financial stability.” It goes on to explain that regulators need to know “how such funds are changing over time and whether any such funds have become so large, leveraged, or interconnected that

³⁴And also that of Calomiris (2009, p. 87) and the Committee on Capital Markets Reform (2009, p. 93).

they require regulation for financial stability purposes” (p. 37)—e.g., by being declared systemically important. While Treasury originally proposed to treat private equity and venture capital funds in essentially the same way, Congress exempted them on the grounds that it seems unlikely that a private equity or venture fund would ever grow large enough to pose systemic risks.

However, Brunnermeier et al. (2009) raise a point that, while reinforcing the need for regulatory transparency, suggests that it may not be enough. Suppose many hedge funds, each of them too small to pose systemic risk, exhibit strong herding behavior; that is, they all (or most of them) move at once and in the same direction. Then the “herd” might pose systemic risks that no single hedge fund, acting alone, would. In such a case, which sounds all too plausible, the systemic risk regulator will certainly need the transparency just discussed. But it may also need some authority to alter behavior in unusual circumstances for macroprudential reasons. Exactly how is a tricky question, to say the least.

Off-Balance-Sheet Entities. Thinly capitalized conduits, SIVs, and other off-balance-sheet entities were among the most viral transmission mechanisms for the crisis. Small losses on, e.g., ABS were sufficient to render them insolvent. The slightest “runs,” which generally took the form of inability to roll over commercial paper, were sufficient to render them illiquid. The size and prevalence of SIVs and conduits were also among the biggest surprises to regulators, to the investing public, and sometimes, it seemed, even to the top executives of the parent companies.

While there may be legitimate business reasons for taking certain activities off balance sheet, many such arrangements were designed primarily to avoid or minimize regulatory capital charges. That should always have been considered a bad reason. The Treasury and Congressional proposals require financial institutions to report off-balance-sheet exposures and require regulators to take off-balance-sheet entities into account in computing capital requirements. I’m not sure why they didn’t take the next step and require that such entities be consolidated onto the parents’ balance sheets.³⁵

³⁵Sufficient capital is not the only issue here; sufficient liquidity is another. When the SIVs became illiquid, they called upon the “liquidity puts” their parents had given them.

Asset-Backed Securities. Problems with asset-backed securities were, of course, pervasive during this financial crisis, and the ABS markets are still pretty moribund. In addition to a general lack of regulation and supervision, one alleged problem was that securitization enabled—perhaps even encouraged—a dangerous game of “hot potato.” Mortgage originators quickly passed credit risks along to securitizers who, after a short delay, passed them on to investors.³⁶ Neither the originators nor the securitizers, it seemed, paid enough attention to the quality of the credits they were passing along. After all, underwriting standards really do not matter if you sell the mortgage before the first payment comes due. Thus, *homo economicus* notwithstanding, the process seemed to hide risks rather than extinguish them.

This perceived weakness of securitization has spawned suggestions to require originators and/or securitizers to retain a fraction of their handiwork in their own portfolios. As one example, the Treasury white paper called upon bank regulators to require *originators* of securitized loans to hold on to 5 percent of them—adding, however, that the regulators might prefer “to apply the requirements to securitization sponsors rather than loan originators” (p. 44). Indeed, the bill that passed Congress moved the 5 percent minimum requirement from the originators to the *securitizers*; it also authorized regulators to set it higher.

I applaud the “skin in the game” approach, but would have liked it strengthened in two ways. First, the 5 percent requirement seems rather puny—less than the sales tax, so to speak. Second, I would like to motivate *both* originators *and* securitizers to conduct more serious due diligence. Mandating 5 percent retention by *each* of these two parties would wound both birds with a single stone.

But “wound” is not “kill.” One thing we witnessed as this crisis unfolded was that many securitizers retained very large CDO positions on their own books—often concentrated in the lowest-rated tranches. Thus, they had more than just “skin” in the game—they had muscle and bone. Such flagrant disregard of elementary risk-management standards was shocking. But most of it was

³⁶Sometimes there were even more links in the chain.

voluntary,³⁷ which suggests that “skin in the game” requirements are no panacea.

3.3.3 The Glass-Steagall Issue

A number of vocal critics have argued that tearing down the walls that formerly separated commercial banking, investment banking, and insurance (under the Glass-Steagall Act) was among the fundamental causes of the financial crisis in the United States.³⁸ I hear this claim almost every day.

First, a personal confession: As Vice Chairman of the Federal Reserve Board in the mid-1990s, I was always lukewarm toward repeal of Glass-Steagall. But my main reservation was amorphous and improvable: the worry that Wall Street’s “burn ’em and churn ’em” culture might infect commercial banking. So I reluctantly endorsed the Board’s pro-repeal position for two main reasons: because markets had torn huge holes in the alleged walls anyway, and because the government should not ban activities unless it has good reasons to do so. That said, I think the Gramm-Leach-Bliley (GLB) Act of 1999 has gotten a bad rap in this episode.

I often pose the following question to critics who claim that repealing Glass-Steagall was a major cause of the financial crisis: What disasters would have been averted if Glass-Steagall was still on the books? I’ve yet to hear a good answer.³⁹ While mortgage underwriting standards were disgraceful, they were promulgated by banks and mortgage finance companies and did not rely on any new GLB powers. The dodgy MBS were put together and marketed mainly by free-standing investment banks, not by newly created banking-securities conglomerates. All five of the giant investment banks (Goldman Sachs, Merrill Lynch, Morgan Stanley, Lehman

³⁷Tett (2009) offers a good discussion of this practice—and of objections to it that went unheeded.

³⁸For one example, see Kuttner (2007). Paul Volcker also aligned himself with this view.

³⁹The closest is that Citicorp would not have been allowed to merge with Travelers, which had previously acquired both Smith Barney and Salomon Brothers. But Citi could probably have done everything it did in the mortgage markets anyway.

