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Strengthening and Streamlining Prudential Bank Supervision

Martin N. Baily

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Introduction

There are a number of causes of the financial crisis that has devastated the US economy and spread globally. Weakness in financial sector regulation was one of the causes and the proliferation of different regulators is, in turn, a cause of the regulatory failure. There is a bewildering, alphabet soup variety of regulators and supervisors for banks and other financial institutions that failed in their task of preventing the crisis and, at the same time, created an excessive regulatory burden on the industry because of overlapping and duplicative functions.

We can do better. This paper makes the case for a single micro prudential regulator, that is to say, one federal agency that has responsibility for the supervision and regulation of all federally chartered banks and all major non-bank financial institutions. There would still be state-chartered financial institutions covered by state regulators, but the federal regulator would share regulatory authority with the states.

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The Objectives Approach to Regulation

The Blueprint for financial reform prepared by the Paulson Treasury proposed a system of objectives-based regulation, an approach that had been previously suggested and that is the basis for regulation in Australia. The White Paper prepared by the Geithner Treasury did not use the same terminology, but it is clear from the structure of the paper that their approach is essentially an objectives-based one, as they lay out the different elements of regulatory reform that should be covered. I support the objectives approach to regulation.

There should be three major objectives of regulation, as follows.

- To make sure that there is micro-prudential supervisions, so that customers and taxpayers are protected against excessive risk taking that may cause a single institution to fail.
- To make sure that whole financial sector retains its balance and does not become unstable. That means someone has to warn about the build up of risk across several institutions and perhaps take regulatory actions to restrain lending used to purchase assets whose prices are creating a speculative bubble.
- To regulate the conduct of business. That means to watch out for the interests of consumers and investors, whether they are small shareholders in public companies or households deciding whether to take out a mortgage or use a credit card.

In applying this approach, it is vital for both the economy and the financial sector that the Federal Reserve has independence as it makes monetary policy. Experience in the US and around the world supports the view that an independent central bank results in better macroeconomic performance and restrains inflationary expectations. An independent Fed setting monetary policy is essential.

An advantage of objectives-based regulation is that it forces us to consider what are the "must haves" of financial regulation—those things absolutely necessary to reduce the chances of another crisis. Additionally we can see the "must not haves"—the regulations that would have negative effects. It is much more important to make sure that the job gets done right, that there are no gaps in regulation that could contribute to another crisis and that there not be over-regulation that could stifle innovation and slow economic growth, than it is that the boxes of the regulatory system be arranged in a particular way. In turn, this means that the issue of regulatory consolidation is important but only to the extent that it makes it easier or harder to achieve the three major objectives of regulation efficiently and effectively.

For objectives-based regulation to work, it is essential to harness the power of the market as a way to enhance stability. It will never be possible to have enough smart regulators in place that can outwit private sector participants who really want to get around regulations because they inhibit profit opportunities or because of the burdens imposed. A good regulatory environment is structured so that people who take risks stand to lose their own money if their bets do not work out. The crisis we are going through was caused by both market and regulatory failures and the market failures were often the result of a lack of transparency ("asymmetric information" in the jargon of economics). Those who invested money and lost it often did not realize the risks they were taking. To the extent that policymakers can enhance transparency, they can make market forces work better and help achieve the goal of greater stability.

Having a single micro prudential regulator would help greatly in meeting the objectives of regulation, a point that will be taken up in more detail below. It is not a new idea. In 1993-94, the Clinton and Riegle proposals for financial regulation said that a single micro prudential regulator would provide the best protection for the economy and for the industry. In the Blueprint developed by the Paulson Treasury, it was proposed that there be a single micro prudential regulator.

