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Some Thoughts on US Financial Reforms

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Macroeconomic Dilemmas and Financial Regulation Challenges
For Europe, America and the World"

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The financial system around the globe faces massive changes to its regulation. Although it seems fashionable for virtually everyone outside of government to talk down the financial reforms that have been agreed upon to date, my own view is that a great deal of progress has been made and the world will be a considerably better place for it. Although there are certainly flaws in the reforms, too many of the complaints seem to be based on an unrealistic view of what regulation can achieve. There will always be booms and busts in the financial world and some of the busts will merit the label "crisis". Realistically, the job of policymakers is not to stop the cycle, which is impossible, but rather to minimize the frequency and severity of the crises and to insulate the real economy as much as reasonably possible from the problems that hit the financial economy. In my view, the combination of legislation and regulatory changes gets us about two-thirds of the way from where we were, which was deeply flawed, to where we should be. In the real world, I consider that to be a real achievement. It is not easy to reform a major part of the economy, especially not in a country like the US which is so prone to political gridlock these days.

The US financial reforms fall into three categories. First, the Dodd-Frank Act became law in the summer of 2010. This was the biggest revision by far to US financial regulation since the Great Depression and changes the law in a wide range of areas. Second, Dodd-Frank, despite its 2300+ page length, left a great amount to regulatory discretion. As a result, US regulators are extremely busy developing rules and policies in time to meet the ambitious deadlines set by Congress. Third, the US will also be implementing regulations stemming from the "Basel III" agreement on global regulatory standards that was just negotiated at the Basel Committee on Banking Supervision and ratified by the G-20 heads of government this month.

Before reviewing the regulatory changes, it is worth examining what they are trying to accomplish. Almost all of the changes are intended to eliminate problems that became apparent in the recent financial crisis, although a few items relate to potential problems that did not appear this time, but could be part of a future crisis. However, there are multiple views of what was at

the core of the financial crisis. Oversimplifying for the sake of clarity, there are three broad narratives of the origins of the financial crisis[1]:

Flawed incentives and structures in financial institutions and markets. Policymakers, along with the media and the general public, have focused principally on problems on Wall Street and its counterparts in The City and other major financial centers. Greed, arrogance, and even the stupidity of financial executives have been major themes in the popular press although more sophisticated analyses have tended to focus less on personalities and more on the incentives that led the financial industry to take excessive risks.

Four sets of incentive problems particularly stand out:

Banker bonuses. Financial executives generally receive the great bulk of their compensation in the form of discretionary bonuses that are tied to annual profits. This creates a financial incentive for investment professionals at these firms to take positions that generate short-run profits in most years even if they are prone to occasional disastrous years in which all the "profits" are given back. Similar incentives affect the CEO and other senior executives, although this is mitigated by their large holdings of company stock.

Excessive leverage/insufficient capital. Top executives in the banking industry were pushed by numerous incentives to take on more asset risk with less capital and more debt. A similar pattern occurred in regard to liquidity management, with cheaper, but riskier, short-term funding sources increasing significantly in importance. As noted, compensation was so high in good years that it discouraged a real focus on the potential for bad years. Further, stock market investors rewarded risk taking while bond market investors did little to push back, partly due to the expectation that the government would not allow failures of major institutions.

Business model focused on origination to distribute. Key parts of the financial markets developed in ways that gave the originators and structurers of credit products the incentive to create packages of investments with considerably more risk than they appeared to have on the surface. For example, the "originate to distribute" model of mortgage banking produces incentives for financial institutions to make loans that are quite risky, as long as the risk is not obvious and they will appear to perform well in the short run. If a lender can make a loan and then package it together with other loans and sell it on in securitized form at a profit, then there is a strong temptation to loosen lending terms in order to maximize the volume on which intermediation profits can be earned. This has been blamed as a key factor driving the vast quantity of excessively risky subprime loans made at the height of the housing bubble. A similar

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[1] A longer explanation of these points is available in a paper that I co-authored with Martin Baily, available at http://www.brookings.edu/papers/2009/1123_narrative_elliott_baily.aspx . I recently wrote a report for the Atlantic Council and Thomson Reuters that followed along these same lines and have used some of the wording in this paper. That report can be found at http://www.brookings.edu/reports/2010/1007_atlantic_council_elliott.aspx

logic led Wall Street to create ever more complex bundles of risky investments that they could sell on in the form of Collateralized Debt Obligations (CDO's) or other securities.