Brothers, and Bear Stearns) got themselves into severe trouble without help from banking subsidiaries,⁴⁰ and their problems certainly did not stem from conventional investment banking activities—the historic target of Glass-Steagall. Similarly, Wachovia and Washington Mutual died (and Bank of America and Citigroup nearly did) of banking diseases, not from entanglements with or losses imposed on them by related investment banks. In short, I don't see how this crisis would have been any milder if GLB had never passed.⁴¹ Furthermore, most of the rest of the world never had GLB.

3.4 *Dysfunctional Compensation Incentives*

I come now to a dangerously jagged rock that was plainly visible for many years before the tide went out, but was nonetheless ignored: the perverse incentives for excessive risk taking that are built into many compensation schemes.

Consider the prototypical compensation plan for a trader, whether employed by a commercial bank, an investment bank, or a hedge fund. If, through skill or luck, he earns copious profits for his firm, he will receive a non-trivial share of that profit in his year-end bonus. In the halcyon days, it was not uncommon for such bonuses to run into multiple millions of dollars; some traders amassed dynastic wealth. If, on the other hand, a trader loses tens of millions of dollars of the firm's money, his bonus (which is the vast majority of his compensation) will be lost. Other than that, he will not share in the firm's pain. In particular, profits in one year are often *not* clawed back when there are losses in subsequent years.⁴² He may not even lose his job. A similar problem inheres in the compensation plans of many other income generators—such as mortgage salespeople, who get paid for originating loans and not docked when loans go bad.

⁴⁰Merrill Lynch had a big bank, but it was not the source of Merrill's problems.

⁴¹One possibility is that AIG Financial Products would have been regulated better by someone other than the OTS. But, given the more-or-less blanket exemption of derivatives from regulation by the Commodity Futures Modernization Act, this seems unlikely.

⁴²Even worse, traders sometimes collect profits on a mark-to-market basis on trades that are still open. That said, some companies *do* claw back profits when there are subsequent losses.

Pay plans that are structured in such a “heads I win, tails I don’t lose” way create powerful incentives for traders to go for broke gambling with OPM (“other people’s money”), for salespeople to originate too many dodgy mortgages, and so on. Add to that the typical demographic profile of a trader—young, smart, brash, single, and risk loving—and you have a dangerous brew.

Amazingly, financial executives were aware of these perverse incentives for decades and did nothing to correct them.⁴³ Why? One brilliant and famous hedge fund executive explained to me about fifteen years ago that it was because everyone else paid their traders the same way; any firm that deviated from the industry norm would expose its top talent to competitive raids. That answer is a variant of what should be called forevermore *The Chuck Prince Principle*: “As long as the music is playing, you’ve got to get up and dance.”⁴⁴ It seemed a terrible answer to me then, as it does now. Besides, a company can offer its traders a compensation plan with the same *average* pay as its competitors but quite different incentives for risk taking.

A second possibility is that senior executives face analogously skewed incentives themselves and therefore *want* their traders to go for broke. Just like the traders and sales personnel who work for them, top executives of corporate financial institutions derive the lion’s share of their compensation from bonuses that are normally linked to the firm’s *annual* profits. They, too, get rich in the fat years and pass the losses on to shareholders in the lean years. So they, too, rationally want to go for broke. In fact, the situation may be even worse for CEOs, for they typically are blessed with “golden parachutes” that pay off handsomely if their contract is terminated. So they may not even lose when the coin comes up tails.

Notice that I used the adjective “corporate” to modify the noun “financial institutions” in the preceding paragraph. Outside the corporate sector—e.g., in the hedge fund and private equity worlds—the risk-taking incentives for the CEO and other top executives (but not

⁴³When Raghuram Rajan (2005) made this point at the Federal Reserve’s August 2005 Jackson Hole conference, he encountered such vociferous criticism that I rose to defend him “against the unremitting attack he is getting” (p. 394).

⁴⁴Quoted in the *Financial Times*, July 10, 2007. Note the date. The music stopped just one month later.

for traders) are quite different. While the general partner will, of course, pass on most of the firm's losses to the limited partners, he will be stuck with a pro rata share himself. Indeed, it is typical for the heads of hedge funds to have much of their personal net worth tied up in the funds. This fact transforms OPM into what I (Blinder 2009) once called MOM ("my own money"), which people have a way of treating with greater respect. I don't think it was a coincidence that the big Wall Street firms became more adventurous when they switched from being partnerships to being corporations.⁴⁵

If this analysis of compensation incentives is anywhere near correct, it points toward several possible remedies. One, which I will explore later, might be to move most trading activities out of the corporate sector, and especially out of the systemically important firms that potentially share their losses with taxpayers. This would be a variant of the "Volcker Rule."

Another might be to regulate compensation practices, e.g., by treating them as an integral part of the firm's risk-management system. The U.S. Treasury advocated this idea in its June 2009 white paper (p. 11): "Federal regulators should issue standards and guidelines to better align executive compensation practices of financial firms with long-term shareholder value and to prevent compensation practices from providing incentives that could threaten the safety and soundness of supervised institutions." In October 2009, the Federal Reserve did precisely that via some proposed supervisory guidance that it posted for comment on the Federal Register. After receiving extensive comments, the Federal Reserve issued its final guidance in June 2010. I see this as a potentially important step forward, but only if the guidance has teeth. We'll see.⁴⁶

The Federal Reserve's guidance gave particular attention, by way of example, to clawbacks, to risk-adjusting incentive pay, and to reducing the sensitivity of pay to short-term performance. The Squam Lake Group added a nice twist to the clawback—or, better yet, holdback—idea: that a portion of the deferred compensation be

⁴⁵That said, the leaders of some of the worst-offending *corporate* firms, such as Bear Stearns, Lehman Brothers, and AIG, had much of their personal net worth tied up in company stock. Alas, there are no easy answers here.