The Main Regulators and Lessons from the Crisis

The Office of Thrift Supervision (OTS) is the federal regulator for thrift institutions, but became a principle regulator for entities such as WaMu, IndyMac and AIG, which purchased a thrift institution to use as its platform the issuance of huge volumes of credit default swaps (CDS). It seems that some institutions that wanted to engage in risky activities deliberately bought small thrifts so that they could be supervised by the OTS.
The Office of the Comptroller of the Currency (OCC) regulates and supervises all national banks and their branches and agencies of foreign banks in the United States. While OCC has had fewer dramatic failures than OTS, there have been a number of problems in OCC banks. OCC regulated banks bought billions of dollars of collateralized debt obligations (CDOs), putting many of them into off-balance-sheet entities and endangering the institutions they supervised. The OCC has been the main effective regulator for the large global banks. They are the place where the greatest expertise has resided for supervising large banks has resided historically. They know the big banks and their operations—but they did not stop the crisis.

The FDIC currently is the primary federal supervisor for state "nonmember" banks -- a little over 5,000 state-chartered commercial and savings banks. It shares exam responsibilities with state regulators for these banks. Views on the performance of the FDIC as a supervisor and regulator are mixed with some key failures. The FDIC also insures the deposits of all national banks, state banks, and savings associations (thrifts); has backup examination authority for troubled institutions regardless of charter (in order to protect the insurance fund); and is responsible for resolving all failing banks and thrifts. In general, FDIC has done a good job in resolving the failures experienced in this crisis among small and medium-sized banks. The FDIC does not have the personnel or expertise to supervise large complex global financial institutions. Its strength has been in small and medium-sized banks. Another important feature of the FDIC is that it is focused on one particular goal—protecting consumer deposits and preserving the fund paid for by the banks that provide this protection. It was not set up with an incentive to encourage innovation or a growing globally competitive financial sector that adds to GDP growth.

Individual state regulators have shared supervisory authority with the Federal Reserve and the FDIC for banks that are state chartered. State regulators also supervise non-bank financial institutions and during the period leading up to the crisis, some state chartered non-bank institutions issued large volumes of mortgages that they quickly resold for securitization. They were not members of the Federal Reserve system and did not have FDIC insured deposits, so state regulators were their only monitor. While some state regulators have a fine record, institutions in this class have been a major source of trouble in the current financial crisis. Often working with brokers, they originated many of the subprime mortgages and also prime and jumbo mortgages that have subsequently defaulted. They provided the initial funding for mortgages, but then quickly sold them to other entities to be packaged and securitized into the notorious CDOs that were sliced and diced and resold with high credit ratings of dubious quality. They made money by pushing mortgages through the system and did not carry risk when these mortgages defaulted. Some (many) state regulators failed to control bad lending practices.

The Federal Reserve is the regulator and supervisor for all bank holding companies, which include the large money center banks and also a lot of small bank holding companies around the country. As is well known, several of the bank holding companies under Fed supervision have faced severe problems in the crisis. The Fed, of course, is also the lender of last resort to financial institutions and has provided greatly enhanced credit guaranties and facilities to the financial sector in response to the crisis. The Fed, in addition to its role as holding company regulator, is the primary federal supervisor for roughly 850 state "member" banks. Like FDIC, it shares exam responsibilities with state regulators. OCC supervises roughly 1,500 national banks and

OTS supervises about 800 savings associations (thrifts).

I have expressed publicly my admiration for the job that Ben Bernanke has done in managing this crisis. Under great stress, he has prevented financial collapse and set the stage for recovery, working closely with the Paulson and Geithner Treasuries and with his own talented colleagues and staff. Taxpayers are understandably angry because of the funds that have been spent or put at risk in order to preserve the financial sector, but the alternative of a more serious collapse would have been much worse. The historical experience of financial crises here in the United States and around the world is that a banking collapse causes terrible hardship to the economy -- the current recession would have been even worse with a full-on financial crisis. Bernanke helped avoid that disaster scenario.

In its role as a regulator of bank holding companies, the record of the Fed is not so good. Bank regulation has been something of a poor relation at the Fed compared to the making of monetary policy. The Fed as an institution has more stature and standing than any other federal financial institution, but this stature is based on its control over monetary policy, not on its role in bank supervision and regulation. In addition, the Fed's powers were limited. It could not gain access to key information from many large financial institutions and had no power to regulate them. Lehman and Bear Stearns are two examples. The Fed has increased its knowledge and understanding of the large banks as a result of managing the crisis and conducting the stress tests.

