

Chapter 2*

The Architecture of Financial Regulation

Overview

Assuming the financial architecture will continue to be dominated by institutions imposing high levels of systemic risk, the creation of a new systemic risk regulator is a central component of post-crisis financial reform. This new regulator would supervise the growing cohort of financial conglomerates and, through a regulatory council, work in tandem with the Federal Reserve and three reconfigured functional regulators regarding both macro-prudential and micro-prudential responsibilities. This task will be facilitated if risk is priced more appropriately and as a result institutions are encouraged to follow more specialized business strategies.

Financial regulation in the best of circumstances tries to achieve a fine balance among several benchmarks – financial efficiency, innovation, transparency, competitiveness in global markets, and safety and soundness. With this many objectives, there are inevitable tradeoffs. Measures that assure greater financial robustness may make financial intermediation less efficient or innovative, for example. The reverse may also be true. Unfortunately the benchmarks are not easy to define in detail, and even more difficult to measure in practice. We know that excessive regulation involves costs, but what are they? We also know that under-regulation can unleash disaster, which can be observed only after the fact. So optimum regulation is the art of balancing the unmeasurable against the unknowable – no wonder financial regulation is so difficult to do well.

Adding yet another layer of complexity are the institutions charged with executing regulatory mandates. Should regulators be organized by function – such as commercial banking, investment banking and financial markets, asset management and insurance - allowing them to gain enough industry expertise to have a reasonable understanding of what it is they are regulating? Or should they be structured in line with the firms they are regulating, ranging from financial conglomerates to community banks, so they can better oversee the complexities and avoid overinvestment in regulatory infrastructure where it isn't needed? And who should watch out for the buildup of systemic risk in the financial structure as a whole (macro-prudential risk), which goes well beyond the remit of regulators covering individual firms (micro-prudential risk)? This in turn raises the question of who gets to determine when firms have failed, and how do we “resolve” them if they are insolvent? And, should those doing the resolution have been involved in preventing the insolvency in the first place?

In great architecture, form follows function. Financial architecture is no different. The institutional structure that should be created to implement the regulatory changes now being discussed by the House and the Senate depends critically on certain macro decisions about the goals of the regulation. If certain activities are carved-out of financial conglomerates into independent financial specialists, for example, a sensible regulatory overlay may be very different from one that would be needed if financial conglomerates are left intact. In addition,

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there are important issues of regulatory execution. We have seen many examples of well intentioned regulation undermined by regulatory arbitrage distorting the intent and implementation of financial regulations over the years.

The bills now being debated in the United States Congress and the discussions being held elsewhere in the G20 nations are already the reflection of popular sentiment (notably emotional antipathy toward bankers), lobbying by special interests, and political posturing. But, that is the history of both our financial system and financial regulation. Here our goal is to offer informed commentary on the new structures for financial regulation that are being proposed and an idea of what might be better in our independent view. Since regulation and government intervention is an explicit acknowledgment of market failure, there is an inherent acceptance that of the cliché that we should not let the perfect be the enemy of the good.

There are many regulatory issues at stake right now. How do we protect consumers? What should we do about corporate pay? What should we do about mortgages? How should we regulate derivatives? And so on. All are important to someone but there is one issue that is important to all. How do we construct a system of regulation in which decisions made in one or a few financial institutions can bring the entire system to halt and the world's economies to their knees? This is the problem of regulating systemic risk. It is **the** primary issue.

To preview our line of thinking, we believe that the best way to address systemic risk is to make the firms that create it pay for having created it - for having put the economy at risk. This requires measuring, pricing and taxing that risk. Alternatively we could require institutions that are very risky and complex to become simpler by separating their riskier activities into smaller independent firms.

Who should make these determinations? We believe the regulator of financial institutions capable of creating this kind of risk (often called Large Complex Financial Institutions or LCFI's) should be a de novo institution that absorbs key micro-prudential functions of the Federal Reserve and should be charged as well with the authority to "resolve" (re-organize or dissolve) insolvent institutions. In addition, that regulator would have responsibility for macro-prudential surveillance. The new regulator would work closely with the Fed and the functional regulators (notably the FDIC, the SEC, the CFTC and a new national insurance regulator or oversight board). The new regulator could be closely linked to reinvigorated international regulatory bodies if that became feasible. In our view such a structure stands the best chance of performing well in the real world of banking, financial markets and political economy. In addition the new regulator would liberate the Federal Reserve to pursue its primary function as an independent institution created to execute monetary policy and act as lender of last resort function.

