Financial Regulation

An Agenda for Reform

By Lawrence J. White

If someone had shouted "financial regulation" in a crowded auditorium a year ago, nary a soul would have stirred. No more, of course. An overhaul of the rules that Wall Street and its friends must live by is near the top of the Obama administration's must-do list. To paraphrase Rahm Emanuel, the president-elect's choice for White House chief of staff, the country's new leaders aren't about to let a perfectly good debacle go to waste.

But with the fate of what has become America's vanguard industry at stake, untangling the web we've been weaving and reweaving since the 1930s isn't a matter to be done casually. Herewith, a primer on what to hope for.

JAMES TURNER (ALL)

THE BACKDROP

Yes, I know: you've heard this part before. But a refresher never hurts. We've just witnessed a record boom in housing prices – they doubled from 1998 to 2006. That run-up was fed by progressively looser lending standards that allowed households with marginal credit to borrow excessive amounts for mortgages. These loans were often bundled into securities that were blessed with solid ratings by the credit-rating agencies, then sold to blithe institutional investors from Singapore to Norway. And in many cases, these securities became collateral for yet other securities, generating more fees for Wall Street and further distancing investors from the unwelcome reality of the risks they bore.

Much of this happened because the market participants – from the borrower to the mortgage broker to the securities packager to the ratings agency – chose to assume that what went up would never come down. Today we earn big bonuses. Tomorrow … well, tomorrow is another day.

This is not the whole story; outright fraud played a part. But it was only a footnote to what amounted to the greatest pyramid scheme in history.

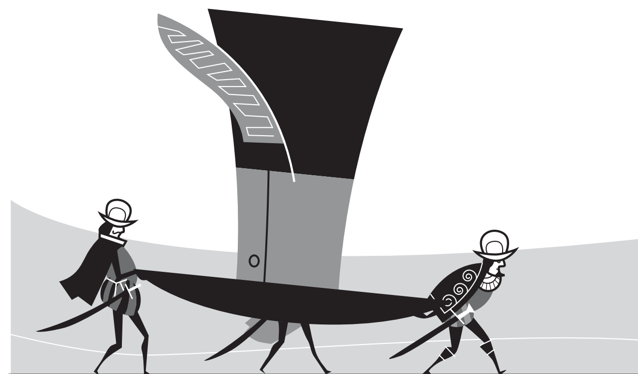
The taste for flying high was infectious: normally cautious banks made loans to highly leveraged private equity firms and failed to insist on the close oversight that would have been *de rigueur* a few years earlier. Similarly, bond investors, who had long demanded an interest premium of five to six percentage points above the rate on Treasury securities on loans to corporations with iffy credit, were doling out cash to borrowers for less than half that premium.

In sum, the combination of a humongous housing boom and a surprising disregard for risk on the part of investors conspired to create an environment in which slipshod practices remained profitable way too long. When housing prices ceased to rise, the housing finance system imploded, dragging much of the overleveraged and under-vigilant financial sector down with it.

Since the spring of 2008, the federal government has concentrated on repriming the credit pump. With luck, those efforts will succeed sooner rather than later. My focus, though, is not on mitigation but on the reforms needed to minimize the chances of a repeat performance.

The big players in the financial markets aren't likely to make the same mistakes anytime soon. Indeed, in the immediate aftermath of the debacle, lenders and investors appeared to have overlearned their lessons: they now shy away from any risk whatsoever.

Nonetheless, Wall Street's collective memory is both short and undependable, and significant structural changes are still plainly needed. What's more, it would make a lot of sense to rethink the ways we protect less sophisticated borrowers and investors – amateurs who can't be expected to keep up with



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the blinding pace of innovation in financial markets.

WHY FINANCIAL REGULATION?

While the loss of a few trillion dollars has a way of raising doubts in almost everyone's mind, we still start with the burden of proof resting on those who would abandon free markets for the alternatives. It's useful, then, to consider the circumstances in which even the most devoted followers of Adam Smith would consider intervention.

Market failure

Free markets aren't an end in themselves. We like them because they can yield "efficient" outcomes in which prices reflect costs and innovation is appropriately encouraged. But markets can fail to meet those objectives for a variety of reasons.