⁴⁶Media reports in June 2010 suggested that banks were not paying much attention to the guidance.

forfeited if the firm becomes the beneficiary of any “extraordinary government assistance.”⁴⁷

A third option might be to enact (or voluntarily adopt) “say on pay” provisions, which give shareholders a voice and a vote on CEO pay—which was also enacted as part of Dodd-Frank.

While I support both “say on pay” and the Federal Reserve’s regulatory initiative, I am a bit skeptical that government can legislate compensation practices effectively. State-imposed rules will be avoided, evaded, and twisted into knots by private-sector participants who have vested interests in doing so, and who are much deeper in the weeds. The job of fixing skewed compensation practices must presumably fall mainly on the (heretofore narrow) shoulders of corporate boards of directors and, more specifically, on their risk and compensation committees.⁴⁸ In saying that, I realize that relying on better board performance is standing on a thin reed—which, of course, raises a far bigger issue that is beyond the scope of this paper: How do we make corporate boards take their responsibilities to shareholders (as opposed to management) more seriously? One possibility might be to pay board members 100 percent in restricted stock. That, in turn, might help directors see the virtues of also compensating traders and CEOs that way.⁴⁹

*3.5 Reforming Regulatory Capital Standards*⁵⁰

I have heard it said that only three things matter in bank regulation: capital, capital, and capital. While I don’t agree, the capital cushion is extremely important. At the conceptual level, our current bank capital standards—whether under Basel I, Basel II, or whatever comes next—have come in for two sorts of well-deserved criticisms: (i) the minimum capital they prescribe is inadequate, and (ii) capital requirements are procyclical.⁵¹ Let me take up each in turn.

⁴⁷French et al. (2010), p. 81.

⁴⁸The Federal Reserve’s guidance places responsibility squarely there, even recommending that banks that lack a compensation committee establish one—with a majority of non-executive directors. I agree.

⁴⁹I owe this suggestion to Burt Malkiel.

⁵⁰This paper was written long before the Basel III agreement in September 2010.

⁵¹In addition, there are many practical criticisms—such as that capital requirements are too easily avoided by using off-balance-sheet entities such as SIVs.

3.5.1 *How Much Capital*

Were banks holding enough capital when the crisis hit? The question seems to answer itself. Indeed, the U.S. Treasury declared that “higher capital requirements for banking firms are absolutely essential.”⁵² That is probably true. But I do not believe the worst leverage problems derived from the conventional Basel I capital-adequacy standards (4 percent tier 1 capital, 8 percent tier 1 and 2, etc.). Yes, I think 4 percent was too little. But the bigger leverage problems arose from (i) investment banks that operated (under a different regulatory regime) with thirty to forty times leverage, (ii) gimmicks such as thinly capitalized SIVs and conduits that (legally) avoided capital requirements, making actual leverage far greater than putative leverage, and (iii) derivatives that manufactured synthetic leverage that was vastly higher than literal leverage (the ratio of assets to equity).

That said, Basel II, which was never officially adopted in the United States, seemed to take several major steps backward. First, it generally reduced capital requirements relative to Basel I, which was almost certainly a mistake—especially for systemically important financial institutions. Second, its “advanced internal ratings based approach” placed far too much weight on banks’ own risk models—which were found wanting, to put it charitably. Third, well-known quantitative tests by regulators a few years ago discovered that different banks, each using their own internal models, calculated alarmingly *different* capital charges for the *same* portfolio of assets. Fourth, the Basel II “standardized approach” relied far too heavily on ratings assigned by the credit rating agencies, which performed miserably.⁵³ (More on the rating agencies shortly.)

I am not a Neanderthal. I realize that the simple risk-buckets of Basel I were crude, misclassified many assets, and set up perverse incentives for regulatory arbitrage. It was not for naught that the world’s bank supervisors labored for a decade trying to improve upon Basel I. Unfortunately, it is not clear that they succeeded. If you believe that Basel II is deeply flawed, as I do, two huge questions arise: First, what capital standards would be better? Second,

⁵²U.S. Treasury (2009b, p. 1).

⁵³Among the many places where these and other issues about Basel II are discussed, see Tarullo (2008).

given that leveling the international playing field has always been a central (and reasonable) objective of the Basel Accords, and that Europe and Japan have already adopted Basel II, what should the United States do now?

I prefer to leave such vexing questions to people more deeply knowledgeable on these matters than I. But here is one quick answer, at least as a stop-gap: Instead of letting banks use their own internal risk models to assess capital adequacy, create an admittedly imperfect standardized model that every major bank in the world must use for regulatory purposes. That's not a perfect solution. But it would at least eliminate the four problems listed above while regulators try to agree on Basel III. According to several insiders, good progress toward Basel III is being made. But the target for the Basel Committee is the end of this year, with adoption by member countries presumably coming long after that. How long can individual countries afford to wait?

The stop-gap approach I have just sketched is *not* favored by the U.S. Treasury, which last year issued a statement of "high-level principles" that should govern any new Basel-type regulatory framework.⁵⁴ These principles (in my phrasing, not Treasury's words, except where quoted) are:

1. Capital requirements should be higher.
2. Capital requirements should be even higher for systemically important firms.
3. Most regulatory capital should be common equity.
4. Capital requirements should take macroprudential considerations into account.
5. The "relative risk weights [must] be appropriately calibrated" and also "reflect the systemic importance" of the various exposures.
6. Procyclicality should be reduced.
7. An overall leverage constraint should be introduced, *in addition to* the risk-based capital rules.
8. A liquidity standard should be added to the capital standard.
9. The regulatory regime must be extended to non-banks that potentially pose systemic risks.

⁵⁴U.S. Treasury (2009b). The quoted phrase comes from page 2 of that document.

I have just dealt with principle 1, and I will take up principles 2, 6, and 8 below. But first a few brief comments on some of the others.