Credit rating agency conflicts. Credit rating agencies have an inherent conflict of interest in their business of rating securitized products, which gave them an incentive to hand out excessively high ratings. For decades, the rating agencies have been paid by the issuers of securities and not by the investors who rely on the accuracy of the ratings, since charging investors runs into a severe "free rider" problem because ratings information is easy to obtain and to pass on. This conflict seemed manageable for corporate bond ratings, since the volume of issuance was determined largely by borrowing needs rather than the level of the credit ratings. After all, the agencies had a long-term business interest in maintaining the credibility of their ratings, which is their main selling point. However, the size of the securitization market is heavily dependent on the ability to obtain "AAA" ratings, since a large segment of the investor base will not buy securitizations with lesser ratings, unlike corporate bonds where there is a robust market for all levels of creditworthiness. Therefore, the rating agencies found themselves with a strong financial incentive to issue their top ratings, which would result in a large volume of issuances on which they could charge fees. Many observers believe that the rating agencies became far too lax in their ratings methodologies as a result of this perverse incentive and that Wall Street firms put great effort into taking advantage of, and encouraging, this laxness.

Failed government interventions in the financial markets. It was not just the private sector that sowed the seeds of the crisis; flawed government policies were also at fault. In the most extreme form, some conservative commentators paint the crisis as essentially the result of the bursting of a massive housing bubble in the US which then had disastrous knock-on effects, given the centrality of housing in the financial markets and the economy as a whole. These critics believe that excessive government encouragement of home ownership and the use of flawed structures to achieve this were the major factors behind the housing bubble.

This extreme version of the argument almost certainly goes too far. It gives too much weight to the housing bubble, while ignoring many other market and economic excesses, ignores private sector incentives unrelated to government actions, and ignores global problems that were unrelated to the US housing bubble. Nonetheless, government incentives in the US were clearly a major contributor to the crisis.

Fundamentally, US government policy has strongly encouraged home-ownership for decades, including through favorable tax treatment of mortgages and of capital gains on house sales. This emphasis became even stronger under Presidents Clinton and George W. Bush, as a result various government actions helped produce ever higher homeownership rates in the US. It is clear, in retrospect, that the rates became unsustainably high. There are, after all, many people

whose economic and other circumstances make homeownership too risky or unwise, given the mortgage debt load that would be required.

One of the more powerful ways in which the US aided housing was by allowing Fannie Mae and Freddie Mac to borrow with an implicit government backstop and to do so in an unsound manner, with too little capital and too little diversification. In addition to the risks created for the financial system from having these extreme cases of "too big to fail" institutions, the government directed their activities in a manner intended to ensure that they provided particular help to certain riskier classes of borrowers. Some observers have argued strongly that the way in which this was done was a major support for the unsound lending practices that arose during the housing bubble. Many of these same observers contend that the large banks were forced in a similar risky direction by provisions of the Community Reinvestment Act.

The US government, along with others, is also often blamed for creating serious "moral hazard" issues by appearing to stand behind the largest financial institutions, come what may. If creditors of these institutions believe that they will be rescued by the government if disaster strikes, then they lose much of their incentive to differentiate between riskier and less risky borrowers. The existence of moral hazard would help to explain why banks and other financial institutions were able to lever up and otherwise increase their risk-taking without suffering any serious increase in the borrowing costs demanded by investors. Given the highly levered nature of financial institutions, such a rise in borrowing costs would have been a strong disincentive to take excessive risks, since it would crimp profits significantly.

Finally, poor government regulation and supervision have been identified by many as exacerbating the crisis. Although the private sector must take primary blame for its own mistakes of judgment and excessive risk taking, it is the role of regulators to spot systemic risk arising from these choices. To the extent these problems were spotted, regulators were quite ineffective in stopping the risky actions. For example, regulators did little to force the industry to bolster what turned out to be quite insufficient levels of capital. Nor did they step in to use their authority to halt risky types of mortgage lending. For that matter, important parts of the financial sector were allowed to develop with little or no regulation, such as in the area of derivatives and in the growth of the "shadow banking" sector.

A severely lessened focus on risks after decades of favorable market conditions. Another, complementary, explanation of the financial crisis focuses on the behavioral aspects of finance. All of the entities in the financial and housing markets are run by human decision-making. As such, they are prone to periods of excessive optimism and excessive pessimism. It is not surprising that a quarter century of favorable financial market conditions would lead to quite excessive optimism that would be reflected in a near-universal failure to fully observe risks and a tendency to minimize the importance of those risks that were not ignored altogether. It is worth

remembering that the US stock market bottomed out in 1982 at a level of 800 on the Dow and went up by a factor of close to twenty times over the next quarter of a century. Most other financial and real estate investments did exceptionally well over that period, as long as they were held through the relatively brief downturns. Similarly, the economy as a whole did so well for much of that period that the term "the Great Moderation" was coined to describe how favorable government policies and benign markets had tamed the worst aspects of the business cycle.