The Securities and Exchange Commission has responsibilities towards all public corporations, including their reporting requirements and code of conduct. It had the main regulatory and supervisory authority for safety and soundness for broker dealers and investment managers (the insurance industry is state regulated). There are many talented individuals at the SEC, but the institution did an abysmal job in this crisis. It told the public that Bear Stearns was fine shortly before the company failed. It did nothing to restrain the credit agencies from hyping the ratings of CDOs. It did not stop Madoff from defrauding investors. The leadership has changed at the SEC and I believe it has learned important lessons from the crisis. It will certainly have to prove itself in the future, however, given its failures during the crisis.

One important point about regulating the large financial institutions is that they are run as single businesses *and it would make sense to have them regulated by a single prudential regulator*. They decide what their business strategies will be and how to execute them most effectively. The specific legal form they choose is based on what they think will work best to achieve their strategic goals, given the regulatory and legal environment that policymakers have set up. Under the current regulatory system, the Fed supervises and regulates the bank holding companies while, for example, the OCC supervises the US banks that are the subsidiaries of the holding company. Most of the large financial institutions are in several lines of business and, at present, are regulated by more than one agency. Inevitably, this encourages them to shift activities to the subsidiary and hence the regulator that is most tolerant of the activity they want to pursue.

Until recently, the Fed was actually prevented from acquiring information about the subsidiary institutions of bank holding companies, which meant in practice that the Fed was not doing much regulation or supervision at all. It was just checking over the holding companies. That situation has now been revised to give the Fed greater access to information, but it is a mistake to believe that the Fed has built up an historical legacy of prudential supervision of large financial institutions. It has not.

This short summary is not inclusive. There are credit unions that have a separate regulator and there are important issues around the GSE's and their regulation and around derivatives and their regulation. But with limited space I will restrict myself to a discussion of the above six entities (counting state regulators in one bucket). This review has been critical of the regulatory agencies but I want to note that there are many people to blame for the financial crisis, including bankers who took excessive risks and failed to do due diligence on the assets they purchased. Economists generally did not predict that such a severe crisis was possible. Very few people saw the possibility of a 20 percent or more decline in the price of housing and almost nobody saw the depth of problems that have resulted from the housing collapse.

What Structure Best Meets the Objectives of Financial Regulation?

Regulatory Performance Must be Improved Regardless of Where it is Done

There must be improved performance in the supervision and regulation of financial institutions regardless of who is doing it. This means there should be more accountability for regulators, so that they are censured or removed if they do not perform the role they were hired to do.[1] It means they should be better paid. It seems paradoxical to reward a group that did not do so well, but if we want better regulators then they must receive salaries that make their jobs attractive to high quality people, those who can understand complex institutions and products. Adequate training must be available. Better quality regulation is a "must-have" of financial reform and must be part of the legislation now being considered. And a lot can be done even under existing legislation if regulators are more aggressive in protecting Americans from instability.

Some people argue that regulation has been the cause of the problem and that if the government were removed from the equation then the financial sector would regulate itself, with weak companies failing and the strong companies surviving. There is a logic behind that view and I am generally a strong supporter of letting markets work. Bitter experience has taught, however that an unregulated laissez-faire solution does not work for the financial sector. There need to be clear rules of the game that restrain the excesses that lead to crises. Further, those who oppose government intervention in the economy make a mistake if they leave us with the worst of both worlds: A situation in which the government provides a safety net for consumer deposits and props up banks in a crisis, but then does not provide effective high quality regulation that will prevent future crises or limit their damage.

The Case for a Consolidated Micro Prudential Regulator for the Financial Sector

A single prudential regulator would become a powerful institution with stature in the policy community that could hire talented staff and attract strong and able leadership It would be formed by drawing together the best people from the existing supervisors and regulators in the OCC, the OTS, the SEC, the FDIC and the Federal Reserve, it would hire financial experts in areas where more expertise was needed, and it would be the primary supervisor of the institutions that make up the financial sector of the United States. The head of the organization would be chosen by the President with the consent of the Senate and would serve for a term of several years. It would be worth considering a structure like that of the Federal Reserve, with a board that served staggered 16 year terms. Thus constituted, the financial regulator would have the standing and capability to stand up to the heads of leading financial institutions and to be an independent arbiter. It would be a partner with and advisor to the Administration, Congress and the Federal Reserve.

