Douglas J. Elliott
The Brookings Institution
December 7, 2009

Evaluating the U.S. Plans for Financial Regulatory Reform

The Administration has proposed a series of changes to U.S. financial regulation stemming from the financial crisis. This paper describes and evaluates those proposals with a particular eye towards their implications for the regulation of finance in emerging market economies. Before going into the specifics of the reform proposals, I start by reviewing the major explanations of the financial crisis, since they affect the choice of remedies, and then discuss the underlying principles of U.S. financial regulation for which there is broad agreement and therefore little pressure for change. In fact, the consensus on these points is so strong that there is very little discussion of these basics[1].

Views of the crisis and their effect on regulatory reform[2]

People instinctively try to understand complex situations by hanging the facts on a simple story line. For example, America's entry into World War I came to be seen after the fact as the result of financiers looking to protect their loans to Europe and our trade flows. This attitude played a major role in the isolationism that kept us out of World War II until we were actually attacked. Similarly, one of the earliest American theories of the Great Depression was that it sprang from the crash on Wall Street, which came to be associated with financial manipulation by bankers and rich speculators. This created much of the impetus for the separation of commercial and investment banking and the creation of the Securities and Exchange Commission and the associated laws to protect investors. In both cases, there were many complex causes and therefore the potential for alternative story lines to have taken hold which would have led to different legislative outcomes.

---

[1] The author would like to thank the Asian Development Bank Institute, The Brookings Institution, and the other sponsors of the conference on policy responses of emerging markets to the financial crisis for which this paper was originally prepared. The paper will appear as part of a forthcoming book edited by Masahiro Kawai and Eswar Prasad on Financial Sector Regulation and Reforms in Emerging Markets.

[2] This section of the paper draws heavily on previous paper by the author and Martin Baily, "Telling the Narrative of the Financial Crisis: Not Just a Housing Bubble," available at http://www.brookings.edu/papers/2009/1123_narrative_elliott_baily.aspx

We have a great body of facts about the current financial crisis, but do not yet have a consensus narrative about the fundamental causes. In my view, there are three major story lines vying for acceptance:

Narrative 1: It was the fault of the government, which encouraged a massive housing bubble and mishandled the ensuing crisis.

Narrative 2: It was Wall Street's fault, stemming from greed, arrogance, stupidity, and misaligned incentives, especially in compensation structures.

Narrative 3: "Everyone" was at fault: Wall Street, the government, and our wider society. People in all types of institutions and as individuals became blasé about risk-taking and leverage, creating a bubble across a wide range of investments and countries.

I believe that narrative 3 comes closest to the truth and that it matters whether that story line becomes accepted by the public. The best regulatory reforms would fix the wide-spread problems in both the markets and in government regulation. In contrast, public acceptance of narrative 1 would lead to too little regulatory change, while narrative 2 would likely encourage a stifling of markets without fixing the problems inherent in our regulatory structure. My preferred narrative encourages a balanced and comprehensive set of changes.

Caveats and apologies

Postulating simple narratives that may take hold in the minds of the public intrinsically forces one to over-simplify and to ignore the subtleties of the analyses presented by those whose views come closest to these simplistic stories. I do not mean to imply that any of the policy analysts arguing for facets of narratives 1 or 2 fail to understand the complexities of this crisis nor that any of them hold precisely the views described here. In addition, this paper is considerably too short to do justice to those complexities. My colleagues and I have tried to cover some of this ground more comprehensively in several previous, much longer, pieces[3].

[3] Please see Martin Neil Baily, et. al., "The Origins of the Financial Crisis," [add link], and Martin Neil Baily and Douglas Elliott, "The U.S. Financial and Economic Crisis: Where Does it Stand and Where Do We Go From Here?", [add link]

I should also note that I will be using the term "bubble" somewhat loosely, in the manner in which it has come to be used in popular discussion. It will refer to any situation in which asset prices become substantially over-valued as a result of psychological factors, including an unsustainably large decline in the premium investors charge to take on a given level of risk. I generally will not attempt to distinguish between over-optimism about future prospects and a willingness to take a correctly estimated risk for an unusually low premium.

The three story lines

This section lays out the three narratives in greater detail.

Narrative 1: The government created the crisis by inflating a housing bubble and mismanaging the resulting risks and problems, especially in regard to Fannie Mae and Freddie Mac. This narrative is popular among conservatives, particularly since it argues for a smaller increase in regulation than the other story lines.

The core of the story is that the crisis was the result of a housing bubble of unprecedented proportions which wreaked havoc because of the central role of housing in the financial system and the economy. This effect was significantly magnified because Fannie Mae and Freddie Mac were effectively encouraged by the government to take on $5 trillion of housing exposure with minimal capital to cover the risk.

The government bears prime responsibility for the housing bubble because it strongly pushed a substantial increase in home ownership rates. Not only did this encourage millions of families to own homes without having strong enough finances to handle the commitment, but the various methods used to make home ownership easier led millions of others to buy larger homes than they could afford or to speculate by buying houses purely as investments. The massive increase in demand for housing led to sharply higher prices, increasing the risks for everyone who bought at the inflated prices. The bursting of the bubble destroyed so much wealth, especially at financial institutions, that it led to all the other problems of which we are so aware. Proponents of this narrative often accept that there were other financial imbalances and even bubbles, but believe that without the housing bubble the other problems would have been much easier to handle, leading to a mild recession at worst.

Narrative 2: Wall Street created the crisis by reckless behavior, greed, and arrogant belief in its own ability to understand and manage excessively complex investments. These behaviors were encouraged and magnified by perverse incentives that encouraged both wild risk-taking and activity that bordered on the fraudulent or even went well past that border. This narrative is popular with the left wing, but is accepted significantly more widely, including in much of the media.

The housing part of the crisis is viewed as principally resulting from financiers pushing naïve consumers into taking on mortgages bigger than they could handle and which were structured to hide large fees and interest rates that would jump after a few years. Financiers knew the loans were too risky, but did not care, since they could package them into mortgage-backed securities and sell them on to investors who relied on the evaluations of rating agencies that were essentially tools of Wall Street. Financiers further took advantage of the silent complicity of the rating agencies by creating collateralized debt obligations (CDO's) that owned the less attractive parts of mortgage backed securities and even CDO's that owned portfolios of other CDO's (CDO Squareds). At heart, these instruments were meant to obtain excessively high ratings for most of the tranches of these risky instruments in order to sell them to investors who relied almost purely on ratings. However, perverse incentive compensation structures even led traders to commit their own banks' capital to owning many of these risky securities, since in most years they would perform well and produce big bonuses for the traders. The worst that could happen is that a bad year would lead to no bonus, but also no repayment of excessive past compensation.