Principles 4 and 5 on Treasury's list seem sensible, important, and devilishly difficult to implement, especially if international agreement is required. That said, one important sub-point under principle 5 is that banks should hold more capital against trading positions—another capital idea. The overall leverage constraint (principle 7) is also appealing, but far trickier than it sounds. Treasury's draft (p. 10) correctly notes *both* that “a simple leverage constraint would make the regulatory system more robust” (which is good) *and* that it “is a blunt instrument that... can create its own set of regulatory arbitrage opportunities and perverse incentive structures” (which is bad). The latter, of course, is why Basel I and II applied risk weights in the first place.

What about special, higher capital requirements on systemically important institutions that have the potential to impose large costs on taxpayers (Treasury's principle 2)? It seems axiomatic to me that, because TBTF status gives those institutions a competitive advantage in the capital markets, they should be required to pay for the privilege. But how? One natural answer is to impose higher capital charges on them. Another, discussed below, is to force them to hold some sort of contingent capital that would become real capital during a crisis. A third is to assess higher FDIC insurance premiums on TBTF institutions with insured deposits. It might be appropriate to do all three.

Notice, however, that imposing any such extra charges on systemically important institutions requires that regulators name them and thus “officially” confer TBTF status on them—as opposed to the current regime, which is sometimes characterized as constructive ambiguity. (Try guessing: Was Bear Stearns TBTF in February 2008? Was Lehman TBTF in August 2008?) Because some people prefer maintaining constructive ambiguity, they oppose naming the TBTF institutions.⁵⁵ I disagree for at least four reasons. First, except around the edges, people will always know which

⁵⁵One way out of this dilemma, advocated by the Pew Task Force (2009, pp. 9–10), is to make capital and liquidity requirements higher for larger institutions, either via brackets or by a continuous formula. Then there is no need to designate TBTF institutions.

companies are TBTF anyway. Second, surprises in this regard (e.g., letting Lehman fail) can have catastrophic consequences. Third, the government cannot collect extra “fees” from TBTF institutions—which I consider crucial—unless it names them. And fourth, TBTF institutions should be subjected to a tougher supervisor regime.

3.5.2 *Procyclicality*

The second main accusation that has been leveled against the existing capital standards is that they are procyclical.⁵⁶ They aggravate credit cycles by allowing too little provisioning for losses when times are good (and loan-loss experience is favorable) and then stiffening requirements when times turn bad (and loan losses mount)—thus forcing banks to set aside more loan-loss reserves and scramble for more capital exactly when capital is hardest to find. The Treasury white paper explicitly recognized this shortcoming and urged the Basel Committee to address it, which the Committee is now doing. But it proposed nothing concrete for the United States.

Maybe it should have. In the United States, the tendency toward procyclicality in loan-loss provisioning is exacerbated by the practices of both the SEC and the Internal Revenue Service (IRS). The SEC requires banks, like all companies, to report GAAP earnings as a guide to investors—which is certainly a legitimate part of its job. However, one unfortunate side effect is that the Commission sometimes accuses banks of using loss provisions to smooth earnings by *over*-provisioning in good times and *under*-provisioning in bad times. That, of course, is precisely what we want in order to reduce procyclicality. The IRS, for its part, seeks to collect the taxes that companies owe according to the tax code. Again, that is their job. But in doing so, the tax agency has been known to prevent banks from setting aside “excessive” loan-loss reserves that would reduce their taxable income.

What to do? It’s debatable. But in my view, the legitimate concerns of the SEC and the IRS must be subordinated to the needs of macroprudential supervision in this case. However, the SEC and

⁵⁶ Among other studies of this issue, see Bikker and Metzmakers (2005), Bouvatier and Lepetit (2008), and Repullo and Suarez (2009). The later takes specific aim at Basel II.

the IRS probably see things differently. In any case, effectuating such changes would probably require changes in law—not to mention regulatory turf wars.

While removing SEC and IRS impediments to prudent provisioning would help, we must still address the *inherent* procyclicality problem. After all, loan losses *really are* smaller in booms and larger in busts. Spain seems to have handled this issue better than most countries with its system of “dynamic” or “statistical” provisioning. The name derives from that fact that provisions for loan losses are increased when actual losses run *below* statistically expected losses, e.g., in boom periods—and are analogously reduced in busts. The Spanish system is designed to be neutral over the business cycle but to stock up on loss provisions during the upswing so as to be ready for the downswing. The Basel Committee is currently considering whether “Basel III” should have this feature and, if so, how.

I myself am attracted to a particular idea for “contingent capital” suggested by the Squam Lake Working Group on Financial Regulation, an ad hoc panel of academic experts.⁵⁷ Their idea, which derives from Mark Flannery’s (2005) clever earlier proposal for “reverse convertible debentures,” is to *require* certain banks to issue a novel type of convertible bond.⁵⁸ Conventional convertible debt gets exchanged for equity at the option of the bondholder; and because this option has value, convertible debt bears lower interest rates than ordinary debt. The proposed new form of convertible debt would give the option to the regulators instead and/or have an automatic trigger.

Under the proposal, regulators would have the power, by declaring a systemic crisis, to *force* holders of these special convertibles (but not holders of other debt instruments) to convert to equity against their will—thus giving banks more equity capital (and less debt) just when they need it most.⁵⁹ Naturally, the existence of such an option would *detract* from the value of the convertible bond and therefore make its interest rate *higher* than that on ordinary

⁵⁷See French et al. (2010, ch. 7).

⁵⁸See also Rochet (2008) and Flannery (2009).

⁵⁹The actual Squam Lake proposal has both a systemic (macro) trigger and a bank-specific (micro) trigger. It has been suggested that investors might not like the idea that regulators can trigger the debt-to-equity conversion.

debt—unless the debt-to-equity conversion was priced below market.⁶⁰ Indeed, if the requirement is limited to TBTF institutions, as seems appropriate, a higher interest rate on a fraction of their debt would constitute a natural part of the penalty cost for being TBTF. Furthermore, the spread on this new type of debt over regular debt could become a useful market indicator of the likelihood of a systemic crisis.

