

Regulatory Reform and the Economy:
We Can Do Better

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I want to thank you for attending this evening's Economic Forum, hosted by the Denver Branch of the Federal Reserve Bank of Kansas City. When Congress created the Federal Reserve in 1913, they believed very strongly that the nation's central bank could not be an institution isolated inside Washington. Instead, they recognized the importance of distributing the Federal Reserve's responsibility broadly across the nation, creating regional Federal Reserve Banks that serve specific regions of the country. The regional Banks and Bank Branches, like the one here in Denver, are under the direction of local boards. Our directors play a key role in connecting the Federal Reserve and its policy deliberations directly to the communities we serve. We have two Denver-area directors on the Kansas City office's board, and the seven-member Denver board includes four Denver-area directors. I would like to recognize how important these Coloradans are to the success of our work and thank each of them for their service to our nation's central bank.

CHALLENGES

In the past when I have spoken at this program, my comments have focused almost entirely on the economic outlook. In that regard, I can tell you that I see nothing that conflicts with the widely held opinion that we are in recovery. Consumer confidence is rebounding, and we are starting to see improvement in business and manufacturing. Additionally, yield spreads between low-risk assets, such as Treasuries, and higher risk assets are narrowing. They are not at prerecession levels, but there is a clear indication that investors are more willing to provide capital, which is extremely important. A vast amount of stimulus has been put in place to spark this recovery, and I believe it will prevent a double-dip recession.

The stimulus will, however, present its own challenges. The Federal Reserve and other central banks around the world will have to unwind the extensive policy accommodation used to halt the economy's decline. That will be a delicate process because removing too soon could return the economy to recession while waiting too long will foster an inflationary spiral. The process will be particularly delicate for this recovery because it will proceed slowly, hampered by a significant debt overhang and uncertainty around the condition of some of the largest financial institutions. Thus, the challenge to monetary policy is to act in such a manner that you encourage the recovery while not fostering conditions for a future crisis, albeit one of a different nature.

As policy is discussed and even debated, it is important to note that the current fed funds rate is zero. We all know that the neutral rate is not zero. Equally obvious to me is that a rate of 1 or 2 percent is not tight monetary policy – it is still very accommodative. As we consider our choices, I would not support a tight monetary policy in the current environment, but my experience tells me that we will need to remove our very accommodative policy sooner rather than later. Even if we were to start immediately, much time would pass before incremental increases could be considered tight or even neutral policy.

Monetary policy, however, is not the only area where we will have to consider the long-term implications of our actions as we emerge from this crisis. In that regard, I think the best use of my time here this evening will be to explain why I think the hard decisions are ahead in the area of regulatory reform, which is currently under consideration in Congress. Looking at some of the policy issues that have emerged in recent weeks, it seems the public debate continues to distract from what I judge was the primary cause of this crisis. We must address the issue of too big to fail or we will repeat the mistakes of the past, with ever-worsening consequences. I know we can do better.

REGULATORY REFORM

Too Big to Fail

Reform in the regulation and oversight of our financial system clearly is needed. As sure as we know that tomorrow will arrive, we know that a financial crisis will occur again at some time in the future. Therefore, the most important exercise that we should undertake now is to ensure that problems at large financial institutions are not allowed to jeopardize the basic survival of our financial system and economy.

How do we do that? How do we prevent incentive compensation schemes that carry high costs to taxpayers? How do we best protect the consumer from unfair and deceptive practices by firms that are currently unregulated or under-regulated? While the Administration has taken an important initial step to address these lapses in our financial system, it is focusing first on symptoms rather than the disease.

