“Preliminary Thoughts on Reforming Financial Regulation”

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Mr. Chairman and Members of the Committee. Past weeks have witnessed historic convulsions in financial markets around the World. The freezing of credit markets and the failure of major financial institutions triggered massive intervention by governments and central banks as they attempted to contain the fallout and prevent total collapse. We are still in damage control mode. We don’t yet know whether these enormous efforts will be successful in averting a meltdown. But this Committee is right to begin thinking through how to prevent future financial collapses and make capital markets work more effectively.

Pundits and journalists have been asking apocalyptic questions, “Is this the end of market capitalism? Are we headed down the road to socialism?” Of course not! Market capitalism is far too powerful a tool for increasing human economic wellbeing to be given away because we used it carelessly. Besides, there is no viable alternative. Hardly anyone thinks we would be permanently better off if the government owned and operated financial institutions and decided how to allocate capital. But market capitalism is a dangerous tool. Like a machine gun or chainsaw or a nuclear reactor, it has to be inspected frequently to see that it is working properly and used with caution according to carefully thought out rules. The task of this Committee is to reexamine the rules.

The essence of market capitalism is that individual incentives for economic gain (sometimes known as greed) can be harnessed to maximize economic growth; channel capital into its most productive uses; and even reduce the risks inherent in economic activity. Yet there are plenty of clear examples of unfettered gain-seeking leading to

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disastrous collective results—greenhouse gas emissions, for example. The answer to such misalignment of individual and collective incentives is not to abolish markets, but to realign incentives so that markets function better in the collective interest. Cap and trade systems for greenhouse gas emissions are an attempt to do just that.

The financial market crisis provides an opportunity to rethink why individual gain-seeking under current rules led to disastrous results and how to change the rules for the future. Getting financial market regulation right is a difficult, painstaking job. It is not a job for the lazy, the faint-hearted or the ideologically rigid--applicants should check their slogans at the door. Too many attempts to rethink regulation of financial markets in recent years have been derailed by ideologues shouting that regulation is always bad or, alternatively, that we just need more of it. The "less" v. "more" argument is not helpful. We don't need more or less regulation; we need smarter regulation.

Moreover, writing the rules for financial markets must be a continuous process of fine-tuning. In recent years we failed to modernize the rules as markets globalized, trading speed accelerated, volume escalated, and increasingly complex financial products exploded on the scene. The authors of the financial market rule books have a lot of catching up to do. But they also have to recognize that they will never "get it right" or be able to call it quits. Markets evolve rapidly and smart market participants will always invent new ways to get around the rules.

Plenty of blame to go around

It is tempting in mid-catastrophe to point fingers at a few malefactors or identify a couple of weak links in a larger system and say, "Those are the culprits; if we punish them, the rest of us will be off the hook." But the breakdown of financial markets had many causes

of which malfeasance and even regulatory failure played a relatively small role. Americans have been living beyond our means, individually and collectively, for a long time. We have been spending too much, saving too little, and borrowing without concern for the future from whomever would support our over-consumption habit—the mortgage company, the new credit card, or the Chinese government. We indulged ourselves in the collective delusion that housing prices would continue to rise. The collective delusion affected the judgment of buyers and sellers, lenders and borrowers, builders and developers. For a while the collective delusion proved a self-fulfilling prophecy—house prices kept rising and all the building and the borrowing looked justifiable and profitable. Then, like all bubbles, it collapsed as housing prices leveled off and started down.

Bubbles are an ancient phenomenon and will continue to recur, no matter what regulatory rules are put in place. A housing bubble has particularly disastrous consequences because housing is such fundamental part of our everyday life with more pervasive consequences than a bubble in, say, dot.com stocks. More importantly, the explosion of securitization and increasingly complex derivatives had erected a huge new superstructure on top of the values of the underlying housing assets. Inter-relations among these products, institutions, and markets were not well understood even by the participants and certainly not by the rest of us. But it is too easy to blame complexity, as in, "Risk models failed in the face of new complexity." Nonsense--too many people failed to asked common sense questions, as in, "What will happen to the value of these mortgage-backed securities when housing prices stop rising and begin to fall?" They didn't ask because they were profiting hugely from the collective delusion and did not want to hear the answers. Bubbles always provide out-sized opportunities for quick profits. They exacerbate greed and fraud and provide excuses for the suspension of common sense. Can we fix this problem by regulation? I doubt it. It is hard to legislate common sense.

What needs to be fixed

Nevertheless, the bubble and the crash were exacerbated by clear regulatory lapses, perverse incentives that had crept into the system, and instances where regulated entities—and even the Federal Reserve--were being asked to pursue conflicting objectives at the same time. These failures present a formidable list of questions that the Committee needs to think through before it rewrite the rule book. Here are some of the items on that list.

Regulatory gaps. The most obvious regulatory gap is also the easiest to fill. We failed to regulate new types of mortgages—not just sub-prime, but Alt-A, no doc, etc—and the lax, sometimes predatory--lending standards that went along with them. Giving people with less than sterling credit access to home ownership at higher interest rates is basically a good idea, but it got out of control. Most of the excesses were not perpetrated by federally-regulated banks, but the federal authorities should have gotten on the case and imposed a set of minimum standards that applied to all mortgage lending. We can argue about what those standards should be, but they should include minimum down payments, proof of ability to repay, and evidence that the borrower understands the terms of the loan. Personally, I would get rid of teaser rates, penalties for pre-payment, and interest-only mortgages. We may not need a national mortgage lending regulator, but we need to be sure that all mortgage lenders have the same minimum standards and that these are enforced.