First, a lack of competition can lead to prices that exceed costs, reducing output and rewarding stasis rather than innovation. Where monopoly is accepted or inevitable – think of, say, the business of distributing electricity – government is justified in regulating the quality and price of services. But the ability to exercise "market power" is rare in the fragmented world of finance. And it certainly doesn't explain why Wall Street jumped off a cliff in 2007-08.

A second justification for intervention is the presence of spillover effects – what economists call externalities. If the behavior of buyers and/or sellers affects third parties, even competitively determined prices won't reflect the costs borne by all parties. Think of a factory spewing pollutants or, on the other hand, education that sustains a civil society as well as increasing individuals' earning power.

Now we're getting somewhere. On Wall Street, the failure of one highly visible firm – say, Lehman Brothers – can lead to a cascade of effects that make it almost impossible for others to operate normally.

A third justification for intervention is market failure induced by "asymmetric information" in which one party to a transaction knows important things that the other party doesn't know or can't find out at reasonable cost. Financial markets are all dogged with information asymmetries. A borrower usually knows more about the chances that she will repay the loan than does the lender; the individual applying for life insurance knows more about his own health than does the insurer. Thus making disclosure a matter of law can improve the efficiency of markets.

A variation on the asymmetric-information problem might be termed the widows-and-orphans problem: Some market participants are not capable of looking after their

own interests. Many retail customers in financial transactions – whether depositors or borrowers – fit the description.

There is, of course, a fifth motive for regulation: the redistribution of income and wealth. Raise the minimum wage and workers at Burger King will take home more money, while the customers will presumably pay more for Whoppers and will have less buying power.

Economists are, at best, uneasy about income distribution as a rationale for market intervention because transferring income this way usually reduces economic efficiency. But I mention it here since policymakers often pay lip service to efficiency when the real name of their game is redistribution. In the context of financial reform, distribution issues lurk behind decisions for rules ranging from limits on mortgage origination fees to caps on executive compensation.

Government failure

Lest one think that only markets fail, it's worth remembering that governments, too, are fallible.

First, the asymmetry problem: regulators' lack of information may lead to unintended consequences. Second, when government does make mistakes, putting Humpty Dumpty back together may prove very difficult. It took half a century to undo trucking restrictions instituted during the New Deal – a half century in which trucks too often ran empty and freight rates were sky-high.

Third, regulators are prone to "capture" by those they are supposed to regulate. It took decades and a threat of court intervention to persuade Washington to open the telephone business to competition. Fourth, even if regulatory capture doesn't occur, the pursuit of advantage through regulation can be immensely wasteful. Consider the thousands of lawyers and lobbyists who earn a living by making friends and influencing people in alphabet agencies ranging from FDA to the FCC to the SEC.

The bottom line: Market failure is not enough to justify regulation. One must also have good reason to believe that the regulators will do more good than harm.

PARSING FINANCIAL REGULATION

At first glance, financial regulation may appear to be a tower of ad hoc-ery. But it's possible to discern method in the madness.

Start with "economic" regulation, the direct control over prices, profits and market access. This form of regulation is often used to address monopoly problems (as with public utilities), but is often wielded in the more problematic cause of redistributing income. In financial services, "usury" limits on interest rates are, arguably, an effort to deal with market power, but may mostly serve the interests of favored lenders at the expense of others.

Second, there is health/safety/environmental regulation aimed at addressing externalities (pollution again) or asymmetric information. (Do diet pills work? The FDA probably knows better than you do.)

In finance, much regulation falls under the rubric of safety. A host of agencies define "prudent" behavior on the part of institutions ranging from banks to insurance companies to pension funds. The goal is to keep regulated institutions solvent so they can meet their contractual obligations.

The economic rationale for intervention is twofold. First, it would be very costly for creditors and customers to learn enough about these institutions' balance sheets to make informed decisions. Second, the failure of one can endanger many, as in the case of Lehman Brothers. Note that both rationales

can be used to justify government insurance against customer losses.

Safety also encompasses requirements that financial institutions provide key information (e.g., monthly payments), often in a standardized format that makes comparison-shopping easier; limits on prices and fees (e.g., late-payment penalties); and outright bans on "predatory" services, such as "payday" loans.