Adam Smith is often thought of as the English-speaking world's father of modern economics. He is widely known for his book titled, The Wealth of Nations, in which he provided

his analogy that a market economy was like an invisible hand guiding resources to their best use. Less well-known is another passage in that book in which he warns that:

“The interest of the dealers ... is always in some respects different from, and even opposite to, that of the public. To widen the market and to narrow the competition is always the interest of the dealers. To widen the market may frequently be agreeable enough to the interest of the public; but to narrow the competition must always be against it, and can serve only to enable the dealers, by raising their profits above what they naturally would be, to levy ... an absurd tax upon ... their fellow-citizens. The proposal of any new law or regulation of commerce which comes from this order ought always to be listened to with great precaution.... It comes from an order of men whose interest is never exactly the same with that of the public, who have generally an interest to deceive and even to oppress the public, and who ... upon many occasions, both deceived and oppressed it.”

To get a sense of what Adam Smith is talking about, I would point out that in 1999 the Congress passed a piece of legislation, heavily endorsed by our largest banking firms, called the Gramm-Leach-Bliley Act. This legislation ended the separation of commercial and investment banking. It broadened the market and allowed for the accelerated growth of large financial firms in the United States, turning them into institutions that were thought to be “too big to fail.”

This should not be dismissed as a populist view of these institutions, but one that is supported by the data. It is best seen by examining the advantages that accrued to these firms with respect to their capital levels. The market, knowing these firms were too big to fail, tolerated an ever-expanding leverage ratio, relative to owner equity. For example, if you look at the 20 largest institutions, their equity-to-assets ratio at the end of the second quarter of 2009 was about 4.3 percent. If you look at the next smaller group of institutions, their equity-to-assets ratio was almost 6.5 percent. The smaller institutions simply must carry lower leverage ratio because all those in the market – management, shareholders and creditors – know they will lose their jobs and investments if they make decisions that cause their banks to fail. This type of market discipline is less immediate to the owners and creditors of the larger firms.

If you were to place these largest institutions under the same leverage constraints as the smaller firms – at least 6.5 percent equity to asset – these larger firms would need to raise more than \$275 billion in new capital or shrink their assets by more than \$4 trillion. This capital difference is an overwhelming advantage to these largest firms and, indeed, has enabled them to narrow the competition to an incredible degree. Since the change in law, the largest 20 firms have increased their control of the nation’s banking assets from about 35 percent to an

astonishing 70 percent. Even more striking perhaps is the fact that some of these firms are now 30 to 40 percent larger than they were when this crisis began, and as you know, many of these firms were protected during the crisis.

When the crisis unfolded and these largest firms were at risk of failure, Congress passed the \$700 billion TARP legislation. It was done to protect the broad economy, but it also had the additional effect of institutionalizing too big to fail in the United States.

Compensation

One of the ironies of this action is that the management of these firms, even those needing TARP funds to survive, continues to receive enormous compensation packages. As a result, one of the issues currently distracting Congress and the public is executive compensation. I certainly understand the anger directed at the well-paid individuals atop large firms that contributed to this crisis. However, a comprehensive plan for resolving these firms and dismissing management, rather than protecting them from failure, would address compensation issues far more effectively because it would leave these individuals out of work and wipe out any ownership stake they hold. That does much more for accountability than simply capping an individual's pay. In fact, there is some question if pay caps could even be firmly implemented – as you may know some firms have already begun to work around compensation limits by raising base salaries to million-dollar levels.

Compensation restrictions also call into question the tenants of capitalism in terms of balancing risk and reward. If we ensure that our resolution system makes management bear the costs of the bad decisions and risks they take, we also need to let them reap the rewards of the good decisions. At the very least, new kinds of market distortions might be created by injecting a degree of disconnect between compensation and performance – the same kind of disconnect that some might suggest fosters the type of carelessness we saw in this crisis.

Let me give you one example. Let's say one of the largest financial institutions wanted to pay a trader a \$100 million bonus based on performance. I'm not a trader, but I know there is no way to earn enough money on trading to generate a \$100 million bonus without taking open positions, which in this example is making bets on behalf of a company that has a major role in our nations' payments system. If the trader wins, the company makes money. If the trader loses, taxpayers fund the bailout because the institution is large and systemically important. The real

problem with this scenario is that the company is too big to fail, not that they are willing to pay an enormous sum of money as a bonus. If it's their money, or the money of their shareholders or creditors, I am in favor of letting them set compensation levels. If it's the money of U.S. taxpayers, then it's an outrage. Mandating an orderly receivership if the institution fails assures that they gamble with their own money.