Outside of housing finance, Wall Street created many other excessively complex financial instruments in the areas of derivatives and securitization, often to give the appearance of holding less capital or more capital per unit of risk. In the end, most of these risks, both those related to housing and those that were not, eventually blew up and created the mess we are cleaning up now.

Narrative 3: Everyone is responsible. Not literally everyone, of course, but virtually every major type of institution and class of people is considered to have failed. Wall Street made the kinds of mistakes and bad actions that lie at the heart of Narrative 2. The government and regulators made the kind of mistakes described in Narrative 1, plus they failed to control, or often even recognize, Wall Street's excesses. The ratings agencies messed up in numerous ways.

Individual consumers and investors as well are hardly blameless in this narrative. Some people were cheating the system by obtaining mortgages under false pretenses or while knowing that they were taking crazy risks, but could always walk away from their tiny equity investments in the houses on which they were speculating. Many other homebuyers willingly accepted the fantasy that house prices could only go up. Similarly, large parts of the middle class over-invested in the stock market, including those who went into retirement with portfolios consisting almost entirely of common stock.

According to Narrative 3, the principal underlying cause of this widespread behavior was a major decline in risk aversion resulting from roughly 25 years of strong performance by the financial markets, encouraged by and associated with the "great moderation" in the macro-economy, whereby business cycles seemed almost to vanish. This showed most tellingly in the stock market. The Dow Jones Industrial Average bottomed out at roughly 800 in 1982 and went up by a factor of almost 20 times over the ensuing quarter of a century. There were a few bumps along the way, such as the Crash of 1987, but the troubles were generally relatively short-term and not usually that severe.

People "learned" that it was good to take financial risks. Not only would one expect on average to be rewarded, as the textbooks tell us, but actual experience showed it almost always paid off much more handsomely and with less pain than the theories said. Individuals learned a similar thing with housing, which did experience some declines but generally produced very satisfactory results. Since homeowners were usually highly levered through mortgage debt, a fairly steady and decent return became a very attractive levered return. The returns on housing, of course, shot up even further as the bubble inflated in the middle of this century.

This decline in risk aversion worked in dangerous combination with the "easy money" conditions of the mid-2000's. Investors working in institutions or acting as individuals found that they could easily fund their purchase of investments whose risk they were significantly under-estimating. The combination was highly intoxicating and seemed to produce great risk-adjusted returns, since the risks were not fully apparent.

Each of these narratives is simplistic, but different players in the political and policymaking process tend towards different story lines, even if no one accepts them as entirely accurate and

all-encompassing. Congressional Republicans tend fairly heavily towards Narrative 1. After all, it has considerable truth, matches their original view of the world, and is politically convenient as a way to oppose the Obama Administration. The liberal wing of the Congressional Democrats leans heavily towards Narrative 2 for similar reasons. There is also considerable truth in this alternative story line, it matches their pre-conceptions, and allows them to align with a populist fury that much of the public feels.

The Administration is made up of many individuals and institutions with diverse and complex views. However, it is probably fair to say that the average view is closer to Narrative 3 than to Narrative 1 or 2, although there are significant aspects of Narrative 2 that color the Administration's proposals. The net result, in my view, is that the Administration is looking for reforms in a wide range of institutions and sets of rules, rather than assuming that there is a clear villain. However, considerably more emphasis is being placed on curbing Wall Street (consistent with Narrative 2) than in reforming the way regulators operate (which would be more consistent with Narrative 1.)

Retaining the basics of regulation and supervision

When officials in emerging market economies examine the moves being considered by other countries, such as the U.S., it is important to note what is not being changed as well as what is. Some of the more important aspects of regulation may be so strongly accepted in a country that they do not really enter into the public debate, which tends to focus on areas of controversy. This section will focus on some of these basic areas of agreement in the U.S.

The most basic point is that the U.S. economy functions on the basis of the rule of law and that regulators are intended to operate within a fairly tight set of legal constraints in order to restrain their discretion and maintain predictability of outcomes. One implication is that there is an implicit separation between "safety and soundness" and consumer protection issues, on which regulators are allowed to intervene, and ordinary business decisions on which they are required to let financial institutions operate as they wish. An important recent example of this relates to the "toxic asset" problem at the banks. It appears that regulators would generally have preferred banks to sell these assets in order to remove their valuation uncertainty, but that many banks were sufficiently sound that they could stick with a business decision to hold these assets and wait for rising prices, since they had the capital to absorb potential further losses. Another implication is that regulators generally do not review individual transactions, but conduct

supervisory exams after the fact to determine if the general approach and situation of a financial institution is sound.

Related to this, there is a strong belief that participants ought to be able to structure financial transactions as they wish, as long as this will not violate laws or specific prudential rules, and assuming that the two parties have relatively equal access to the relevant information to make decisions. This does not preclude a considerable body of laws and regulations intended to protect consumers, which are based on the assumption that financial institutions have much better information than do consumers as well as superior ability to draw conclusions from that information. Nor does this preclude requirements for standardization of certain types of contracts or the outright prohibition of others, where safety and soundness issues enter into the picture. For example, regulators now believe that the huge "over the counter" market in derivatives, particularly credit default swaps, poses systemic risks. As a result, they are proposing requirements to use exchanges or clearing houses where possible for these instruments, as discussed below.

As a related point, the U.S. approach implicitly places considerable emphasis on the avoidance of over-regulation which might hinder efficient operation or useful financial innovations. Even after the deepest financial crisis in many decades, fears of blocking innovation remain a powerful political argument within the U.S. Congress as debate proceeds on financial regulatory reform. This is a sentiment that may not be share in the emerging economies. Even in the U.S., there are some academics who argue that financial innovation has done more harm than good, although this is not a belief that I share.

The U.S. system also places great emphasis on the political independence of financial regulators. There has been a fear that a lack of independence would create pressures to push banks to lend more in total or to lend to politically favored groups or would force regulators to allow unsound behaviors by banks with political clout. In order to avoid this, regulators are substantially shielded from political oversight of their decisions by law, organizational structure, and custom.

In general, regulators and politicians are discouraged from pushing financial institutions to allocate credit in a particular manner, except where it is perceived that there has been discrimination. One of these exceptions is the Community Reinvestment Act (CRA) which was

passed in large part to reduce perceived discrimination against minorities. Governments do provide positive incentives to favor certain types of lending, such as guaranteeing many loans to small businesses, but using the "carrot" of incentives is viewed differently than using the "stick" of regulation.

An implicit, but important, difference between the U.S. and many other countries is that regulators and politicians here are comfortable with a system in which most credit is allocated via financial markets rather than directly by banks. Most countries in the world have financial systems dominated by banks, whereas non-banks and financial markets in the U.S. are substantially larger than the banks. Although this was not necessarily an explicit goal of previous governments and regulators, it could not have arisen without a regulatory system that made it possible.