Another obvious gap poses a far more difficult question: whether and how to regulate complex derivatives? Much of the financial crisis stemmed from over-leveraged unregulated trading in complex financial derivatives. The question is: should we clamp down on the leverage or on the products themselves? I incline to think that we will be more successful if we operate on the leverage by imposing higher capital requirements on all financial institutions that have any claim on federal help if they are in danger of failing. We should also improve the transparency of derivatives, but I doubt it would be useful to screen classes of derivatives before allowing their sale. Charging a regulator

with the task of weighing the risk-spreading value of a class of complex derivatives against the risk posed by the complexity itself strikes me as too hard to pull off.

Perverse incentives. One case of perverse incentives is that the commissions of mortgage brokers are bigger if they bring in higher interest (i.e., riskier) loans. I am not sure how to correct this, someone should be charged with making sure that the borrower understands how the mortgage broker is compensated and encouraged to shop around for a better deal.

Another clear case, it seems to me, is that rating agencies are compensated by the sellers of securities. We should find a way to have rating agencies paid by the buyers of securities instead. This suggestion is often scorned by economists, who say it poses a "free rider" problem, but I think that could be handled by requiring that all investment funds over a certain size pay a small percentage fee to support the services of rating agencies.

A much harder question is what to do about the fact that widespread securitization of mortgages (and other consumer lending) disconnects the lender from the borrower and creates incentives for the lender to ignore repayment risk. Don't worry about the credit-worthiness of the borrower: just make the loan, sell it to someone else and move on. Securitization has many benefits—and we cannot go back to the days when small town bankers were afraid to lend to working people lest a local plant closure wipe out the bank's mortgage portfolio. However, we certainly need to clear up the legal responsibilities of loan originators, servicers, packagers and owners of mortgage-backed securities (MBS). We need to ask whether the social utility of slicing up MBS into risk tranches to be sold to investors with different appetites for risk is worth the confusion that ensues when the loan has to be renegotiated. I would favor giving bankruptcy judges the power to adjust mortgages as they do can do with other debts, but it also has to be clear who is on the other side of the mortgage transaction.

Conflicting incentives.

An example of conflicting objectives that need to be resolved concerns the future role of Fannie Mae and Freddie Mac. These institutions were told that they were private companies whose job was to make money for their shareholders and that they should not expect federal help if they failed. At the same time, they were told to further the public purpose of expanding affordable housing and put some of their profits into revitalizing low income communities. While the collective delusion held, these objectives were compatible. Fannie and Freddie borrowed huge amounts--arguably at marginally favorable rates because lenders did not believe they would be allowed to fail—bought a lot of mortgages, including subprime, made high profits, and supported a lot of worthy projects. But their rapid growth helped fuel the bubble, and when the collective delusion collapsed, they had to be taken over by the government. In the end we will have to decide whether we want Fannie and Freddie to be public utilities supporting the secondary mortgage market or truly private (and presumably much smaller) private entities that disappear into the private financial sector. But that is a discussion for the distant future. Right now we need Fannie and Freddie to provide support for the faltering mortgage market. Debate over their ultimate status will have to wait.

Another example of conflicting objectives is the responsibility of the Federal Reserve to mitigate asset price bubbles. The Fed has clear responsibility for the stability of the whole economy. It must use monetary policy (a limited tool at best) to keep the economy growing at maximum sustainable rates and restrain inflation when it threatens to derail growth. Asset price bubbles pose a difficult dilemma for monetary policy: when should the Fed try to slowdown growth in the whole economy to control an emerging bubble in some class of assets? The Monday morning quarterbacks of monetary policy have criticized the Fed for not raising interest rates in 1997-98 to curb the dot.com bubble. (Have they forgotten that inflation was falling and that the aftermath of the Asian/Russian financial crisis was causing a credit crunch?) Critics also blame the Fed for failing to raise interest rates in 2002-03 and the first half of 2004 to curb the housing bubble. (Have they forgotten the slow recovery from the recession of 2001?) While it is not realistic to expect the Fed to pursue several objectives simultaneously with the one blunt

instrument (the federal funds rate), we certainly need to be more creative about curbing asset bubbles. Maybe we have to invent another instrument specifically aimed at slowing asset bubbles. At a minimum, we could charge the Fed or some other entity with issuing warnings that some class of asset prices is getting out of line. The entity so charged would need strong protection from political interference.

Moving the boxes on the organization chart

My partial list of hard questions does not include a grand new structure of regulatory relationships such on the U.S. Treasury's *Blue Print for a Stronger Regulatory Structure (2008).* There is certainly both fragmentation and overlap in the current structure. State regulation of insurance companies is an extreme example of fragmentation, and the responsibilities of the Federal Reserve, the Controller of the Currency, and the Federal Deposit Insurance Corporation certainly overlap with respect to regulation of commercial banks. Nevertheless, I don't think neatening up the organization chart deserves high priority in a campaign to make regulation more effective. I am skeptical both of the workability of the Treasury's proposal for organizing regulation by objective rather than function and of the British model of centralizing regulation in a separate Financial Services Agency. Rather, I would start where we are and work to clarify and strengthen the roles of the agencies we have. I would beef up the mandate and resources of the Securities and Exchange Commission (SEC) and clarify the role of the Federal Reserve in insuring that bank holding companies manage their risk competently. In this role, the Fed could be required, not just to pose the common sense questions about risk to the executives of financial behemoths, but to meet periodically with their boards of directors to focus their attention on better risk management.

Thank you, Mr. Chairman and members of the Committee.