It is also important to acknowledge that policing such an executive compensation policy will be difficult and inconsistent. For those who are angry about individuals profiting obscenely from a crisis, it will do nothing to prevent that. Many investors did so during this crisis by rightly interpreting that the government would bail out failed institutions and that the stock prices would recover. Heads I win, tails the public loses is a one-way bet. It's not capitalism; it is bad policy. Once again, I suggest that ending too-big-to-fail is the first step in addressing compensation issues.

Consumer Protection

Another headline issue in the regulatory reform package relates to the proposed Consumer Financial Protection Agency. Fair treatment of consumers is extremely important. We do a lot of work throughout our District on consumer education and consumer issues. Our Bank also hosts a nationwide call center on behalf of the entire Federal Reserve System. Consumers can contact us by phone¹ – and they will talk to an actual person, not a machine – or online at www.FederalReserveConsumerHelp.gov to discuss problems related to any financial institution, regardless of the regulatory agency involved. These calls are extremely illuminating in what they tell us about the relationship between consumers and financial institutions. First of all, we handle about 40,000 consumer questions a year, which suggests a lot of concern and often confusion about consumer rights under the law. However, 90 percent of the complaints we receive are targeted on the largest banks and most often related to credit card issues. Very few complaints are made against community banks. And, after these complaints have been investigated, few against community banks are actually found to involve violations of the consumer protection rules. This suggests that clarification or simplification of consumer protection rules may be necessary for consumers to better understand what their protections are under the law.

¹ 888-851-1920

I think we also need to recognize that, while effective consumer protection is a critical foundation of our financial system, weaknesses or gaps in the enforcement of these laws was not the only factor, or even the driving factor, behind the run-up of subprime lending and the resulting wave of foreclosures. What we experienced was a distortion of incentives in financial markets amid inflated real estate prices, skyrocketing demand for mortgage backed securities and a resulting deterioration in underwriting standards for many lenders as they rushed to originate more loans. These dynamics caused too many loans to be extended without a reasonable probability of repayment. The consequences were, of course, disastrous when the housing market collapsed. This experience raises important questions about the incentives involved in securitizing loans, the ability of consumers to receive a loan with little or no upfront money, and the role of nonbank firms, among other issues. There are also lessons to be learned about the scope and effectiveness of consumer protection laws, as well as the expectations for regulators enforcing these laws.

There are more discussions and debates to take place on this topic, and it is the choice of Congress to decide. My experience tells me, however, that comprehensive oversight of banks is important for both effective and efficient supervision. Under the coordinated approach we currently utilize, our goal is to create a good outcome for consumers and depositors through ensuring a financially sound and well-managed banking operation that complies with specific consumer protection rules. Separating those functions will create inefficiencies in information collection and analysis, and add an additional layer of communication and coordination.

But in any case, the fact remains that the consumer and the public more generally will be best served if we address the root cause of the abuse that many unfortunate consumers have suffered during the crisis. We must change the incentives and enhance the accountability of the institutions that generated the complex products that served the principle goal of generating fees rather than being sound loan products.

Solution

Many times in the last year I have expressed my astonishment that Congress was able to approve \$700 billion in TARP funds in approximately one week and yet 18 months have passed since Bear Stearns was acquired by JPMorgan and there is still no resolution authority for the largest financial firms.

Failure resolution for these largest firms and other yet-to-be-defined systemically important firms is part of the proposed reform package now before Congress. Unfortunately, the proposal does not adequately address the too-big-to-fail problem in that it still provides too much latitude to rescue failing firms. It confirms the practice of addressing failure of the largest firms in an ad hoc manner with individuals rather than the rule of law deciding which firms get rescued and which do not. As eager as we might be to address the shortcomings of our financial system, we must also be careful to get it right.