In this favorable environment, it is easy to see why virtually every group became lax about risk. Wall Street and its foreign counterparts loaded up on risky investments, regulators and rating agencies remained more conservative than Wall Street but not nearly as vigilant as they should have been, policymakers encouraged or allowed risky actions, and individuals collectively took on considerably too much risk in both the housing and equity markets.

These three broad views of the principal causes of the crisis can lead to quite different policy recommendations. If perverse government interventions in the housing and financial markets were the central cause, then the main lesson is not to intervene in those ways. On the other hand, if incentives in the financial markets were the key drivers of the disaster then there are a large number of specific actions that need to be taken to fix known weaknesses. The final theory, that crises of some magnitude are inevitable in the long run due to human weaknesses, would suggest that measures need to be in place to minimize the frequency and severity of these crises. This latter theory is complementary to the others, primarily underlining the importance of safety measures rather than allocating the blame between financial markets, regulators, and government policymakers.

In practice, Dodd-Frank focuses almost exclusively on the first narrative, that of bad incentives in the financial markets and the private sector more generally, and does relatively little about the government's own role in unwittingly facilitating the financial crisis. Congress and the Administration have expressed a strong desire to fix the housing finance system in upcoming legislation, which would be a considerable step forward if it actually happens and is sensibly designed. Dodd-Frank did also try to tackle some of the moral hazard issue by making "bailouts" harder to do and less appealing for the rescued institutions.

Dodd-Frank makes changes to a quite comprehensive range of financial regulations, including the following areas:

- Derivatives
- Securitization
- Credit rating agencies
- Compensation and corporate governance
- Capital requirements

- Consumer protection
- Proprietary trading
- Hedge funds and private equity funds
- Expanding the perimeter of regulation
- Limitations on the size and scope of banks
- Ability to intervene with troubled financial institutions
- Management of systemic risks
- Reorganization of regulatory bodies

The wide range of reforms, and the technical nature of many of them, make it too difficult to summarize here. In general, the reforms focus on: increasing the transparency of transactions and risks; better managing the credit risk that parties to derivatives transactions take on due to the promise of the future performance of certain actions; changing the incentives of bankers and rating agencies so that they will be more focused on risks; providing better protection for consumers overall; and giving regulators the ability to intervene more quickly and effectively when large financial institutions run into problems.

The reader can find a relatively detailed summary of US and EU actions in a report that I wrote for the Atlantic Council and Thomson Reuters, available at http://www.brookings.edu/reports/2010/1007_atlantic_council_elliott.aspx The points that I would emphasize here are that the Act changes some aspect of almost every important area of the financial markets and the institutions that participate in them. Further, it directs the various US regulators to fill in a wide range of important detail on which Congress was unable to agree or which were too detailed for it to tackle. It will be difficult to fully judge Dodd-Frank until we see what it looks like after the regulators are done with it. Unfortunately, all of these prospective changes create considerable uncertainty which has been blamed as one of the causes of low business confidence dragging down the economy. However, this level of uncertainty was virtually inevitable given the depth of the financial crisis and the need to revise so many different aspects of regulation.

The US has also participated in the negotiations at the Basel Committee on Banking Supervision as it designed new rules on capital and liquidity requirements for banks, following the direction of the G-20 heads of government given in 2009. These rules should make banks quite substantially safer by requiring them to have significantly more funds from shareholders to back up the risks they take. Rules will also be put in place to require banks to keep more cash on hand and securities that can be readily converted to cash without “fire sale” losses in a financial crisis.

Some in the banking industry have argued that the Basel III rules go too far, substantially increasing the costs of running a bank and that these costs will be passed on to borrowers and other customers, slowing the economy significantly. Directionally, these arguments are clearly

correct, since the increased safety will come at a cost. However, detailed neutral analyses, including my own, have almost universally concluded that the costs are not that high and are more than justified by the benefits of greater stability. This makes intuitive sense when one considers the terrible economic losses created by the recent financial crisis. Even if these are relatively rare, it is worth quite a lot to minimize their frequency and the damage they do.

As noted earlier, I believe that the legislative and regulatory changes do considerably more good than harm and are of real value even though they do not solve all the problems and there are flaws in some aspects that will make specific things worse. (I am a strong opponent of the Volcker Rule, for example, which I think does economic harm without providing any significant increase in safety, due to a misguided approach to constraining investment risk.) Regulation will never be perfect, but I think where we are heading will represent a considerably better balance than where we started.