The financial sector does not stand still. It evolves and innovates and new institutions and products are born. A single prudential regulator with the necessary staff and skills would be best positioned to evolve along with the industry and adapt regulation to a changing world. Having a single prudential regulator would make it much easier to avoid gaps in regulation and discourage the kind of regulatory evasion that contributed to the crisis. It would also reduce the regulatory burden on financial institutions because it would avoid much of the duplication that now exists.

A single prudential regulator would supervise and regulate large institutions and small and be able to maintain a level playing field for

[1] I am aware that civil service rules make it very difficult to replace federal employees. However, there must be a merit-based system for those who work to safeguard the financial sector even if that means making some exceptions to the usual rules.

competition. It would be able to examine all of the activities of the large global banks and make sure they were not accumulating excessive risks through a combination of activities in different parts of their businesses.

There is a great deal to be said for competition in our economy. Ultimately, competition in the private sector drives innovation and growth and provides choices to consumers. It is the lifeblood of our economy. It is not clear, however, that competition among regulators a good thing. The serious danger in regulatory competition is that it allows a race to the bottom as financial institutions seek out the most lenient regulator that will let them do the risky things they want to try, betting with other people's money.

The principle advantage of regulatory competition is that it could make it easier for companies to innovate. A single regulator might become excessively conservative and discourage new products even if these would bring substantial benefits. However, given the experience of the recent crisis, the dangers created by multiple regulators, including a race to the bottom, are greater and outweigh the possible advantages of competition among regulators.

An effective single prudential regulator acting as a cop on the beat could actually increase the level of effective competition among private companies in the financial sector, thus making the private market work better. In addition, it would be very important that the mandate of the single prudential regulator include the promotion of innovation and economic growth. The US financial sector has been one of the strongest in the world and has been one of our major exporters. Prior to the crisis there was great concern that the New York financial markets were losing their global competitive position—see for example the Bloomberg-Schumer report. The goal of sustaining a dynamic and competitive sector remains vital.

Another advantage of creating a single federal prudential regulator is that it would enhance the independence of the Federal Reserve in making monetary policy. It gets the Fed out of the regulatory business and lets it concentrate on its main tasks.

The Role of the FDIC

With a single micro prudential regulator, the FDIC would lose the supervisory and regulatory authority it has now. Staff from the FDIC that have performed well in this crisis would move to the new prudential regulator, so there would not be a loss of knowledge or expertise. The role of the FDIC as manager and supervisor of the deposit insurance fund would continue. In this position, it would also be able to sound warnings about depository institutions in difficulties, acting as a backup for the new unified prudential regulator. Further, I discuss later the possibility that the FDIC would become the principal agency dealing with the resolution of failing institutions.

The SEC as the Conduct of Business Regulator

With the single prudential regulator described above, the SEC would lose its authority to supervise non-bank financial institutions, which would reside instead with the prudential regulator. The SEC would continue to have a very important role as a protector of the interests of shareholders, a bulwark against insider trading, market manipulation, mis-selling and other practices that can undermine our capital markets. There is a case for giving the SEC additional authority to provide consumers protection against financial products that are deceptive or fraudulent.

The Treasury White Paper proposed establishing a brand new agency, the CFPA, to provide consumer protection and it is understandable that such a proposal is made given what has happened. There were a lot of bad lending practices that contributed to the financial crisis. As noted earlier, many brokers and banks originated mortgages that had little chance of being repaid and that pushed families onto the street, having lost their savings. There was also misbehavior by borrowers, some of whom did not accurately report their income or debts or manipulated their credit scores. I agree with the Administration and many in Congress—notably Chairman Dodd—on the importance of protecting families against a repetition of the bad behavior that proliferated in recent years.