The third broad category of regulation is designed to cope with information asymmetries. Think standardized disclosure rules for consumer loans and standardized conventions for corporate accounting.

REFORMING REGULATION

Enough theory; here's the beef.

Address large institutions that pose systemic risks

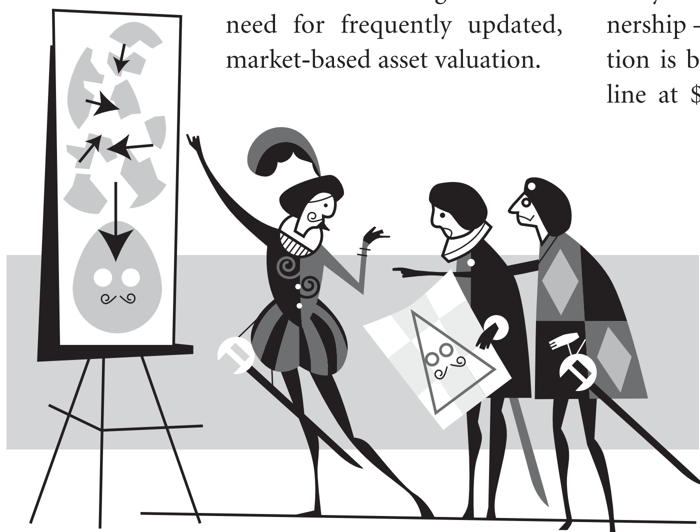
Perhaps the biggest surprise has been how much systemic damage could be wrought by the insolvency of large investment firms, like Bear Stearns and Lehman Brothers, that didn't take deposits. With hindsight, it is obvious these firms had become so enormous (Merrill Lynch's assets exceeded $1 trillion) and so interdependent with other sorts of financial businesses that their failure could have widespread consequences. Indeed, fears of their failure led to "runs" on them by their creditors; these had all of the characteristics of classic runs on deposit-taking banks. Compounding the problems, these firms operated with such thin cushions of capital that even modest losses could threaten their solvency.

Much of this problem has been solved by ad hoc government measures – probably at great future cost to taxpayers. Lehman Brothers was liquidated, while Bear Stearns was absorbed (with a dowry from the Federal Reserve) by JPMorgan Chase; Merrill Lynch rushed to the altar with Bank of America. Meanwhile, Goldman Sachs, Morgan Stanley and a slew of lesser names converted themselves into bank holding companies, gaining access to cheap government capital at the price of accepting heavy-duty prudential regulation. AIG, a financial conglomerate masquerading as an insurance company, has received more than $130 billion in federal loans and investments in efforts to save it from going down in the credit-default-swap mess.

Nevertheless, some large financial firms remain outside prudential regulatory regimes – GE Capital, Vanguard, Fidelity, some large hedge funds, and a rehabilitated AIG come to mind – and others may arise in the future (the privatized Fannie Mae and Freddie Mac,

discussed below, would be candidates). The goal, then, is to impose rules on them that are both broad and flexible. At the heart of such a regime:

Risk-based capital requirements (or, equivalently, maximum allowable leverage), as determined by sensible accounting conventions. Capital protects a financial institution's creditors – or protects the government agencies that implicitly or explicitly (e.g., through deposit insurance) promise to reimburse creditors if the institution becomes insolvent. The thinner the minimum capital buffer, the greater the need for government restrictions on the institution's discretion to bear financial risk and the greater the need for frequently updated, market-based asset valuation.



Keep it simple. If regulators can't understand an activity of a financial institution well enough to set sensible capital requirements, the activity should not be permitted. This may seem harsh. But the experience of the last decade, in which the risks linked to complex securities and risk-shifting arrangements eluded regulators, makes it necessary.

Special scrutiny of non-arm's-length dealings. It is all too easy to divert an institution's resources for the benefit of its owners at the expense of its creditors. Regulators must scrutinize the whole range of dealings in which conflict-of-interest questions arise – everything from dividend policies to loans to family and friends.

Management competence. Regulators need the capacity to assess the competence of the senior managers, and to replace them if they put the financial system at risk.

Receivership powers. If a financial institution becomes insolvent, regulators must have clear powers to merge or liquidate it with far greater speed and certainty than a bankruptcy court.