This touches on another point where there is some debate in the U.S., but little likelihood of action. A few prominent voices, such as former Federal Reserve Chairman Paul Volcker, have called for a division of financial groups between those that do traditional banking and those that perform more risky activities, somewhat similar to the division between commercial banks and investment banks that existed under the old Glass-Steagall law in the U.S. Although this has some appeal for many people, there is no broad support for such a change and it is virtually a dead issue politically. My own belief is that the U.S. financial system is much too complex these days to usefully be able to divide activities into the two groupings. For example, I do not know how to tell the difference between a "loan" and a "security" now that most large loans can be, and are, traded. Without some of these basic distinctions, it becomes impossible to implement a Glass-Steagall like division, even if one felt it were worthwhile. Perhaps it would be more practical in emerging economies which have less developed markets.

Finally, despite the acceptance of a large role for financial markets in the U.S., banks are considered to play a critical role in the economy that cannot be fulfilled easily by other means. This role is important enough that banks have been chartered on a special basis by governments since the founding of the republic. Banks fund themselves in large part by accepting deposits from individuals and companies that can be withdrawn on short notice, but which tend, on average, to remain for much longer periods. The "stickiness" of the deposits allows banks under normal conditions to make loans and investments that are much longer-term in nature than the very short-term legal nature of the deposits. This "time intermediation"

function is important to the economy as otherwise a great deal of savings would have to be employed in such short-term undertakings that it would provide little value.

As a result, banks hold large amounts of funds that individuals and companies cannot afford to lose and to which they could need access on short notice. Prior to the advent of deposit insurance, a bank failure would do immediate harm to the depositors. They would likely suffer losses and often had funds tied up for some time. Even worse, this result was disruptive enough to cause runs on other banks, as depositors who could not be sure of the solvency of those banks would rush to avoid the possibility of suffering a similar fate. In order to mitigate these problems, the U.S., like most other countries, has created a deposit insurance system that is implicitly guaranteed by the government.

In exchange for guaranteeing deposits, the government also stepped in with a wider range of regulation in order to protect the deposit insurance fund. This guarantee role is the implicit or explicit reason for much of the safety and soundness regulation in the U.S., as well as the existence of a specialized insolvency regime for banks. Even before the institution of deposit insurance, the Federal Reserve System (Fed) was created in large part to serve as a lender of last resort which could lend banks funds against solid collateral if they faced a liquidity crisis, such as a bank run. Such a role was not intended to deal with solvency crisis where there would be insufficient good collateral to offer the Fed.

Other financial institutions in the U.S., like money market funds and investment banks, have taken on some of the intermediation role of banks. However, at least until this crisis, banks were treated on a privileged basis in terms of the government efforts to protect their solvency and liquidity.

The Administration’s Financial Reform Proposals

The Administration has offered many detailed proposals for the reform of financial regulation, covering a wide range of topics. The remainder of the paper will focus on what I believe are the key points, including:

- Higher capital requirements for financial institutions
- Stronger liquidity requirements for financial institutions
- A greater focus on systemic risks

- Tougher regulation of systemically important financial institutions
- Expanded “resolution authority” for regulators to take over troubled financial institutions
- Modest consolidation of regulatory functions
- New regulations for securitizations
- New regulations for derivatives
- Stronger consumer protections led by a new Consumer Financial Protection Agency
- Greater international coordination

The process

Before walking through the substance of the proposals, it may be worth reviewing the process that will determine what actually becomes law. In the U.S. system, laws are originated in the legislative branch. This is the Congress, made up of two equal chambers, the Senate and the House of Representatives, each of which must pass an identical bill before it goes to the President, as the head of the Executive Branch, for signature or veto. The Administration’s proposals are suggestions for legislation to be initiated by Congress. In practice, the two chambers are generating their own legislative bills which overlap considerably with the Administration’s proposals, but do differ in significant ways.

In each chamber, the process starts with the appropriate committee drafting and voting on legislation. In the House of Representatives, this is the Financial Services Committee, chaired by Congressman Barney Frank. In the Senate, it is the Banking Committee, chaired by Senator Chris Dodd. After each committee approves a bill, it moves on to the floor of the full House for debate and a vote. The bills passed by the House and Senate will undoubtedly differ, which will require the appointment of a Conference committee, composed of selected members of both chambers, who will work out a compromise bill to propose back to the two chambers. Assuming this compromise bill can generate sufficient support, each chamber would separately approve the measure and it would go on to the President. The President could theoretically veto the legislation and force a new vote requiring a super-majority for passage, but it is virtually certain that the President in this instance would simply sign the measure and it would become the law of the land. President Obama is of the same party as the majorities in both chambers, so there is little likelihood of a reform package out of Congress that is simply unacceptable to the President.

This process is significantly lengthier than the legislative processes in many countries and is likely to take until well into 2010 before it is finished. (The U.S Constitution was designed to force careful deliberation and consensus on important issues, at the expense of speed or certainty of action.)

Higher capital requirements

The current crisis has reinforced the importance of a strong level of capital at banks and other key financial institutions. In purest form, capital represents the portion of a bank's assets on which no one has a claim except the owners of the bank -- the holders of the common stock (or "ordinary shares" as they are called in many countries.) The common stockholders' role is to absorb any losses, in exchange for which they receive any profits. The accumulated value of their original investment, plus any retained profits or losses, is known as "common stockholders' equity."[4] This common stockholders' equity is available to pay for mistakes and misfortunes, which we have vividly seen are a real possibility in this business. The more capital is held, the greater the level of errors and bad luck that can be tolerated.

In addition, certain other types of securities, generally in the form of preferred stock, are also considered capital, usually up to a limited percentage of total capital. (Preferred stock falls between debt and common stock. It has a fixed dividend rate, like debt, but failure to pay the dividend is not grounds to force a firm into bankruptcy. Preferred stock ranks below debt in bankruptcy priority.)

The criteria for being considered capital relate to how closely the instrument mimics the key features of common stock: the residual nature of the claim; the perpetual term of the instrument; and the lack of any requirement to make periodic payments. For example, a junior preferred stock whose claim in bankruptcy ranks below everything except common stock, whose term is thirty years or more, and whose dividend can be skipped without incurring a long-term obligation, might easily be considered a form of capital only modestly weaker than common stock. Please see "Bank Capital and the Stress Tests," http://www.brookings.edu/papers/2009/0303_bank_capital_elliott.aspx , for a more detailed explanation of the various forms of capital and current regulatory requirements.

[4] This can be thought of as the accountants' estimate of the value of the firm's assets that would be left over after all other claims are paid off. However, this value can differ considerably from the actual liquidation value and from the market value of the common stock, since accounting rules are fairly mechanical and backward looking and strive to minimize the role of estimates of future values.