However, I urge Congress to consider placing the authority to take on this task in the SEC rather than creating a separate new agency. It is the view of this testimony that the proliferation of regulators was a contributory factor in the crisis, so that adding a new agency is something that should be done reluctantly. While the SEC did badly in the crisis, there has been an important change in leadership and the new head of the agency is clearly someone of strength and talent who has pledged reform in the operations of the agency. Congress should ask the SEC to form a new division within its ranks charged specifically with consumer protection.

Placing the tasks of the CFPA into the SEC would also make it easier to gain acceptance for greater consumer protection from the financial industry. The CFPA has become a lightning rod for opposition to regulatory reform and the "plain vanilla" proposal has become a particular sticking point. I realize that Congress and voters are both angry at the industry and, correctly, blame financial companies for many of the problems we have had. Congress could respond by creating a very activist CFPA, but I advise against that path. The financial industry must be able to provide the products consumers want at a reasonable return and continue to be an important creator of wealth and employment. An overly active CFPA could be counter-productive, discouraging the provision of products that are among the most helpful to poorer families with limited access to credit.

The Treasury is to be applauded for the way it presented its vision for the CFPA as a balanced institution that would not be too restrictive on the industry. Nevertheless, a new consumer protection agency would be a magnet for activists who wanted to provide "protection" without a good understanding of how markets work in practice.

Fighting an endless battle with a financial industry that deeply opposes the package of consumer protection reforms that Congress passes could slow down or derail progress on overall reform and it is not necessary. Having a strong consumer protection group within the SEC would not constitute a capitulation to the financial industry and it would ensure that we do not see a repeat of the abuses of the past.

Another important issue is that of pre-emption. The Treasury proposal indicates that state regulators would have the power to enact consumer protection legislation that was stronger than that in the federal statute. I understand the case for states' rights in this arena, but the prospect of a myriad of different state rules is daunting and has the potential to reduce the efficiency of the massive US marketplace. There has been enormous progress towards a single market in financial products, leveling the playing field for businesses and consumers, so that the terms of loans or other financial activities are the same in all states. Whether or not federal consumer protection rules pre-empt state rules is not a major issue for safety and soundness, but having single set of consumer rule uniform in all states would improve economic efficiency. As a result, I support the view that federal rules would pre-empt state rules in this area.

Regulating State Chartered Financial Institutions

Starting with a clean sheet of paper, I would prefer to see all banks and relevant non-bank financial institutions have federal charters and be supervised by the unified prudential regulator. However, that is not the situation we are in and I recognize the importance of states' rights and the desire to have local institutions that can help local businesses by using the power of personal knowledge and relationships. It is a fact of life that there will continue to be state chartered banks subject to state supervision.

In the short run, it is unlikely that we will see again state chartered non depository institutions that are originating and selling bad mortgages. The markets have been burned and will remember for a while that such institutions may not be selling quality products. Over the years, however, memories will fade and regulatory reform enacted today should avoid problems in the future as far as possible. I urge Congress to require state regulators to partner with the federal prudential regulator in order to harmonize safety and soundness standards and to exchange information for state chartered banks and non banks. The federal prudential regulator should set out minimum standards that it would like to see in state run financial institutions. And state regulators should be required to exchange data with the federal regulator and work in cooperation with them. This is already how

things work for most banks and it is important that we do not see in the future a situation where state charters are exploited by non bank financial institutions to undercut the safety of the financial system.

The Systemic Risk Monitor or Regulator

The Treasury White Paper has proposed that there be a council, an extension of the President's Working Group on financial stability to coordinate information and assess systemic risk. The Working Group has played a valuable role in the past and I support its extension to include the leaders of all institutions with power to regulate the financial sector.