The extension of prudential regulation to every small hedge fund and investment partnership – from which much financial innovation is born – seems unwarranted. A bright line at $25 billion in assets under management feels about right.

Who should be the regulator? Perhaps the Federal Reserve, since such prudential regulation is the Fed's bailiwick. Certainly not the SEC, whose established mission has been the promotion of financial transparency, not the oversight of risk-taking.

Should the regulator guarantee the liabilities of these large financial institutions? Probably not. If the beefed-up prudential regime succeeds, that future crisis ought not to happen. If it does, anyway, the decision to bail out creditors can be tailored to the needs of the moment. That way, creditors won't assume that Uncle Sam will always be there to backstop them – and act accordingly.

Rethink Fannie Mae and Freddie Mac

Until their government takeover in September 2008, the Federal National Mortgage As-

sociation and the Federal Home Loan Mortgage Corporation were large hybrid (private-public) companies that dominated the secondary market for residential mortgages. They had two lines of business: securitizing mortgages that conformed to high credit standards and guaranteeing their repayment, and increasing the liquidity of the mortgage market by trading actively.

Though their stock was traded on the New York Stock Exchange, they had special ties with government that conferred both disadvantages and advantages. On the one hand, the rules barred them from originating mortgages, restricted the size of mortgages they could own, and required them to facilitate lending to lower-middle-income households. On the other, they could borrow at low rates because the financial markets believed (correctly) that the federal government would backstop their debts.

This implicit guarantee meant that, in normal times, Fannie and Freddie were able to borrow at about 0.35 to 0.4 percentage points less than their financial condition would otherwise have justified. About two-thirds of this benefit was passed through to consumers in the form of lower mortgage rates.

Both Fannie and Freddie grew rapidly in the 1990s, but accounting scandals at both institutions in 2003 and 2004 caused their growth to slacken – especially in the accumulation of mortgages for their own portfolios. Nevertheless, at year-end 2007 their combined holdings of mortgages and mortgage-backed securities totaled about $5 trillion, an astonishing 40 percent of residential mortgages outstanding.

To casual observers, the benefits provided by Fannie and Freddie seemed a free lunch: mortgage rates were lower, and low-to-moderate-income households were able to get greater access to loans, at apparently no cost to Washington. Meanwhile, shareholders in the two hybrid companies did very well by doing good – exceptionally low capital requirements and reduced borrowing costs made it a very profitable business.

Although Fannie and Freddie were not at the center of the subprime debacle, their portfolios did grow riskier because both had made big investment in "Alt-A" mortgages, with credit ratings between prime and subprime. Further, where housing prices fell steeply – Las Vegas, Southern California, South Florida – even some prime mortgages owned by the giants proved vulnerable to default. Fannie and Freddie were also burned on investments in supposedly safe mortgage-backed securities created from loans to lower-income households.

The free lunch turned out to be an illusion, of course. At the time of their takeover, the Treasury set aside a whopping $200 billion to cover Fannie and Freddie's losses.

In the current shaky environment, the government can't just throw Fannie and Freddie back into the swim. But once the financial markets have stabilized, the two companies should be privatized – this time, with no strings attached. The Federal Home Loan Bank System – another government-sponsored entity in the mortgage market that is neither fully public nor fully private – should get similar treatment.

Encouraging home ownership remains a worthwhile social goal. But instead of trying to do it on the cheap, Washington should offer on-budget subsidies to moderate-income buyers. Among other advantages: less risk of the sort of mission creep that made Freddie and Fannie major players in high-income housing.

Set free the ratings agencies

Ratings agencies offer "opinions" about the

creditworthiness of bonds of corporations, governments and, recently, mortgage-backed securities. The three major agencies in the United States – Moody's, S&P and Fitch – clearly played an enabling role in the debacle: Without their sunny assessments of questionable mortgage-backed securities in 2005 and 2006, the housing boom would have ended sooner and the collapse would have been less severe.