There is a strong consensus, both in the U.S. and internationally, that the recent crisis has demonstrated a need for higher total capital and for more of the capital to be in the form of common stock. There are, however, some who disagree. Generally, they pursue one or both of two lines of argument. First, virtually everyone accepts that higher capital requirements will make lending more expensive for banks, leading to at least a modest increase in loan pricing and corresponding decrease in loan volume. Opponents of higher capital contend that the effect on credit will be too painful to be warranted by what they see as only a small increase in the safety of the banking system. Second, some observers believe that the banks will find ways to "game" the system by use of devices such as off-balance sheet entities which will allow them either to retain most of the risk without raising more capital or to increase their risk-taking in proportion to their new capital, leaving the safety margin no higher than before.

In addition, even advocates of substantially higher capital requirements usually support a significant transition period, so that banks are not forced either to try to raise large sums of capital quickly in these difficult markets or to cut back on their lending.

The Administration has made clear that it supports substantially tougher capital requirements, to be agreed upon by the end of 2010, and implemented by the end of 2012. (Implementation might, of course, include a transition period. The Administration was silent on this.) It has not provided specific suggested changes, but listed eight core principles that will be incorporated into a detailed proposal from Treasury that will be issued by the end of this year.
These are:

- Capital requirements should be designed to protect the stability of the financial system (as well as the solvency of individual banking firms).
- Capital requirements for all banking firms should be higher, and capital requirements for Tier 1 Financial Holding Companies (FHCs) should be higher than capital requirements for other banking firms.
- The regulatory capital framework should put greater emphasis on higher quality forms of capital.
- Risk-based capital requirements should be a function of the relative risk of a bank's exposures, and risk-based capital ratios should better reflect a bank's current financial condition.

- The procyclicality of the regulatory capital and accounting regimes should be reduced and consideration should be given to introducing countercyclical elements into the regulatory capital regime.
- Banking firms should be subject to a simple, non-risk-based leverage constraint.
- Banking firms should be subject to a conservative, explicit liquidity standard.
- Stricter capital requirements for the banking system should not result in the re-emergence of an under-regulated non-bank financial sector that poses a threat to financial stability.

My assessment: The Administration has outlined very sensible principles for capital reform, but has not provided the detail to truly judge their specific proposal. We will have to await the fuller proposal that will come out in December. In terms of principles, I strongly agree that capital requirements need to be lifted fairly sharply and that most, if not all, of the increase should be in the form of common equity rather than weaker forms of capital. My preliminary analysis strongly suggests that concerns about the effects of higher capital on lending are generally being overstated. It appears that a four point increase in the ratio of common equity to total assets might be achievable with only a 0.2 percentage point increase in loan pricing and a very modest tightening of loan conditions. Although counter-intuitive to some, this result makes sense when one considers three key factors.

First, banks are highly levered, meaning that there just is not that high a level of equity backing each loan. As a result, even though equity is much more expensive than bank debt, only about a fifth of the cost of an average loan is required to pay for the equity allocated to it. Second, investors in common stock lower their return requirements when they perceive lower risk, which would clearly be the case when capital levels are raised significantly. Third, banks have multiple ways of adjusting to higher capital costs, not just the single lever of loan price. Using these various means in combination, including reductions in compensation and other expenses, allows for a less harsh increase in loan pricing. (Please see “Quantifying the Effects on Lending of Increased Capital Requirements”, http://www.brookings.edu/papers/2009/0924_capital_elliott.aspx, for considerably more detail.)

Substantially higher levels of capital should make the system significantly safer, a benefit that outweighs what looks to be a relatively modest change in credit conditions. I hope that the Administration sticks to its plans and works with the regulators and the international community to provide sensible, uniform increases in capital requirements across the globe and across

types of financial institutions. I do agree, however, that a significant transition period may be necessary to avoid any chance of helping send the economy back into recession.

One way to soften the effects of higher capital requirements would be to allow a portion to be in the form of “contingent capital,” as many academics and policymakers have proposed. In its simplest form, this would be a debt instrument where the holders have agreed in advance that it would be swapped for common equity in the financial institution in the event that the institution runs into serious trouble, defined in a specific manner up-front. This essentially guarantees a “debt for equity swap” if it is needed at some future point and specifies the terms in advance. This instrument should not be used as the main form of capital, but could be a useful supplement that would be significantly less costly for banks to raise, since investors would generally price it much more like a debt instrument than an equity instrument, since under the large majority of circumstances it would remain debt.

Implications for emerging economies: It seems likely that emerging economies may also need to increase their capital requirements, since they have often been set using similar principles to those used for the more established financial markets or have been calibrated directly with respect to those levels. The logic of the analysis would be very similar to that applied to developed economies, but would dependent on the individual circumstances of each country.

Higher liquidity requirements

Banks have classically borrowed short-term and lent long-term, as discussed earlier. This brings with it the danger that funds will be demanded in a panic in greater amount than can be raised without “fire sale” liquidations of long-term assets that would result in major losses. Banks themselves in the U.S. are relatively cushioned from this concern by the existence of deposit insurance backing much of their funding. However, even a bank can get into a precarious liquidity situation if it relies too much on other forms of funding that are short-term in nature, such as borrowing overnight from other banks in the “Fed Funds” market or through commercial paper. One of the roles of the Fed is to act as a “lender of last resort” to provide liquidity in exchange for loans using bank assets as collateral. One of the ways the Fed does this is by offering liquidity through its “discount window”, which is also used on occasion as a matter of convenience in more ordinary times.

The liquidity problem is potentially much worse for non-banks, which by definition do not have access to insured deposits and traditionally did not have access to the Fed's discount window or other lender of last resort functions. Bear Stearns, for example, got into the habit of borrowing a large portion of its needs overnight or for very short periods, which held down its average cost of funds, but made it very vulnerable to a loss of confidence.

The issue of non-bank liquidity has become much more of a problem over time as they have increasingly taken on economic functions that mimicked those of banks to some extent, but without the same degree of government protection, involvement, and regulation.

The Administration supports tougher liquidity requirements, as do most other governments and central bankers. Indeed the industry has also recognized the importance of this, even if they argue about the need for government enforcement and its precise form.

The Administration has not released a detailed liquidity proposal, but gave a good summary of the principles on which it should be based in the same paper in which it outlined its goals for a revised capital regime. The paper indicated:

> "Liquidity regulations should be designed to accomplish two goals: (i) enhancing the short-term resiliency of banking firms by requiring them to hold a pool of unencumbered, liquid assets sufficient to cover likely funding shortfalls in the event of an acute liquidity stress scenario; and (ii) reducing longer-term structural asset-liability maturity mismatches at banking firms. The core attributes of a desirable liquidity regulation include simplicity; comparability across firms and across countries; conservative assumptions about the liquidity of assets during times of financial stress; and conservative stress-case assumptions about runoff rates for all types of liabilities, collateral calls by derivative counterparties, draws by borrowers on committed credit facilities extended by the banking firm, and implicit support that would be provided to vehicles sponsored and advised by the banking firm."