As others have said, however, committee meetings do not solve crises. The strong performance of the Fed in managing this crisis strongly suggests that this institution should be the primary systemic risk monitor/regulator—indeed that is essentially what the Treasury White Paper says. Even if it is no longer involved in the routine supervision of bank holding companies, the Fed can and should expand its mandate to cover systemic risk by creating a division within the organization that is charged with looking over the whole national and global financial system and monitoring for danger signs. The micro prudential regulators will see each institution one at a time, but will not focus on patterns that may be emerging across many institutions or many countries. That is an important job for the Fed and one that is entirely consistent with its role as the maker of monetary policy and the lender of last resort to banks and qualified non-banks.

I am not over-optimistic about the ability of the Fed or anyone else to foresee the next bubble or crisis, but it is definitely worth trying. In particular, the Fed may be able to spot a concentration of purchases of risky assets made with borrowed funds. A systemic regulator could have seen that many banks had lent large sums to long-term capital management (LTCM) to speculate in Russian bonds or other risky assets. It should have been able to spot the build up of risky CDOs in SIVs that were affiliated with the banks. It could potentially see if large hedge funds or private equity companies were using borrowed funds and concentrating on a particularly risk class of assets.

The Fed as systemic regulator would need to work closely with the prudential regulator so that it knows what is going on inside the big institutions, and the small ones. It would also need to work closely with the Treasury and the new stability council, exchanging information with all members that could help it see dangerous trends as they emerge.

An important question is what the systemic regulator actually does if it sees problems. One answer is that it provides warnings to the prudential regulator, the FDIC and other members of the stability council and they take any necessary actions. The Fed also, of course, has the power to control monetary policy and respond by changing interest rates. In addition, I urge Congress also to consider giving the systemic regulator (the Fed in my view) the power to adjust lending requirements or margin requirements. If it seems that a speculative bubble is developing, the Fed could require that purchasers of a class of assets be required to put up at least a given percentage of the purchase price from their own funds. For example, they could require a lowering of the loan to value ratio for residential mortgages if house prices were to form a new bubble in the future. The Fed does have the power to set margin requirements on stock purchases, a power introduced after the 1929 stock market crash.

Making the Federal Reserve the Regulator and Supervisor of Tier 1 Financial Institutions

I have argued in this testimony that a single micro prudential regulator should supervise and regulate all banks and other major financial institutions. However, I noted earlier that it is more important to improve the performance of regulators than to focus on a particular arrangement of the regulatory boxes. The Treasury White Paper proposed that the Fed be the principal regulator of large institutions and many experts whose opinions I trust, including former Fed Vice Chairman Alan Blinder and my Brookings colleagues Robert Litan and Charles Schultze, favor the Treasury's plan. While this arrangement would not be my first choice, I can envisage a successful regulatory reform in which the Fed retains its power to supervise the Tier 1 financial institutions. To repeat myself, it is more important to improve regulation than to fight over who does it.

If Congress decides that the Fed should regulate and supervise large institutions, it would be essential that the capability of the Fed to carry out this task out be strengthened. One member of board of governors, perhaps the Vice Chairman, should be chosen on the basis of his or her expertise in bank regulation and supervision and should be made the head of the regulatory section of the Fed. That section would have to be expanded and strengthened and given a greater status within the overall institution.

One advantage cited for keeping supervisory power within the Fed is that it already has status and power and so it would find it easier to attract the best available people to work there. I have also noted that the Fed has increased its knowledge of the large banks as a result of managing the crisis. Another reason given for keeping supervisory power at the Fed is that it is important to know what is going on inside the banks in order to make monetary policy. A cause of the failures in the UK was that there was poor communication between the Bank of England and the FSA that delayed the response to the problems at Northern Rock.

To me, the advantages to having a single prudential regulator for all covered institutions outweigh the advantages of placing the Fed as the primary supervisor and regulator of large institutions. The single regulator would avoid having duplicative regulatory activities. It would concentrate the best regulatory talent available and create an institution that could attract outstanding people to do a broad and vital job. By getting rid of its regulatory and supervisory role, the Fed can concentrate on the activities in which it has excelled—managing monetary policy and acting as a lender of last resort. The problems that occurred in the UK around Northern Rock could be avoided fairly easily by requiring frequent direct consultation between the Fed and the prudential regulator, as well as through the information exchange provided through the stability council. Parenthetically, even if the Fed were to be the regulator for Tier 1 institutions, there would seem to be no good case for having the Fed continue to supervise the smaller bank holding companies. These should be moved to the prudential regulator.