Without mandatory resolution authority directed under “the rule of law” for the largest firms, financial reform will be incomplete and ineffective. Management will remain able to game the compensation programs that we define, and consumers will be subject to higher fees and unfair treatment, even under a new regulator, should it come to be. There can be no confidence in the system until there is a sense of fairness in the treatment of institutions whereby management and investors are held accountable for their decisions regardless of their firm’s size. We all know the names of these firms. They were central to this crisis as it expanded and became a global recession. However, while the crisis caused workers to lose their jobs and families to forfeit their homes, the stockholders and creditors of these firms enjoyed special protection funded by the American taxpayer.

To begin with, the legislation needs to establish a mandatory, non negotiable resolution process for too-big-to-fail firms that are no longer viable as a going concern due to insufficient capital or liquidity. With appropriate legislation, failing firms could still avoid liquidation or a drawn-out bankruptcy process. Instead, they would be put into receivership or conservatorship so as to provide an orderly process for maintaining essential services and avoiding systemic instability while making management, shareholders and creditors accountable for their decisions. The resolution process would apply to every financial institution whose problems might threaten financial or economic stability and is involved in the “plumbing” of the financial system – that is, those involved in the payments system and the provision of liquidity within the financial system.

A resolution process where creditors bear losses commensurate with their investment decisions would be significantly less costly to the taxpayer than the price we are currently paying in lost jobs, lost economic growth and actual outlays of public funds. Alternatively, if we do not find a way to end too-big-to-fail, the largest institutions retain an inequitable competitive

advantage, will continue to escape market discipline and are incited to engage in practices that ultimately harm the financial system.

A sound resolution process would provide greater assurance of equitable treatment for all parties, which is essential in a democratic, capitalist system. As a nation, we will soon need to address other enormous financial challenges, such as reducing the budget deficit and providing future funding for Social Security and Medicare. We must not fool ourselves that citizens will – or should – accept higher taxes or reduced benefits until we have addressed existing vulnerabilities in our financial system that risk public funds.

To those who say that some firms are too big to fail, I wholeheartedly agree that some are too big. However, these firms can be unwound in a manner that does not cause irreparable harm to our economy and financial system but actually strengthens it for the long run. As a regulator during the banking crisis of the 1980s, I was involved in closing hundreds of failed institutions. Continental Illinois, which was one of our nation’s largest and most complex bank holding companies, was taken into receivership in an orderly fashion.

I have testified before Congress on this issue and recently offered a detailed process that would hold the ownership and senior management of these institutions accountable for their actions when their firms fail. The businesses would then be restructured through a prescribed process under the rule of law. If you are interested in the details of this plan, I encourage you to visit our website, www.KansasCityFed.org, where you can review it in its entirety. I am not aware of any other proposal that would prevent situations like Bear Stearns, Lehman Brothers and Merrill Lynch from being handled exactly the same way. That is unacceptable.

CONCLUSION

While some argue that moving legislation quickly forward gives us a better outcome sooner, my view is that this approach will result in a set of unintended consequences with a more expensive outcome. I have no doubt that all policymakers involved in the debate have the same goals of benefitting the consumer, the industry and the nation’s economy. That is why I believe the full package of regulatory reform deserves more time for careful consideration and national debate, but resolution authority is well over a year too late. The likelihood of real success in financial stability; consumer protection; and, importantly, public confidence in policymakers’

resolve to fix what actually went wrong in our financial system starts by addressing too-big-to-fail.

I know that this is a difficult problem to fully understand, and certainly will be a complicated situation to fix. But we must fix it. Based on experience, my view is that we do not have to subsidize or “learn to live with” the financial oligarchy that exists. Furthermore, our handling of too-big-to-fail institutions will define the future role of the United States in the global economy. Our failure to insist on a stable, market-based financial system jeopardizes the U.S. leadership position.