The Crisis - Aftermath

Twenty months after the onset of the financial crisis, the public guarantee of the liabilities of large financial institutions continues to overshadow financial markets and distort the allocation of capital and competition among financial intermediaries. Taxpayer support has been important to these institutions as they work themselves out of the crisis, and it is not our goal to question

the decisions made to provide it. But government support has severely distorted incentives and decision making. At the moment it is putting the weakest institutions at a disadvantage and providing a windfall to the strongest players, severely distorting the financial marketplace. This distortion will eventually come at a high cost to the economy.

In June 2009 the Administration announced a package of proposed regulatory reforms and new measures to deal with systemic risk. These proposals would apply tough new requirements on the quantity and quality of capital, leverage and liquidity to both banks and nonbanks. Financial firms would be free to choose their business models, but if they are deemed systemic they would come under the new rules. The idea is to sufficiently suppress systemic risk through rules and monitoring, so that the probability of having to use the public safety net will be reduced. The value of the implied guarantee for systemic risk - and its distorting effect on markets and capital allocation - would disappear under these proposals. But it was clear from the start that the success of this approach will depend on the government's ability to install and enforce effective new rules through effective regulatory agencies for a wide variety of different types of institutions. This is a tall order, given that regulators have had a dismal record of preventing crises through the enforcement of rules in the existing regulatory structure.

An alternative to the Administration's approach, championed for example by former Fed Chairman Paul Volcker, would narrow the scope of any implicit government guarantee of financial intermediaries only to commercial banking and client-driven investment banking. It would disavow guarantees for other types of financial institutions such as investment banks, insurance companies or investment companies like hedge funds. If these ideas are implemented in lieu of the Administration's plan, the moral hazard of a government safety net would be limited to a relatively small number of important financial institutions (both highly specialized and more diversified) rather than extended across the entire spectrum of financial intermediaries. Banks would be transformed into low-risk public utilities, and nonbanking activities such as proprietary trading, principal investing, commodity speculation and running in-house hedge funds would be carried out in nonbank firms which would not be entitled to the implicit safety net and would have to manage themselves prudently in the absence of any assurance of a government bailout if they ran into trouble. It does not imply that these remaining institutions could not be systemically risky. But, that would be addressed by having procedures for the orderly failure of non-banks and their supervision by competent, dedicated functional regulators without resorting to taxpayer support.

This approach would greatly simplify the challenge of effective regulation. The argument is that the more focused the regulatory targeting, the more successful the regulator in understanding what's going on and verifying regulatory compliance, whether or not the firm is systemic. Under such a system the FDIC would be the lead regulator for institutions having commercial banks at their core, the SEC for investment banks, hedge funds, mutual funds and other specialized intermediaries as well as key markets, and ideally a new national insurance regulator for the life and non-life insurance industries. Such a structure would require a council of regulators and would not preclude regulatory oversight at the state level, especially given the success of the states in surfacing issues that federal regulators have missed in the past and benefiting from a certain degree of regulatory competition.

We assume, given the current proposals under discussion in Congress that the option just discussed - the simpler one from the perspective of institutional design - will not be enacted. Consequently our comments will focus on how to regulate systemic financial conglomerates that will potentially be active in all aspects of financial intermediation – and that will continue to consolidate, become more complex and grow in size in proportion to the national economy, and therefore pose even greater systemic risk that they already have. .

Current Proposals

The House of Representatives recently passed the legislation (HR 4173, the *Wall Street Reform and Consumer Protection Act of 2009*) that provides that the Federal Reserve take a lead role in overseeing large financial firms regardless of their institutional structure and, if necessary, intervene in those whose failures pose a risk to the economy. It imposes fees on financial firms that would be pooled in a "systemic resolution fund" to cover any bailout costs incurred by the government.

Reform proposals under consideration in the Senate (*Restoring American Financial Stability Act*) would strip the Federal Reserve of proposed authority to supervise and restructure the nation's biggest banks and financial firms. It would consolidate regulatory authority in a single national bank regulator, replacing most bank regulatory powers held by the Federal Reserve and the Federal Deposit Insurance Corporation and eliminating the Office of the Comptroller of the Currency and the Office of Thrift Supervision.

Both the House and Senate bills support the creation of a new regulatory oversight council, composed of existing regulatory agencies, to monitor and create rules for large firms with more than \$10 billion in assets. The Senate bill proposes that the oversight council be headed by a presidential appointee who is subject to confirmation in the Senate, while the House bill provides that the Treasury secretary chair the council. The Senate bill would also alter the funding of the Securities and Exchange Commission in order to give it a "self-funding" structure to provide more resources to detect fraud.