As in many cases, one key question is price—specifically, how large an interest rate premium would investors demand to cover the risk that their bonds could be converted into equity at adverse moments? If this premium proved to be very large, these new convertibles would be a very expensive form of capital that banks might shun, preferring ordinary equity instead. On the other hand, perhaps after an adjustment period, the premium might prove to be modest. Only experience will tell.

3.5.3 The Rating Agencies

The discussion of Basel II's shortcomings brings up another problem: what to do about the rating agencies—which were supposed to be among the built-in safeguards of our financial system but failed us badly.

The Treasury white paper proposed to solve, or perhaps I should say to mitigate, this problem with tougher regulatory oversight: “The SEC should continue its efforts to strengthen the regulation of credit rating agencies, including measures to promote robust policies and procedures that manage and disclose conflicts of interest, differentiate between structured and other products, and otherwise strengthen the integrity of the ratings process” (p. 14). I agree, and as a matter of fact, the rating agencies have been working hard on these “integrity” issues right now.⁶¹

But many observers think the fundamental problem lies deeper: with the issuer-pays model. As long as rating agencies are for-profit companies, paid by the issuers of the securities they rate, the agencies will have a natural tendency to try to please their

⁶⁰I owe this last point to Mark Flannery.

⁶¹I happen to have personal knowledge of the strenuous efforts being made at one of the rating agencies to erect Chinese walls, to empower an ombudsman, etc.

customers—just as any business does. Unfortunately, the most obvious alternative, switching to an investors-pay model, is infeasible except in markets with very few investors. Otherwise, information flows too readily, and everyone wants to free ride. What to do? The way out of this dilemma, it seems to me, is to arrange for some sort of third-party payment.⁶² The government (e.g., the SEC) or an organized exchange or clearinghouse seem to be the natural alternative payers. In either case, they could raise the necessary funds by levying a user fee on all issuers.

3.6 *Liquidity Regulation*

Earlier, I expressed skepticism about the notion that capital is the only thing that matters for safety and soundness. One reason is that banks and other financial institutions can also founder on insufficient *liquidity*. Indeed, this crisis demonstrated many times over that there is no bright line between illiquidity and insolvency in a maelstrom. It is at least arguable, for example, that institutions such as Bear Stearns, Lehman Brothers, Merrill Lynch, and others crumbled, or nearly did, from lack of liquidity rather than from lack of assets—just as in an old-fashioned bank run.⁶³ The point is that, where there is a severe maturity mismatch between assets and liabilities, a liquidity crisis can morph quickly into a solvency crisis. For example, firms that cannot roll over their short-term debt may be forced to sell illiquid assets at distressed prices.

The business models of what were once the Big Five securities firms in the United States—Merrill Lynch, Goldman Sachs, Morgan Stanley, Lehman Brothers, and Bear Stearns—were based on extreme leverage, as has already been mentioned. But they were also based on incredible reliance on extremely short-term financing, e.g., from the overnight repo market.⁶⁴ These liabilities were massive in volume and could run in a day. In a somewhat different way, many large bank holding companies (e.g., Bank of America and Citigroup) also put themselves in perilous liquidity positions by providing explicit or implicit liquidity guarantees to their SIVs

⁶²This idea was suggested by Rochet (2008).

⁶³See, among many others, Gorton and Metrick (2009).

⁶⁴Among many sources that could be cited, see Morris and Shin (2008).

and conduits. When the crisis hit and the SIVs could no longer roll over their commercial paper, they turned to their parent banks for massive liquidity support.

Thus one regulatory lesson learned in this crisis is that minimum capital requirements need to be supplemented by minimum *liquidity* requirements, and the Basel Committee has taken this lesson to heart. But it is not an easy task.

Since liquidity issues result largely from maturity mismatch between the asset and liability sides of a firm's balance sheet, there are two basic approaches. Regulators could insist on, e.g., less reliance on very short-term non-deposit funding,⁶⁵ or they could constrain the composition of assets, insisting on more liquid ones.⁶⁶ In either case, problems of assigning the right "liquidity weights" arise. This is perfectly analogous to the Basel II problem of finding the right capital weights, and may be just as difficult.

To illustrate how hard it may be to develop liquidity standards, consider the schizophrenia evidenced when the U.S. Treasury tried to elaborate on its liquidity ideas. Its "principles" (2009b, pp. 11–12) state that "the liquidity regime should be independent from the regulatory capital regime" even though "capital regulation and liquidity regulation are highly complementary" so that there may be merit in "making regulatory capital requirements a function of the liquidity risk." Furthermore, liquidity regulations should be "strict but flexible." Got that?

3.7 Risk Management

The "M" in U.S. regulators' CAMELS ratings for banks stands for *management*. One essential aspect of bank management that failed badly was *risk* management—and not just at commercial banks. Some of the most elementary precepts of sound risk management, such as limiting asset concentrations, were violated massively and repeatedly by allegedly smart financial institutions. Incompetence is one thing; and it can be mitigated, though never eliminated, by

⁶⁵I say "non-deposit" because even demand deposits are very sticky; they don't "run."

⁶⁶See again Morris and Shin (2008).

more rigorous supervision. But I think there also was—and still is—a structural flaw.

Think of the typical position of a risk manager within the hierarchy of a large financial company that is making handsome trading profits while the good times roll.⁶⁷ She becomes worried that a certain business line is taking excessive risks with the firm's capital. The line manager disagrees; after all, his traders are making millions for the bank's bottom line. So they take their dispute to the CEO, where the argument may go something like this:

RISK MANAGER: Joe's traders are taking huge risks with the company's money. This could all blow up in our face.

