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Regulatory Reform After the Fall of Wall Street

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Any opinions expressed here are my own and do not necessarily reflect those of the Federal Open Market Committee members.

The clamor for regulatory reform

- The Panic of 1907 $\Longrightarrow$ Federal Reserve.
- The Depression $\Longrightarrow$ Glass-Steagall and the FDIC.
- The 1980s Thrift Crisis $\Longrightarrow$ FDICIA.
- Enron/Worldcom $\Longrightarrow$ Sarbanes-Oxley.
- Conclude:
  - Reform legislation unlikely to stall out.

What can reform accomplish?

- Better long-run growth prospects?
- Better stabilization?
- Bubble avoidance?

Intermediation and long-run growth

- Growth theories for industrialized economies tend to de-emphasize intermediation or the depth of financial markets.
- Instead, they tend to emphasize improvements in technology or human capital.
- Conclude: even perfect regulation probably will not improve long-run growth.
  - The literature on finance and growth applies to developing countries.

BETTER STABILIZATION

- Financial crises can be associated with recession.
- Avoiding this means avoiding the *panic element* of a crisis.
- In the past, this has meant avoiding "bank runs."
- Our system turned out to be susceptible to a new form of a "bank run."
- Conclude: It may be possible to address this problem in a reform.

AVOIDING BUBBLES

- Bubble has become an overused term.
- There is a large literature on multiple equilibria in macroeconomics.
- Usually, high-volatility vs. low-volatility equilibria.
- The high volatility equilibria are driven by self-fulfilling expectations.
- The policy response is to knock out the multiple equilibria.
- This leaves an economy that responds only to fundamental shocks and has no "extra volatility."
- Conclude: It may be possible to address this type of problem as well.

Plan for this talk

- What are the core problems?
  - Failure of financial engineering.
  - "Bank runs" on non-bank financial institutions.
  - Implicit insurance of creditors to financial institutions, a.k.a. TBTF.
- Some portions of the regulatory system work well. Why?
- What to do about the large financial institutions?
- The role of the Federal Reserve.

A failure of financial engineering

- Securitization markets are in principle a good financial innovation.
- The initial success of mortgage-backed securities (MBS) masked underlying problems.
- By the time of failure, large quantities of MBS and related assets were held globally.
- Few major players escaped unscathed, suggesting few knew the dangers.
- Some parallels with other types of engineering failures.

More on failed financial engineering

- The resulting shock to the global macroeconomy is large and real.
- There is no escaping the adjustment that must occur.
- Government intervention cannot offset this large shock completely, only mitigate some of the effects.
- The design of the securities was a core problem: They did not perform well in some states of the world.
- *Some reforms being discussed do at least indirectly address this.*
- One goal should be to revive securitization markets.

"Bank runs" on non-banks

- Bank runs have been a macroeconomic hazard for hundreds of years.
- Conceptualized as simultaneous withdrawal of deposits from a depository institution.
- Diamond and Dybvig, 1983.
- Policy intervention:
    - Deposit insurance ...
    - ... plus prudential regulation.

More on "bank runs"

- This crisis has instead produced "runs" on non-bank, non-depository institutions.
- There was no regulation in place for this hazard
  - ... because it was not generally viewed as a hazard.
- Bear-Stearns, for instance, borrowed short-term, but against collateral.
- *Deposit insurance does not solve this problem.*
- What to do?
- *Most reform suggestions do not address this problem either.*
- "Keep a closer eye on these guys" does not work.

Portions of the regulatory system work well

- Bank regulation outside the largest financial institutions has worked well during the crisis.
- We do not see the small bank panic that characterized the Depression, even though this is a large crisis.
- The system of deposit insurance plus prudential regulation solves that problem.

More on successful regulation

- There are bank failures in the system, but they have not caused market disruption.
- Why the success?
- The first component is good monitoring.
- A fairly clear rating system is in place.
- The monitoring system means that the regulator is aware of which banks may fail and can prepare accordingly.

More on successful regulation

- The second component is a clear and credible resolution regime.
- Credibility means that all parties understand what will happen in the event of bank failure.
- The U.S. has a system for closing banks in a way that does not damage others in the industry.
- Conclude: Good regulation is good monitoring plus a clear, credible resolution regime.
- We can learn from the success of this system.

What the successful regulatory structure does

- The system is not designed to "keep banks in business at all costs."
- Nor is the system designed to tell owners how to run their business.
- It says little about internal incentive systems.
- The system in fact allows some failure to occur.
- What it is designed to do is to turn potentially disorderly failures into orderly failures.
- The system succeeds here.

Large, global enterprises

- Key problems involve large banks and large non-bank financial firms.
- These are often global enterprises.
- Cross-border regulatory competition is a powerful force.
- It is far from clear how much real progress can be made on global regulatory coordination.

Two missing pieces

- The monitoring problem for large institutions is much more difficult.
- As a result, it has been difficult to discern how these firms are coping with the financial engineering failure.
- The firm's incentive is to say "all is well" until the bitter end.
- Firms near failure might alert authorities only days before the event.
- So the first part of good regulation was missing: monitoring was poor.
- In addition, the resolution regime is unclear.
- The second part of good regulation, a clear, credible resolution regime, was also missing.