Evaluation of Current Proposals

The House bill requires that Congress legislate new powers to the government to take over failed non-banking financial institutions, and that this power be vested in the Federal Reserve, in agreement with the Administration's proposals, subject to oversight of a committee of senior officials. It is hard to imagine a more complex and politicized task, starting with severe reluctance on the part of Congress to further enhance the Fed's already vastly expanded powers and entrust it with monitoring and controlling an array of new, complex risks which have heretofore successfully eluded its scrutiny.

Neither the House nor the Senate bills anticipate any line-of-business restrictions or activity carve-outs, but instead envisage that enhanced risk limitations can be successfully imposed and enforced by the functional and systemic regulators. The danger is that the rules may end up being too weak, or too complex to be enforced effectively, or too easy to end-run in a political environment where the regulators themselves are captured by those they are supposed to

regulate. Or the regulation may turn out to be too restrictive for bank-based financial conglomerates to be able to compete successfully in the capital markets and related financial businesses, which could deprive them of their competitive advantages. Getting the balance right is tricky if not impossible.

There are significant measurement problems for systemic supervision. Which metrics will be used to define systemic risk exposure, and how might these metrics be “gamed?” This is a significant issue in implementing any kind of regulation. In the run-up to the recent crisis, banks and nonbank financial firms were able to “game” the prevailing metrics, and the regulators either acquiesced or failed to realize what was happening. The general philosophy was rooted in the Basel II risk-based capital ratios, adopted after eight years of wrangling among regulators, which turned out to rely excessively on flawed internal risk models, assigned the wrong capital weights on what emerged as troubled asset classes, failed to deal with effective stress-testing of credit portfolios, and omitted a key focus on market risk and liquidity risk. Whatever could go wrong with Basel 2 ended up going wrong -- although the US was spared some of the damage by not adopting the Basel 2 standards because of concerns on the part of the FDIC.

Going forward, the cohort of systemic financial firms will not be very large in number (perhaps 15 to 20 firms in the US, perhaps 30 worldwide), but it will require a group of smart, well-trained and well-paid regulators to control them. Qualitative measures related to issues such as risk control capabilities, risk-based incentives, and the adequacy of corporate governance practices together with the appropriate quantitative indicators might be enough to get an agreement that is acceptable internationally. Time will tell.

Recommendation

In the absence of functional separation or carve-outs of highly risky financial activities that pose a threat to conglomerate financial firms whose failure would injure the integrity of the financial system, a powerful regulatory capability is essential. The crisis has shown the inability of managerial self-regulation, proper corporate governance, industry self-regulation and market discipline to successfully contain the systemic risk, and it is too late to argue that lessons have been learned to make sure that firm-level and system-level risk management works better next time. And, there will surely be a next time. Once large risks have been socialized, the public has a right to affect the terms and conditions under which risks are engaged going forward.

We favor material reform and strengthening of functional regulation in the commercial banking, investment banking, asset management and insurance sectors to effectively incorporate systemic threats posed by specialized but systemically-sensitive financial firms. This includes hedge funds and insurers, including the creation of a national insurance regulator. With the exception of the latter, this would mainly involve significant beefing-up of the existing functional regulators – the FDIC, the SEC / CFTC – with clearly delineated flows of information and accountability for systemic risk dimensions. The latter would be the key responsibility of a new systemic risk regulator, uniquely responsible for large financial conglomerates as well as (together with the responsible functional regulators) any specialized financial firms whose failure is judged to pose a systemic threat. The systemic risk regulator would also be responsible for assessing aggregate sources of risk developing in the system, in close cooperation with the Federal Reserve. The

systemic and functional regulators, along with the Federal Reserve and the Treasury, would comprise a regulatory council which would create an emergency response system including contingency planning, backup options and failure resolution capabilities including living wills.

We do not believe the Federal Reserve should serve as the new systemic risk regulator. We believe central bank monetary policy independence is a valuable asset that favors long-term economic performance. Micro-prudential activity on the part of the central bank invariably undermines that independence and the Federal Reserve, however necessary its crisis interventions may have been, will have a hard time winning it back. Assigning a micro-prudential role to the Federal Reserve runs the risk of hijacking monetary policy in times of stress, and the market will expect this to happen – making sound monetary policy much more difficult to achieve and creating large doses of moral hazard in the system. Nevertheless, close cooperation with an independent systemic risk regulator through a systemic risk council could influence Federal Reserve Policy targeting to prevent incipient crises.