The paper went on to describe how liquidity requirements needed to be considered at the systemic level as well, as liquidity problems in one part of the financial sector can feed into other parts. Finally, there is discussion of the interplay between liquidity and capital requirements, with

the suggestion that it is worth considering having higher capital requirements for less liquid financial institutions.

My assessment: The principles outlined by the Administration are both comprehensive and sound. However, it is difficult to assess the effectiveness without considerably more detail.

Implications for emerging economies: As with capital requirements, there may be considerable overlap with the considerations that applied to the more established financial markets. The issue is worth serious re-examination at a minimum.

Systemic regulation

Regulation in the U.S. has largely focused on ensuring that each financial institution is sufficiently sound in its own right with less attention paid to how the dominos could fall if a major institution fails. Unfortunately, banks and other financial institutions are now so interconnected that problems at one can lead to problems at others which are then magnified throughout the entire system. The level of systemic risk before this crisis was much higher than had been appreciated, spurring the government into significantly more extreme responses than one would have expected to be necessary.

There are two key questions about systemic regulation. First, who will act as the regulator? Second, what power will the systemic regulator have to respond if it perceives developing problems?

There is a dual response in the proposals to the need for more systemic oversight. In both cases, the Fed is intended to play a key role. It is nominated to be the lead regulator identifying emerging risks to the system. However, the Treasury Department would head a new Financial Services Oversight Council (FSOC) whose role would be to oversee what the Fed does in that regard as well as to coordinate regulatory activities in general. In addition, the Fed would have regulatory power over individual systemically important financial institutions of all types, as discussed later.

This dual approach appears to be a political compromise. The Administration's initial impulse was apparently to give the Fed sole authority over systemic risk regulation, both at the systemwide level and in regard to individual systemically important financial institutions. There

would have been the usual consultation with its peers, but nothing close to a veto power wielded by the other regulators. However, Congress is not happy with the Fed at the moment. The Fed's role in the bailouts, especially of AIG, has annoyed many in Congress. This has magnified concerns about the huge financial power of the Fed and its dramatically expanded role in the credit markets, where it operates with little Congressional oversight.

In addition to the obvious issues of divvying up power between institutions and trying to match competences with responsibilities, there is also a concern that many have expressed that a strong role regulating the financial system could cause conflicts with the Fed's other responsibilities. One concern is that the Fed might compromise monetary policy in order to aid the financial system or that it might go the other way and nudge banks and other financial institutions to offer credit freely or act in ways that aided monetary policy, but hurt the financial system. It should be noted, of course, that if monetary and overall economic goals conflict with stability of the financial system, these issues will not go away simply by placing them with separate institutions. There will still need to be some method for balancing the different concerns. The best argument for separation may be that having the goals overseen by one institution may keep them from being fully argued out in public, whereas separate institutions would be likely to defend their viewpoints in the open.

There is also a concern about maintaining the relative independence of the Fed, which is largely a matter of custom rather than law. (Congress has the ability to alter how the Fed operates and has done so on a few occasions in the past.) Most observers believe that monetary policy is best executed by an independent agency operating with relative freedom from political constraints, since halting inflation often requires short-term sacrifices that are difficult for politicians to support. Mixing the Fed into the politically sensitive area of systemic regulation, with the potential requirement to support tough action to halt a popular asset bubble, could make Congress more inclined to place additional limits on the Fed that might also affect their independence on monetary policy.

Moving to the second question, it is not clear what powers the Fed or the FSOC would have once they have identified a systemic problem. At one end of the spectrum, they might only play a role as "systemic monitor", simply warning the Administration, other regulators, Congress, and the markets that there is a problem that will require action. It would then be up to the individual parties to act with whatever degree of coordination they voluntarily chose. At the other end of

the spectrum, the systemic regulator could forbid or restrict certain activities or raise capital requirements on them in order to discourage them and provide greater protection if they do go wrong.

My assessment: It makes sense to have a regulator responsible for watching over risks to the system as a whole, but there is a real limit to how effective it can be because it would be asked to do something extremely difficult. Ideally, the regulator would spot problems before they spawned bubbles whose bursting would cause great economic pain afterwards. However, it is not necessarily easy to spot a bubble in advance, no matter how clear it seems in retrospect. Some things which may appear to be bubbles are not, but rather reflect true long-term changes in the economy. Other trends may be bubbles, but seem as if they are not. For example, what happens if commodity prices go up further and oil reaches $100 a barrel again? Is that a commodity bubble or a natural response to tight energy supplies in a recovering world economy? Bubbles almost always start as a reasonable response to changing circumstances – the problem comes when they accelerate beyond reason as investors pile in to a rising market.

It is worth pondering Alan Greenspan's famous observation about the "irrational exuberance" of the stock market in the mid-1990's. This was widely interpreted to mean that he perceived the existence of a stock market bubble, in at least its initial stages. Even in retrospect, we do not know if such a concern was correct. On the one hand, the stock market went up very considerably after that for several years, suggesting that perhaps there was not really a bubble at the time he spoke. On the other hand, the compounded growth rate of stock prices since then has been quite lackluster and there are concerns that even now we have returned to over-valuation. Such low returns may mean we have spent over a decade working off a bubble that he correctly identified in its early stages.

The actual powers of the FSOC in practice will matter, as will its approach to using them. At one end of the spectrum, there could effectively be little more than a power to warn about danger, which could be useful, but might not make much difference. At the other end of the spectrum, there would be solid authority to force changes, perhaps by raising capital standards or even limiting certain activities outright. Ironically, the stronger the power, the harder it may be to use. Bubbles grow because there is a widespread belief in the underlying thesis driving the market and investors are profiting from following that belief. Thus, there will be strong resistance to any regulator who argues against the prevailing belief, especially if they are seen as about to

destroy a profitable market opportunity that will be argued to be beneficial to society at large. For that reason, there is little risk in practice of the opposite problem, that a systemic regulator will act too strongly or too soon, although this does remain a theoretical possibility.

Despite the risks of ineffectiveness, it is better to have a regulator responsible for leaning against the wind when market forces are pushing too hard in a particular direction. Warnings and the threat of specific actions may still help rein in at least some of the excesses associated with bubbles, even if the regulatory actions themselves were to be thwarted. It would be better, however, to have a single regulator play this role rather than a council. The need to win a consensus across all the regulators, with their different views, constituencies, and institutional interests is likely to make it excessively hard to achieve the desired systemic safety.