Another advantage of having a single prudential regulator is that it avoids the task of naming the specific institutions that are Tier 1. The danger in naming a set of institutions that are regulated by the Federal Reserve and that operate under special rules is that we may end up with a whole set of Fannies and Freddies. Regardless of how you judge the role of the GSEs in the financial crisis, we really do not want a lot more of them. We do not want to expand the number of financial institutions that carry an implicit guaranty that they will not be allowed to fail. Taxpayers clearly do not want to carry that burden going forward.

One key point: Whatever Congress and the Administration decide to enact in the way of financial reform, the statutes must make it absolutely clear which agency has responsibility for all the different aspects of regulation, supervision and risk management. A basic goal of regulatory reform is that we avoid the gaps that have contributed to the current crisis.

Resolution of Failing Institutions

The previous section introduced the issue of too big to fail, a topic on which I testified to this committee a short time ago. The question of how large and small financial institutions should be dealt with when they are failing and who should administer the resolution mechanism is too large to be dealt with properly here. In order to exploit the full advantages of having a single regulator, there is a case for giving the resolution authority to the single prudential regulator. Given the successful history of the FDIC in resolving small and medium sized bank failures, however, there is a good case for giving resolution authority to the FDIC, both for small and large institutions. That would require augmenting the capabilities of the FDIC to handle large institutions. I do not have a strong position on which institution should perform this function. I do think it is vital that a resolution authority (or possibly a special bankruptcy procedure) is created for large institutions so that no institution is considered too big to fail under normal economic conditions. The Fed would always play a role in resolution, given its role as a lender to the banks, and it would be deeply involved in the handling of any situation where failure of one or more large institutions threatened the stability of the financial sector.

Conclusion

A single strong agency would meet the objective of micro prudential regulation of all financial institutions that were subject to regulation and supervision. It would work with state regulators, especially to make sure the abuses that contributed to the crisis could not be repeated. It would work closely with the SEC and the Federal Reserve to ensure that consumer protection is adequate, that monetary policymakers are well informed and that all these institutions and the Treasury would work together effectively to deal with a new crisis should it occur in the future.

The Federal Reserve has shown its mettle in managing the crisis and should be given the role of principal systemic regulator or monitor. It would work closely with the members of the risk council in performing this task. It should have some limited power to adjust borrowing rules if it sees a bubble developing based on excessive leverage. The independence of the Fed is vital and I oppose the plan to install the GAO as an auditor of the Fed. That would unsettle markets and is not necessary. The Fed has done an excellent job over many years on monetary policy.[2]

The SEC is a natural home for the consumer protection role now being suggested for the CFPA. The SEC would become the primary conduct of business regulator, with a mandate to protect small and minority shareholders and to protect consumers in financial markets.

Simplifying and streamlining regulation and creating a powerful micro prudential regulator does not require more regulation or more regulators—maybe even the opposite. Under the old system, large financial institutions had legions of regulators, all taking up office space provided by the bank and drawing salaries paid by taxpayers. But they did not prevent the crisis. We need better regulation and regulators who feel empowered to do their jobs. We can achieve that by streamlining the regulatory agencies and hopefully may even be able to reduce the number of regulators by untangling their agencies and organizational structures, and giving the regulators who already have the core competencies the tasks they do well. The changes that are needed must be more than just moving around the boxes.

[2] Some economists blame the Fed for keeping rates too low too long in the run up to the crisis. There is some truth to this, but whatever mistake the Fed might have made, it was not the main or even a major cause of the crisis.

ABOUT THE AUTHOR

MARTIN N. BAILY is a Senior Fellow in Economic Studies and the Bernard L. Schwartz Chair in Economic Policy Development at the Brookings Institution.

Initiative on
Business and Public Policy
at BROOKINGS

The Brookings Institution
1775 Massachusetts Ave., NW, Washington, DC 20036
(202) 797-6000

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