The SEC recently proposed regulations with the goal of eliminating the cozy relationship between the ratings agencies and the companies they assess. But a larger perspective is necessary. For decades, financial regulators have demanded that their wards heed the ratings of the select few agencies – for example, by investing only in bonds rated as "investment grade." In 1975, when the SEC followed the bank regulators down this road with respect to broker-dealers, it created a "nationally recognized statistical rating organization" (NRSRO) designation and grandfathered the three large ratings agencies into the category. Other financial regulators soon adopted the same system.

Although the SEC has designated six additional NRSROs since 2000, the commission's approach clearly created a major barrier to entry into the ratings business. It thus shouldn't be a surprise that the incumbents grew careless.

There is an alternative. Suppose financial regulators withdrew the special blessing on the NRSROs, and instead put the burden of assessing asset safety on the institutions they regulate. Banks would then have the incentive to choose the information-gathering method they found most reliable (and acceptable to the regulators) instead of blindly following the judgments of the ratings agencies. As important, information suppliers would have incentives to develop innovative ways of assessing asset risk, perhaps opening the door to worthy borrowers who have effectively been shut out since the 1930s.

The polar alternative approach would be to nail down the criteria on which the ratings agencies could base their opinions.

At the moment, the agencies can cling to the idea that they are not, in the end, responsible if bad things happen to highly rated securities. Enforcing legal accountability would presumably force the ratings industry to reform itself.

Insure deposits

Deposit insurance introduced during the New Deal was limited to $2,500, but Congress has raised the maximum several times since. Then, in early October, the figure was tempo-

rarily raised from $100,000 to $250,000 on interest-bearing deposits and made unlimited for plain-vanilla checking deposits.

Where to go from here?

The logic of limiting insurance is based on the assumption that large depositors will increase their vigilance and thereby deter banks' inclination to take chances. Such "market based" regulation seems sensible when applied to bonds, where the buyers are mostly specialized financial institutions like pension funds and insurance companies, but is misplaced when it comes to deposits in banks and thrifts.

Households are unlikely to become experts on their banks' financial condition. Even midsize enterprises, which periodically need to keep on hand hundreds of thousands or even millions of dollars to cover payroll, invoices, taxes and the like, are ill-prepared to police bank behavior.

The most sensible approach, then, is to insure all the deposits of federally regulated banks, thrifts and credit unions. Bank monitoring should be the responsibility of the Federal Deposit Insurance Corporation and its credit-union equivalent.

Reform mortgages

A handful of reforms here would make a big difference.

As anyone who has bought a house can attest, the closing is a horror. There are stacks of documents to sign, no clear statement of costs, and no time to read what is made available. Small wonder, then, that unsophisticated buyers are ill-informed and sometimes defrauded. We need a one-page document in plain English that lays out the buyer's obligations. Where the future costs are contingent – as, say, for an adjustable-rate mortgage – the statement of costs may be a bit more difficult. But bringing greater clarity to costs is not a matter of rocket science.

Second, it should be possible for a single party to be a consolidator for all of the relevant services: appraisal, title insurance, document filing, etc. Current federal law discourages that approach, forcing people who may buy a house only once in their lives to shop around for these esoteric services.

Third, there should be a "suitability" and "know your customer" fiduciary obligation on the part of the lender and other intermediaries like mortgage brokers. These obligations seem to work fairly well in stock brokerage – brokers rarely try to stuff middle-income retirees' portfolios with volatile investments. So there's reason to believe they would deter predatory lending as well.

Fourth, as the financial debacle revealed, mortgage renegotiation is much harder when

the mortgage has been securitized and sold in a zillion pieces. Mortgages, as well as securitization documents, should clarify the authority of the companies that collect mortgage payments to renegotiate terms when default is the alternative.

Re-enact Glass-Steagall?

The Glass-Steagall Act of 1933 put a wall between commercial banking and other investment services. Beginning in the 1960s, regulators and courts began to punch holes in the wall. And the barrier was removed entirely by the Gramm-Leach-Bliley Act of 1999.

Finger pointers now claim that repeal of Glass-Steagall contributed in a major way to the financial crisis. But it is hard to see how Glass-Steagall would have tempered the frenzy of mortgage originations, securitizations and derivatives creation that inflated the bubble in the first place. Note, too, that if Glass-Steagall had been on the books in 2007-08, the big commercial banks could not have absorbed Bear Stearns and Merrill Lynch. By the same token, Goldman Sachs and Morgan Stanley could not have found shelter from the storm by converting themselves to bank holding companies.