BUSINESS LINE MANAGER: No way. We're beautifully hedged. Besides, my guys made \$500 million for the bank last quarter. How much did your folks make, Jane?

RISK MANAGER: Well, actually, my risk controllers didn't earn the bank a dime. We're a cost center. You know that, Joe.

Soon the meeting is over, with the CEO siding with the business line manager,⁶⁸ who probably outranks her in the corporate hierarchy anyway.

Can this built-in bias against risk managers be overcome? I fear the answer may be no. One way to try is for the board of directors—those alleged guardians of shareholder interests—to hold management's feet to the fire by elevating the importance of the risk-management function, including giving the chief risk officer a direct reporting line to the board's audit or risk committee. But history suggests that this degree of board activism may require—at least—an external prod. To provide this, bank supervisors could insist on such changes. Since money talks in a financial institution, another, complementary approach might be to direct top management to design a compensation and promotion system that treats risk controllers on a par with the traders they allegedly control—the

⁶⁷The best eyewitness account of this problem may be the anonymous "Confessions of a Risk Manager" in *The Economist* (2008).

⁶⁸Remember the previous discussion of CEO compensation incentives.

objective being to get as much (or more) talent into risk management as in trading.⁶⁹ Maybe there are better ideas—such as the idea mentioned earlier to pay traders, CEOs, and directors all in restricted stock. But in the interim, bank supervisors should keep a sharp eye on companies' risk-management practices.

3.8 *Consumer Protection*

I come, finally, down to ground level—to the consumers of financial products.

Perhaps the greatest financial crisis the world has ever known had its roots in risky sub-prime mortgages in the United States, most of which should never have been written. Of course, some of the mortgagees put themselves in the financial line of fire knowingly and deliberately by gambling that ever-rising house prices would bail them out of otherwise-untenable mortgages. It is hard to stop consenting adults from engaging in reckless behavior. But other people, especially poor and unsophisticated ones, either had no idea what they were signing up for or were duped into dangerous mortgage contracts they did not understand. It is this group that commands our attention and needs our help.

Some would seek the answer in greater financial education, but I am skeptical—not because I doubt that financial literacy is desirable, but because I fear it may be unattainable. Surveys of consumers regularly turn up evidence of mind-blowing levels of financial illiteracy. Even the simplest ideas, such as compound interest or the notion that diversification reduces risk, are foreign to most people.⁷⁰ Maybe I'm wrong, but the situation looks hopeless to me. It's like teaching adherence to speed limits to people who don't understand the difference between miles per hour and kilometers per hour. So I fall back on the second line of defense—state intervention to protect people from deceptive practices.

What might that mean in practice? Banning certain financial products? Maybe some, but I'd hope not many. There really are

⁶⁹According to Tett (2009, ch. 7), JP Morgan Chase raised the status and pay of risk managers when Jamie Dimon became COO. I have also heard it claimed that Goldman Sachs has followed this practice for years. Is it just a coincidence that these two firms weathered the storm better than most of their peers?

⁷⁰Among many sources that could be cited, see Lusardi (2009).

people for whom an adjustable-rate mortgage (ARM) with a teaser rate makes perfect sense, maybe even an option ARM. And we don't want to squelch useful financial innovations. But people who do not understand complicated financial products should be warned—or if necessary, guided—away from such products. What we need, instead, are:

- suitability standards for consumer financial products, so that sellers who lure unsophisticated customers into inappropriate (for them) products face legal peril, just as stockbrokers do today;
- simple, plain-English disclosures, perhaps modeled on food labels, which tell people “what's inside” at a glance and thereby facilitate comparison shopping;
- requirements that financial institutions offer “plain vanilla” options that are straightforward, easy to understand, and easy to comparison shop;
- good default options so that people who simply cannot or do not make up their minds are put into reasonable options.

With the exception of the first, the Treasury white paper called for each of these. But Congress, bowing to industry pressure, dropped most of them. It remains to be seen what the new Consumer Financial Protection Bureau will (or will not) do along these lines.

One final point about consumer protection, which I make with some regret as a former Federal Reserve Vice Chairman: Congress, in its wisdom, gave much of the responsibility for enforcing the various consumer financial protection laws to the Federal Reserve. No one would call this task an integral part of central banking (Blinder 2010). Furthermore, I believe consumer protection will always be a “weak sister” inside a central bank, which attaches much greater importance to its other responsibilities, such as monetary policy. In practice, the Federal Reserve performed its consumer protection duties poorly and deserved to lose that authority—not as a punishment, but because another agency, focused on the mission, will probably do the job better. That judgment, I think, is reflected in the recent U.S. legislation.

4. The Propriety of Proprietary Trading

The crisis raised numerous questions about the proprietary trading (a.k.a. gambling) activities of large financial firms, both in the United States and elsewhere. In the United States, it led the Obama administration to advocate (belatedly) the so-called Volcker Rule, which would proscribe proprietary trading by depository institutions.⁷¹

Before diving into these perilous waters, I want to make it clear that I have no puritanical aversion to gambling, that I realize that risk taking is an integral part of capitalism, and that I understand that even the simplest financial businesses (e.g., commercial lending) are inherently risky. All that said, I am among those who wondered, even before the crisis, whether our leading financial institutions hadn't taken proprietary trading too far. And now that so many big gambles have gone awry, I'm pretty much convinced that they did.

Let me approach the conceptual issues by analogy. Start with the case of an isolated *homo economicus*, meaning a completely rational person who confers (and imposes) no externalities on anyone else. Call him Harry. Among other things, Harry has no family to support, no employees, and no access to the social safety net. (If this sounds unrealistic, keep reading.) If Harry chooses to wager most of his net worth on something, society should presumably let him. If he fails, he will bear the entire cost.