Implications for emerging economies: Every financial system and economy is subject to systemic risk. Emerging economies should re-examine their approach to ensure that they have not focused excessively on supervision of individual financial institutions at the expense of watching over the system as a whole and that they have the best tools available for considering issues affecting the wider system.

Tougher regulation of systemically important financial institutions

The Administration appears to believe, in common with most observers, that, as things stand now, certain financial institutions are so large or interconnected with other key market players that they cannot be allowed to fail. In practical terms, this means that there is an implicit government guarantee covering those institutions and therefore a potentially large cost to taxpayers if they begin to fail. This is often referred to as a policy of “Too Big to Fail.”

Almost everyone who believes that some institutions are Too Big to Fail would like to see this situation change. However, there are strong disadvantages to each of the approaches that might achieve this goal. For example, one could place absolute limits on the size and range of activities of financial institutions sufficiently stringent that the system could handle their demise. In practice, this would likely require breaking a Citigroup or J.P. Morgan into 10 or more pieces, which is politically infeasible. Even were it practical, most observers believe that the economic costs would outweigh the benefits by a considerable distance. In addition to the large transitional costs of breaking up such a bank, many believe that the global, complex, and inter-

connected nature of business requires that at least a few U.S. banks have this kind of scale to operate effectively.

A second approach to eliminating Too Big to Fail is to change the way that financial institutions operate, are supervised, and are liquidated so that the economic costs to the public of failure would be acceptable. Virtually everyone supports the attempt to achieve this, but there is a great deal of doubt that the various changes will add up to enough of a solution to allow this.

The Administration is careful not to argue that there will always be financial institutions that are Too Big to Fail, but its proposals appear to fall in line with this belief, or, at the very least, that this will be a difficult and time-consuming process. Therefore, the Administration has proposed to regulate the largest and most interconnected financial institutions substantially more stringently, in order to reduce their chances of failure still further and to lower the cost of any taxpayer rescue that might be needed in the future.

A newly designated group of Tier 1 FHCs would be established by the Fed, in consultation with the FSOC. These entities would be required to hold more capital and perhaps bear additional restrictions not applicable to other financial institutions. The higher capital requirements will be very important, but are difficult to judge at this point, given that there have been no concrete proposals. Nor has there been much specified about how activities might be restricted, if at all. Clearly the intention is that the treatment of Tier 1 FHC's would be substantially more stringent, but we know little more than that currently.

My assessment: I am in the camp that does not see a cost-effective method for eliminating the problem of Too Big to Fail institutions. Therefore, I favor the approach of making them substantially safer. It is reasonable to take regulatory steps to reduce the risk of failure for those institutions below the risk for less significant ones. Those restrictions may also reduce the temptation for smaller institutions to find a way to become too important to fail and thereby gain the same implicit federal guarantee. In addition, it makes sense to reduce the potential cost of any necessary taxpayer bailouts, including the use of expanded "resolution authority," discussed next, which is a key element of regulation being proposed for Tier 1 FHCs.

Implications for emerging economies: This issue may or may not be directly relevant to a given emerging economy. Sometimes rules and procedures have already been established that focus

principally on the largest financial institutions, in which case there may be no need for additional action.

Expanded resolution authority

U.S. regulators have available an elaborate set of powers to deal with banks that have fallen into trouble, powers that allow intervention well short of when a bank becomes formally insolvent. There is a regime of "prompt corrective action" steps that regulators can require banks to take once they become undercapitalized or hit other severe problems. Federal regulators have much less authority to deal with troubled financial institutions of other types, with the level of authority falling to zero for insurers or hedge funds. (Insurers are regulated at the State level while hedge funds are largely unregulated.)

Under current law, most types of financial institutions are subject to the same bankruptcy rules and procedures as for ordinary corporations. This has three major implications. First, the government has very little authority to take pre-emptive actions to try to head off an insolvency, unlike with banks, where the prompt corrective action rules are broad and strong. Second, in the event of bankruptcy, the rules do not provide an effective avenue for the government to influence the resolution process in a manner intended to serve the public good. Bankruptcy procedures are essentially a means to maximize the remaining economic value from an insolvent firm and to divvy up the losses between the economic parties most immediately involved, such as creditors, stockholders, employees, etc. Bankruptcy judges can take account of the public good under limited circumstances, but it is a secondary consideration. Third, bankruptcy processes tend to be time-consuming, especially as they invite extensive negotiation among the affected parties and provide many avenues to try to block actions that are opposed by any of the principal parties.

In contrast, bank resolution procedures give the regulators great powers, including pre-emptive ones, and encourage quick resolution in order to avoid excessive disruption to the bank's customers and the overall economy. The current crisis has underlined the key role played by financial institutions in the economy and the many ways in which financial troubles can spread to the "real" economy. The crisis has also shown that the weak tools the government currently has to deal with problems at systemically important non-bank financial institutions can steer interventions into paths that are more difficult and costly, as has been demonstrated with AIG

and Lehman. In the latter case, the Fed and Treasury have argued that the limitations made it impossible for them to keep the firm out of bankruptcy, with all the pain that ensued.

The Administration is proposing to give the Federal Reserve and the FDIC powers over systemically important financial institutions, including bank holding companies and Tier 1 FHCs that are not bank holding companies, that are similar to the prompt corrective action powers already enjoyed by regulators of banks. The Fed would be principally responsible for using these powers while the financial institutions remain solvent, with the FDIC taking over any institutions that actually fail, employing a resolution process where they would have great control.

My assessment: This would be a major and controversial change to existing regulation and insolvency laws. It seems clearly necessary in regard to bank holding companies, which are standard corporations covered by regular bankruptcy rules, but which are so bound together with their bank subsidiaries as to form one integral whole. My earlier paper, "Pre-emptive Bank Nationalization Would Face Thorny Problems," http://www.brookings.edu/papers/2009/0325_bank_nationalization_elliott.aspx discussed some of the serious difficulties in dealing with a bank and its holding company under different legal bases.

There is also a good case for extending bank-like resolution authority to insurers, finance companies, and securities firms that are affiliated with Tier 1 FHCs, although the answer is not as clear-cut as with bank holding companies. Here the arguments for resolution authority are tied quite closely to the basic premise for tougher regulation of Tier 1 FHCs in general. If we establish a separate class of Tier 1 FHCs, they will be implicitly guaranteed by the government, giving the taxpayer a greater stake in their health. We therefore need to optimize the way we deal with such entities if they become insolvent, including, preferably, establishing rules and authorities that make it less likely that they will reach insolvency. The prompt corrective action requirements used with banks are a sensible way of doing this.