Too big to fail quickly

- Large financial firms are often considered "too big to fail" because of the market disruption that might be caused.
- The correct phrase is "too big to fail ... quickly."
- All firms fail eventually.
- Regulators may encounter fraud—for example: Enron.
- Some plan has to be in place to shut down the failed institution in that case.

Resolution regimes

- We want an *orderly* resolution regime that will close down the failed firm without creating problems for the remaining firms in the industry.
- Ronald Feldman and my colleague Gary Stern emphasize that this resolution regime must be credible.
- Credible means that all parties understand what the regime is and that it will indeed be employed in the event of failure.
- Is the resolution regime in the Treasury proposal credible?

RESOLUTION REGIMES AND PRICING

- The resolution regime affects the entire equilibrium pricing structure.
- Market players are pricing in the probability of failure along with their payout in that state of the world.
- Uncertainty about the resolution state injects uncertainty into all financial market prices.
- For this reason the resolution regime may be the most important reform.
- Chairman Bernanke has repeatedly emphasized the need for a resolution regime to handle large financial institutions.
- Used correctly, this will turn disorderly failures into orderly failures and avoid panic.

Existing resolution regimes

- Bankruptcy court has been considered inadequate for certain types of large non-bank financial firms.
- A simple reform would be to rewrite the bankruptcy code to allow for special considerations that apply to financial firms.
- This would not help us with the monitoring question: the filing may still be "sudden."

Size limitations

- One simple approach that has been suggested might be to limit the size of firms.
- This would bring large financial institutions within a regulatory framework which is robust and is known to work well, even in a crisis.
- Still, it is questionable whether size restrictions could be adequately enforced.
- The global aspect of these firms might also make this idea difficult to implement.
- A version of this would be to place a tax on firm size.
    - A tax does not seem to help either with monitoring or with resolution.

Monitoring without a resolution regime

- The most common response to the situation has been that we need more monitoring of large financial firms.
- It is unclear what monitoring by itself can accomplish. We need the resolution regime.
- Monitoring can help authorities track which firms are likely to fail.
- It cannot do very much about poor business decisions.
- Regulators are not going to have a better idea than business leaders as to which direction their firm should go in order to be profitable.

The lender of last resort

- The Fed is the nation's lender of last resort.
- If the Fed may be lending to institutions, it will need to have a role in regulating those institutions.
- Otherwise, the Fed will be unable to make a judgement on whether to lend and under what terms.
- The role of Fed lending in mitigating the current crisis has been substantial.

THE NATION'S MONETARY AUTHORITY

- The Fed also runs the monetary policy of the nation.
- To perform this function effectively, the Fed needs to know the condition of the financial system.
- This also argues for a substantial Fed role in the regulation of these firms.
- The need to know the status of financial markets has been underscored by recent events.

Systemic risk regulation

- The Fed has been the *de facto* systemic risk regulator.
- Many financial market problems, whether under the official Fed purview or not, have come to the Fed during this crisis.
- The world expects the Fed to fix financial market problems as they occur.

A poorly defined debate

- The debate on systemic risk regulation needs to be sharpened substantially.
- The definition of systemic risk regulation is far from clear.
- A macro-prudential view: does the Fed already do this?
- A narrower, institutional view: what new powers to assign?

A macro-prudential view

- A macro-prudential view often emphasizes a regulator that "takes everything into account."
- Coupled with monetary policy, it means taking everything into account when setting interest rates.
- I think the Fed already does this.
- Certainly, policy debates in the last twenty years have discussed bubbles in technology stocks and in housing prices.

The Fed and Systemic Risk

- Three important systemic calls by the Fed:
  - William Poole on GSEs.*
  - Gary Stern on "Too Big to Fail."**
  - Ned Gramlich on subprime.***

*"Financial Stability," 2002; "Housing in the Macroeconomy," 2003; and "Reputation and the Non-Prime Mortgage Market," 2007.

**Gary H. Stern, Ron J. Feldman, Too Big To Fail: The Hazards of Bank Bailouts, Brookings Institution Press, 2004.

***Edward M. Gramlich, Subprime Mortgages: America's Latest Boom and Bust, Urban Institute Press, 2007.

A narrower view

- A narrower view would contain the idea that certain market practices may need to be curtailed.
- Alternatively, business practices at certain firms might need to be discouraged, should they be viewed as systemically risky.
- What is unclear is what powers a new regulator would need to carry out these tasks.
- How would firms operate, knowing that a particular practice might be found "too risky" at some point in the future?
- I do not think the answers are clear at this point.
- The debate needs a much sharper focus.

Conclusions

- For smaller banks, the U.S. regulatory system works well and is robust during a crisis.
- This is important: It solved a problem that plagued our nation for decades.
- For large banks and non-bank financial firms, monitoring is more difficult and the resolution regime is unclear.
- Key improvements would be to develop a credible resolution regime for large financial institutions, and to upgrade monitoring.
- The Fed's lender of last resort and monetary policy functions mean that it will have to remain closely involved in the regulatory structure.
- The systemic risk regulation debate needs to sharpen up.

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