Now suppose Harry supports a family, or runs a business whose employees depend on him for their livelihoods. Since going broke now has serious consequences for others, *someone* might want to place limits on Harry's ability to gamble—as a way to protect these innocent bystanders. Precisely what those limits might be is a hard question, however. Since risk taking is such an important part of capitalism, we certainly do not want to overdo it. And if Harry is a sole proprietor, rather than a corporation, it's far from clear who might constrain his behavior anyway. Besides, Harry should recognize his responsibilities to others and impose sensible limits on himself. Many people will stop right there, leaving the government

⁷¹This "rule," which is due to Paul Volcker, was not part of the U.S. Treasury's original proposals. The administration embraced the idea in January 2010.

no role. Certainly, not much state intervention, if any, can be justified on this count.

But things get murkier when there is any sort of social safety net, for then taxpayers are obligated to pick up part of the bill for failure. If Harry, his family, or his employees are entitled to state-provided benefits in the event he goes broke, then the state—acting in the taxpayers' interest—seems to have reason to limit the risk that Harry can take, either by restraining his behavior (example: requiring seat belts in cars), or by requiring him to purchase insurance (example: automobile collision insurance), or by levying taxes or fees to finance state-provided insurance (example: unemployment insurance). Except on the libertarian fringe, these ideas are widely accepted in all countries. But practical applications are often contentious.

One direct application in the financial context is to deposit insurance, whereby the government socializes some of the risks of bank failures by collecting insurance premiums and paying off (insured) depositors when necessary. Recent events raise a parallel question in the case of proprietary trading losses: If the government will, in practice, shoulder some of the losses in the event of failure, should it either limit or “tax” risky trading activities?

Before attempting to answer that question, let me consider some possibly pertinent deviations from the hypothetical norm we have just discussed. First, suppose Harry is not a rational person. Then, especially if innocent bystanders are involved, but perhaps even if not, most people would consider it reasonable to impose some limits on Harry's gambling—on the paternalistic grounds that he must be “protected from himself.”

Next, imagine that Harry is so rich, and his business empire so far-flung, that his financial ruin could have serious systemic consequences. Harry might then be considered “too big too fail.” We could try telling Harry that he is on his own, but the words would not be credible. In such a case, society might want to charge Harry for the special safety net that sits under him. The financial-sector parallels here are obvious—and germane to proposals, such as those mentioned earlier, to charge institutions for the privilege of being TBTF. Think Citigroup.

Third, suppose Harry is not rich enough to be systemically important per se, but is nonetheless heavily entangled in

counterparty relationships with dozens, if not hundreds, of other institutions, some of which are systemically important. His failure might then undermine the viability of these counterparties, and perhaps the entire financial system. One possible reaction, in this case, would hold that Harry's counterparties should limit their exposures to him so that his failure would *not* bring them down too. Fair enough. But what if they don't? What if, instead, Harry's failure threatens to bring down a significant portion of the house of cards? Then, again, we have a plausible case for state intervention. In finance, this thought is the origin of the "too interconnected to fail" doctrine. Think Bear Stearns or, for that matter, Long-Term Capital Management in 1998.

The morals of this story are two. First, when "no man is an island," various (but not all) forms of state intervention into risk-taking behavior become at least *potentially justifiable*. Second, when, in particular, a taxpayer-financed safety net will pick up some of the bills, state intervention of some kind becomes not merely justifiable but perhaps even *obligatory*—as a way to protect taxpayers.

This reasoning leads straight to a pretty radical-sounding question, evocative of the now-famous Volcker Rule: Does proprietary trading belong in *any* financial institution that has access to the financial safety net—including, in the United States, FDIC insurance, the Federal Reserve's discount window, and other safeguards? Answering "no" leads to some radical departures from current practice because the list of such institutions obviously includes *all* insured depositories and *all* TBTF (or TITF) institutions.⁷² But I must admit that I have a hard time getting to "yes"—unless capital charges against trading activities are raised enormously. So the radical solution seems to merit serious consideration. For example, the Group of Thirty (2009, p. 28)—hardly a bunch of populist renegades—concluded that, "Large, systemically important banking institutions should be restricted in undertaking proprietary activities that present particularly high risks... and large proprietary trading should be limited by strict capital and liquidity requirements." That's not quite a ban, but it's getting close.⁷³

⁷²Thus the list of possibly eligible institutions extends beyond Volcker's depository institutions. It does *not*, however, include modest-sized hedge funds. More on this shortly.

⁷³It is no coincidence that Paul Volcker was instrumental in drafting this report.

But there is a downside: Roping off “proprietary trading” from other, closely related activities of banks is not as easy as it sounds. For example, banks buy and sell securities, foreign exchange, and other assets for their clients all the time. Often, such buying and selling is imperfectly synchronized or leaves banks with open positions for other reasons. Does that constitute “proprietary trading”? Furthermore, market making has obvious synergies with dealing on behalf of clients. Do we want to label all such activities as “proprietary trading”? And what about times when investment banks bring out securities, can't sell all of them, and get stuck with some? The point is: There is no bright line. That is why Adair Turner (2009), the chairman of Britain's FSA, concluded that “we could not proceed by a binary legal distinction—banks can do this but not that—but had to focus on the scale of position-taking and the capital held against position-taking.”

Next, consider explicit trading in various sorts of assets. Suppose a firm owns a corporate bond and buys a CDS to insure it. It has hedged, not gambled, because the CDS extinguishes the default risk of the bond. But buying or selling a “naked” CDS creates risk rather than destroying it. The trouble is, we cannot always tell the two actions apart. And what if the truly hedged bank subsequently sells the bond, leaving itself an open position in the CDS? It seems hopeless to expect regulators to monitor banks' trading activities with that degree of precision.