There are two broad arguments against extending resolution authority, as well as numerous more technical concerns. First, some analysts do not think that the separate status should be established in the first place. In part this is because it makes it more likely in their view that taxpayers will have to subsidize failures and in part because it could give an unfair competitive

advantage to the largest competitors, leading them to become bigger still. Second, there are fairness issues involved in changing the insolvency regime for investors who have held bonds of the affected institutions for years under the clear understanding that they would be protected by regular bankruptcy law in the event of an insolvency.

I do not believe that expanded resolution authority would increase the probability of a taxpayer rescue. Arguably, creating the Tier 1 FHC status could create this problem, although I think that investors already believe that these institutions will be rescued as needed, meaning we already have the "moral hazard" problem. Whether or not this is true, once this status is conferred, I do not believe the expanded tool kit for dealing with those that become troubled would lead to more rescues, rather I think it would reduce the likely cost of those rescues that do occur.

I am, indeed, concerned about the fairness issues inherent in changing insolvency regimes in a major way when there are long-term bondholders who made commitments years ago assuming that longstanding bankruptcy rules would remain in place. However, I do not see a way to avoid this. Perhaps there can be transition rules or procedures to ease this problem, but we may have to sacrifice some fairness in order to better stabilize the financial system for the common benefit.

There are also analysts who argue that we can preserve the existing bankruptcy system for non-bank financials while making the necessary changes to allow early intervention, consideration of the public good in the resolution of an insolvency, and ensure speedy decisions. There are good arguments for this, but it seems to me that by the time all the necessary changes have been made, the arrangement will just look like a clumsier version of the bank-like resolution mechanism that the Administration proposes. Therefore, I prefer the clarity of the Administration proposal.

Implications for emerging economies: This issue is very specific to the U.S. and may not have resonance for any of the emerging economies. The general lesson is simply to ensure that governments and regulators have the tools they need to deal optimally with troubled financial institutions.

Consolidation of regulatory functions

There are many different bank regulators in the U.S. Different banks and bank-like institutions are regulated by: state regulators; the Office of the Comptroller of the Currency (OCC); the Federal Reserve; the Office of Thrift Supervision; the National Credit Union Administration; and, for certain important purposes, the Federal Deposit Insurance Corporation (FDIC). It appeared earlier that the Administration would propose significantly reducing the number of bank regulators, perhaps to as few as a single regulator. This thought appears to have died in the face of intense opposition by many in Congress and elsewhere. Senator Dodd, Chairman of the Senate Banking Committee, has revived the idea of going with a single regulator, but the idea still faces very strong opposition that makes it unlikely to pass. The Office of Thrift Supervision is the only regulator who appears to have lacked the institutional support to retain their separate existence. The Administration has proposed merging them with, and effectively into, the OCC.

No one would design the banking regulatory system the way it is now if they were starting from scratch, but it is extremely difficult to eliminate an existing institution in Washington. There are always interests who are comfortable with the present system and will fight to preserve it. Further, the system of government in the U.S. is deliberately designed to make change difficult, through the famous sets of “checks and balances” that spread the decision-making power over multiple institutions, such as the two houses of Congress.

My assessment: Effectively eliminating the OTS makes sense, but does not provide nearly the advantages the broader consolidation would have brought. Different regulators will inevitably have different approaches, especially as they are generally given substantial independence in order to reduce the politicization of regulatory decisions. These differing approaches can reduce the effectiveness of systemic regulation, in part by opening up the possibility of “regulatory arbitrage,” where financial groups put their various activities into the affiliates which have the softest regulatory requirements. It is true that tighter regulation of consolidated groups at the holding company level will reduce the ability to arbitrage the regulators, but it is unlikely to entail supervision as detailed as that which will occur at the level of the regulated subsidiaries.

Outside of bank regulation, there are two financial market regulators, the Securities and Exchange Commission (SEC) and the Commodities Futures Trading Commission (CFTC). It makes compelling sense to combine them, but the politics are apparently too difficult. (For one thing, the Agriculture committees of the two houses strongly wish to retain authority over a robust CFTC.)

Nor has insurance regulation been touched. This has historically been the preserve of regulators in each of the 50 states, with virtually no federal role. I believe that federal regulation of at least the largest insurers is important, because it will be increasingly difficult to draw a line between insurers and other financial institutions and activities. A given package of financial rewards and risks, whether related to housing, the equity markets, or commodities, can be structured as a security, a derivative, an insurance policy, or a bank product. The more fragmented the regulatory structure the worse the potential problems. State regulation of insurance is often quite weak and magnifies this potential for harmful regulatory arbitrage.

Implications for emerging economies: The regulation of emerging economies is usually new enough to have avoided these legacy problems. The U.S. can serve as a good object lesson for the importance of not fragmenting regulation excessively in the future.

New regulations for securitizations

Many of the losses by financial institutions and other market players came from problems with securitizations of mortgages and other assets or from problems with derivatives, particularly credit default swaps. The Administration proposes greater regulation in both areas.

The biggest change to securitizations would be a requirement that the originators of the loans underlying the securities retain at least 5% of the risk. The Administration is also proposing other steps related to securitization, including: greater transparency about the assets backing the securities; clearer guidance from the rating agencies about the differences between asset-backed securities and regular corporate debt; and changes to the compensation structure for the parties involved in securitization.

My assessment: The idea of “keeping some skin in the game” is intuitively appealing and should help. However, it is important not to take excessive comfort from this change. Banks will indeed pay more attention to the quality of the assets they securitize if they retain even a small fraction of them. But, the financial incentives in a bull market for those assets will still push them towards taking greater and greater risks, since they will immediately gain most of the benefits through securitization while only having a future risk on a small fraction of the asset pools. Also, banks are not immune to the euphoria that grips the larger markets during an asset bubble. The

banks, to their regret, actually retained much of the mortgage risk from the bubble period, sometimes even buying more in the open market.

The other proposed changes are also sensible, but the devil will be in the details and it is difficult to fully judge them yet.

Implications for emerging economies: Regulators would be well advised to better understand how securitization impacts their financial markets and institutions. The lessons may be very different from those in the U.S., where securitization is hugely important and long established. I would suggest avoiding one potential lesson, which is that securitization is harmful. Although difficult to prove definitively, securitization has been a powerful force for good in U.S. financial markets, which is why there are virtually no proposals for its abolition.

New regulations for derivatives

The Administration is pushing for all standardized derivatives to be traded through an organized exchange and/or cleared through a clearing house. An exchange is a centrally organized marketplace for the purchase and sale of financial products. The best known is probably the New York Stock Exchange, but there are also several prominent exchanges that do a major business in derivatives already. Exchanges bring a real benefit from transparency about the pricing and volume of trades, as well as making it easier for regulators to track trading positions of major parties. In contrast, much of the trading volume in derivatives now takes place "over the counter," between two counterparties who are not generally required to report details of the trade and who take each other's credit risk in regard to the transaction. This credit risk is often mitigated by requiring collateral, but it is clear in retrospect that this process was not well-managed in many cases, leaving a large number of institutions very exposed to the credit risk of AIG, for example.