Clear financial derivatives

There's good reason to believe that most financial innovations do more good than harm. In particular, they allow markets to slice and dice risk with the goal of distributing it to those most willing to bear it. But, as we now know all too well, financial innovation can magnify the impact of market failure.

To reassess the need for regulating derivatives, then, we need to know the likely impact of regulation. And as René Stulz discusses in detail elsewhere in this issue (see page 58), requiring that derivatives be traded through clearinghouses makes sense. Subjecting them to hands-on government regulation or forcing them on to exchanges amounts to throwing the baby out with the bath water.

Clean up the architecture of regulation?

Five federal agencies, as well as one or more agency per state, regulate deposit-taking institutions. The states also regulate lenders that are not depositories. Fannie Mae, Freddie Mac and the Federal Home Loan Bank System have their own regulator. Two federal agencies, as well as 50 state regulators, oversee securities. Each state regulates insurance companies. Two federal agencies, and all 50 states, have a say in pension regulation. Oh, lest we forget: consumer fraud in financial products is the turf of yet another federal agency, as well as the shared jurisdiction of the 50 states.

This crazy-quilt pattern would cry for simplification even in the absence of financial crisis. But two qualifications should be kept in mind. First, overlapping regulation did not cause the financial meltdown, and it is far from clear that a simpler framework would have better addressed the problems building over the last decade. Second, regulatory complexity and overlap can work to open the system to new ideas. Just as a monopoly in the private sector can be an impediment to innovation, so, too, can a monopoly in government regulation.

Exchange-traded financial derivatives were introduced in Chicago – not New York – and the fact that the Commodity Futures Trading Commission (CFTC) rather than the SEC blessed them was not a coincidence. The instruments were seen as competition for securities traded in New York, on the SEC's turf.

Or consider the requirement, dating from the Depression, that the Federal Reserve limit the interest that could be paid on insured de-

posits. The original idea was to restrict bank competition for deposits, which was wrongly thought to have contributed to the wave of bank failures in the early 1930s. But in reality it mostly led banks to compete for deposits by offering toasters, commemorative plates and Green Stamps as bonuses.

Enter the National Credit Union Administrator, which in the early 1970s placed no restrictions on the interest rates that credit unions could pay to their depositors. Banks lobbied hard to be able to compete, and managed to get the interest rate limit on interest-bearing deposits repealed in 1980.

In Robert Bolt's *A Man for All Seasons*, Sir Thomas More asks his son-in-law (William Roper), "What would you do? Cut a great road through the law to get after the devil?" When Roper replies affirmatively, More responds, "Oh? And when the last law was down and the devil turned 'round on you, where would you hide, Roper, the laws all being flat?" Think of a monopoly regulator versus the alternatives that the current regulatory structure offers.

WAIT, I'M NOT FINISHED…

While we're on the subject, I'd add the following to my wish list:

Let Wal-Mart (and others) be bankers

For the past decade, Wal-Mart and other nonfinancial firms have been rebuffed in their efforts to enter the banking business. And – no surprise – the regulators have been congratulated by incumbent banks, which don't relish the prospect of competition from brand-name retailers. I believe that preventing entry into banking by an otherwise successful company prepared to meet prudential standards is always a mistake. The error is particularly egregious in the case of Wal-Mart because the giant retailer caters to moderate-income households – precisely the households poorly served by the banking establishment.

Strengthen the Pension Benefit Guaranty Corporation

The PBGC insures the sort of pension plans in which an employer (or its union) guarantees specific benefits to retirees. It thus aims to keep pension funds solvent, with assets exceeding obligations to current and future retirees. But pension fund accounting rules give fund sponsors enormous wiggle room in demonstrating solvency. Worse, when a company makes new pension promises to its employees, the law gives it many years to ante up the money. So if it goes bankrupt in the meantime, the PBGC foots the bill.

The PBGC finances itself primarily from insurance premiums levied on companies with existing plans. The premiums bear little relation to risk borne by the PBGC, however. Plainly, then, the agency needs ways to tighten accounting rules and to match premiums to risk. M