Is there a way out? Certainly not a perfect one. One idea might be to require banks to segregate all their trading activities (including dealing for customers and market making) into a separately—but not thinly—capitalized affiliate, and then to make it clear that the affiliate has *no* claim on the safety net and *no* claim on the parent.⁷⁴ That's a step. But, of course, the parent company will still suffer a reputational hit if its trading affiliate goes under. So the Chinese wall can never be impermeable.

Furthermore, this suggestion evokes the notorious SIVs that were the source of so much trouble during this crisis. There would be two important differences, however. First, if the parent has access

⁷⁴A controversial proposal that was half-heartedly embodied in the Dodd-Frank Act segregates derivative trading in approximately this way. But I call it “half-hearted” because most derivatives are exempted.

to the safety net, the law should make it *illegal* for the parent to downstream capital to the affiliate.⁷⁵ Creditors of the trading companies need to know—with *legal certainty*—that they are on their own. Second, and presumably as a consequence of the first, trading affiliates would need sizable capital and liquidity cushions of their own. To make this idea work, of course, no trading affiliate can ever be permitted to grow large enough to be TBTF in its own right.

Finally, let's go back to Harry and now suppose he represents the leadership of a corporation. In that case, his putative risk controller is supposed to be the board of directors. But it's equally clear that too many boards were far too passive and permissive, if not somnolent, to safeguard shareholder interests effectively. Their failures raise a host of questions about corporate governance that extend well beyond the scope of this paper. But I want to close with one last issue: the difference between proprietary trading inside and outside the corporate form.

As I mentioned earlier, skewed compensation systems give both corporate executives and traders incentives to gamble too much with stockholders' money. For them, it's often, "Heads, I win; tails, the stockholders lose." But there is an alternative to the corporation, mentioned earlier: the partnership. Partnerships internalize most of these externalities because decisionmakers are "playing" with their own money. It is also true that, e.g., hedge funds rarely grow large enough to be systemically important. Both of these considerations suggest that the financial system might be sturdier if more proprietary trading were to migrate out of giant corporations and into, e.g., hedge funds—as long as no hedge fund is allowed to grow too big to fail.

5. Brief Summary

The efficient markets hypothesis notwithstanding, the case for laissez-faire in financial markets now looks extremely weak. Finance does not appear to be self-regulating—except at enormous cost.

⁷⁵An analogous provision exists in bank supervision. The Federal Reserve's "source of strength" doctrine allows the holding company to transfer funds to help the bank, but not vice versa. But Congress has never enshrined this principle into law.

Regulation of financial businesses is readily justified by the needs to protect consumers from being duped, to protect taxpayers from shouldering large bills, and to protect citizens from the dangers of financial and macroeconomic instability.

But that macroprudential rationale for regulation is not a license for government to do anything it pleases. Regulation should be well targeted at specific problems. It should be efficiently designed and run. It should rarely (and then only with very good reasons) regulate prices, quantities, or limit entry.⁷⁶ And it should strive both to be fair and to avoid stifling valuable innovation. A sound regulatory structure will minimize both regulatory gaps (activities without a regulator) and regulatory overlaps (activities with multiple regulators). It will harness incentives rather than fight them. And its success will not require outguessing the markets, which is a hopeless task in any case.

America's current regulatory system falls short on many of these criteria, and it failed miserably when put to the test a few years ago—with appalling consequences. The same was true of the regulatory systems of most countries.⁷⁷ The systems therefore cry out for change. The recently enacted U.S. law should make the system sturdier and more effective, but certainly not foolproof.

While recognizing that no one can do the job perfectly, I believe that virtually every country would benefit from having a systemic risk regulator—and that that regulator should be the central bank. In these respects, my views align with those of the U.S. Treasury and Congress. I also believe that having some financial companies that are “too big (and/or interconnected) to fail” is inevitable, and so we need a new mechanism to resolve such institutions in an orderly way. While the most appropriate form of such a mechanism (e.g., a special resolution authority versus a new chapter of the bankruptcy code) is not entirely clear, it appears that special resolution holds some significant advantages over “Chapter 16.” Again, that is what Congress also decided.

Simplifying the existing maze of federal regulators in the United States would be highly desirable. And going down from six agencies (the Federal Reserve, OCC, FDIC, OTS, SEC, and CFTC) to

⁷⁶This last point is germane to the debate over Glass-Steagall.

⁷⁷One notable exception was Canada, which fared quite well.

five hardly qualifies as a great leap forward. But I understand the political imperative to tread lightly here, and the new Consumer Financial Protection Bureau—though bringing us back up to six, if counted as a free-standing agency—should help fill an important gap.

What to do about regulating derivatives, which caused a great deal of trouble, and hedge funds, which probably did not, is far from clear. But pushing the trading of as many derivatives as possible onto organized exchanges, and insisting on regulatory transparency from all sizable hedge funds strike me as valuable first steps that the new U.S. law takes.

The Basel II capital standards need work, to put it mildly. They probably require too little capital and are procyclical to boot. They place far too much faith in both ratings agencies and banks' internal risk models, and they are too permissive about off-balance-sheet entities. They also need to be supplemented by liquidity requirements for, as we have seen, illiquidity can turn quickly into insolvency. And that's just for starters. The good news is that the talks that (hopefully) will lead to Basel III are dealing with all of these issues and others right now, purportedly effectively. The bad news is that Basel III will require international agreement, which will come slowly (if at all). Since we cannot wait another decade, this poses a difficult question for national authorities: Should they wait for Basel or go it alone?

Last, and certainly not least, the recent serial financial catastrophes highlighted three huge jagged rocks that were concealed by the high tide: dysfunctional compensation systems (for both traders and CEOs), sleepy if not irresponsible corporate boards, and the question of how much proprietary trading should be allowed in institutions that have (tacit or explicit) government backing. None of these problems are easy to solve, though I have made some suggestions for each. What is abundantly clear is that the status quo will no longer do. "If it ain't broke, don't fix it" is a wise, old adage that I quote frequently and try to live by. But it does not apply here.

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