The major exchanges dealing in derivatives use central clearing houses that act as the counterparty to both sides. If A sells an option to B on the exchange, the clearing house would interpose itself, buying from A and selling the option on to B. The sole purpose of this interposition is to eliminate B's credit exposure to A. If the option becomes valuable over time, B needs A to make good on its promise. If A doesn't, the clearing house would make good, protecting B. Such clearing houses can also handle trades that were done off of an exchange, which will be an allowed alternative in certain cases.

It should be noted that using a clearing house does not eliminate counterparty risk altogether. The clearing house could become insolvent itself if enough of its counterparties fail to meet their obligations. This should still represent a diminution of the total credit risk in the system, since clearing houses are well-capitalized and operate in a clearly defined business that is easier to manage than a broader business, but there could be extreme circumstances where a government rescue would be required.

The big controversy with derivatives is what to do about customized derivatives. The use of derivatives to manage risk by sophisticated corporations is pervasive. Sometimes those derivatives are significantly cheaper or more effective if they cover the exact risk rather than using one or more standard derivatives to approximate the desired protection. The Administration is trying to preserve those efficiencies by allowing the continuation of the current system for customized derivatives, but there is a fear that financial firms will deliberately sell slightly non-standard derivatives in order to avoid the tougher rules on standardized ones. The Administration attempts to mitigate this in two ways. First, any derivative which an exchange is willing to trade or a clearinghouse to clear must be traded or cleared in that manner, rather than done as an over the counter transaction with the customary clearing procedures. Second, customized derivatives will carry significantly higher capital charges, in the hopes both of reducing the risk level by holding a higher buffer and of steering customers and banks away from customized derivatives where there is not a compelling economic case.

My assessment: Virtually everyone agrees that more use of exchanges and clearing houses would be a good thing for standardized derivatives. However, this is another area where the devil is in the details. The trick will be to provide incentives or requirements to use standard derivatives where possible, while leaving the ability to use customized ones where they serve a genuine need. The Administration's proposal attempts to strike this balance. It will be interesting to see what comes out the other end of the legislative process, given the combination of a high degree of public anxiety about derivatives combined with a lack of understanding of this complex topic by many who are voicing opinions about the proper course of action.

Implications for emerging economies: The implications here are similar to the ones for securitization – examine your specific situation and think carefully about it. Try to avoid jumping

to the conclusion that derivatives are not worth the trouble, as they too have been a powerful aid to modern financial institutions and markets.

Stronger consumer protections

The Administration has proposed creating a Consumer Financial Protection Agency (CFPA), responsible for all aspects of regulation of mortgages, credit cards, and other consumer-focused financial products, with a few exceptions, such as mutual funds which are left with the SEC. The CFPA appears to be a fairly powerful agency, with the power to set binding regulations, conduct supervisory exams, impose fines, etc. It would be specifically authorized to impose an obligation to offer "plain vanilla" products, such as a standardized 30-year fixed rate mortgage, with the possibility that consumers who wish to make another choice will have to specifically waive their right to have the standardized product. (This aspect of the proposal appears likely to disappear in the face of staunch opposition, although there may remain an attempt to encourage plain vanilla products without requiring them.)

There has been intense opposition by the banking industry to the creation of the CFPA. It has been portrayed as creating another layer of bureaucracy and a potentially conflicting source of regulation alongside that of the existing bank regulators. There is also the fear that the CFPA will be so focused on consumer protection that it will impose unreasonable constraints on the banks, especially if it is allowed to develop and push plain vanilla products. Another bone of contention is that the Administration's proposal would allow individual states to impose more stringent consumer protection requirements, from which national banks are currently immune due to federal pre-emption of state consumer protection laws as they apply to nationally chartered banks. For their part, the existing regulators are generally arguing that while they may not have been perfect in the past, they will do a much better job of protecting consumers in the future and therefore there is no need to change the existing structures.

My assessment: There have been many bad practices that developed in the bubble period which harmed consumers, especially related to sub-prime mortgages. It would be useful to have a clear regulatory focus on eliminating those problems and avoiding others in the future. The critical issue will be the extent to which the CFPA is able to find the right balance between promoting consumer safety and allowing innovation. Everyone can agree on the need for transparency. What is harder is when there are both risks and rewards to a given product, from

the consumer's viewpoint. How much will the CFPA try to protect consumers from taking risks that might actually be legitimate in light of the potential rewards?

Another key issue that will be determined by a combination of legislative wording and regulatory choices over time is the extent to which the CFPA will move out of products that are clearly consumer products into a wider range of financial products. For example, would the CFPA ever find itself imposing regulations on derivative products, perhaps on the basis that some individuals do invest in them? This appears not to be the intent of the proposal, but there will doubtless be gray areas in practice.

In general, I fear that leaving consumer regulation with agencies that also focus on the financial safety of the banks and of the financial system would inevitably cause consumer protection to become a lower priority over time. There are disadvantages of a separate consumer protection agency, but these appear to be more than offset by the benefit of focus. That said, it would be important to get the details right and to strike the best balance between protection and innovation.

Implications for emerging economies: Consumer protection is very important. Unfortunately, it is easy for regulators to focus instead on safety and soundness issues. It is critical to make sure that consumers are not given short shrift in designing and running regulatory structures. Not only would that be bad for the many individuals who would suffer, but it can help to produce massive systemic problems.

Greater international coordination

Finally, the Administration has also highlighted the need for greater international regulatory cooperation. The idea is to have comparable capital and liquidity requirements across the world, as well as similar regulatory changes related to derivatives and securitization, among other areas.

My assessment: This would indeed be useful, particularly if the U.S. develops tougher rules in some areas than currently exist elsewhere. However, it is not likely that there will be a large effect on U.S. policy from this international cooperation. As has already been seen with the failure to propose significant regulatory consolidation, financial regulation in the U.S. is a very

parochial affair, with entrenched interests fighting their corner with relatively little regard for what is going on in the rest of the world.

The short-term dangers of differing policies among some of the major financial centers in the world may not be terribly large. However, the risks grow over time. For example, if one significant jurisdiction has substantially laxer rules on capital levels, there is a strong likelihood that more and more business would migrate to that jurisdiction. Thus, the average level of regulatory rigor around the world would deteriorate, creating increasingly large risks over time.

Implications for emerging economies: Do not count on this or any future Administration to be able to take the regulatory actions that are best globally. Administrations will generally place a higher priority on this than Congress will, since the Administration is charged with the day-to-day running of the country in a truly globalized world where our actions have consequences overseas. Congress tends to focus much more on the parochial issues on which citizens are focused in their own district or state. As a result, international cooperation is a low priority for the legislature.