The Governance of Financial Regulation

Reform lessons from the recent crisis

Motivation

- Finance is powerful. It shapes …
  - … economic opportunity
  - … the efficiency of resource allocation
  - … economic growth
- How can we make finance work better?

Purpose

- Propose an institution to improve the "governance" of financial regulation
  - Design of financial policies
  - Interpretation and implementation of those policies,
  - Evaluation and reform financial policies

Two-part strategy to achieve purpose

1. Document that the collapse of the global financial system reflects a failure of financial regulatory governance
2. Propose a new institution to act as the public’s sentry over financial policies

Suicide: Crisis happened *to* policymakers

- Greenspan:

  “The roots of the crisis reach … to the aftermath of the Cold War …

  … that led to a dramatic decline of real long-term interest rates.

  … that in turn engendered a dramatic global home price bubble, which was heavily leveraged …

  … A classic euphoric bubble

  … Everybody missed it.”

- Prince (former CEO of Citigroup):
  - “When the music stops … things will be complicated. But as long as the music is playing, you’ve got to get up and dance. We’re still dancing.”

Accident: Crisis happened *to* policymakers

- Greenspan, Bernanke, Paulson, Geithner, Romer:
  - It was a “hundred years” flood
    - Global savings glut
    - Massive capital inflows to the U.S.
    - Financial innovation, fraud, and herd behavior

- Robert Rubin:
  - *I’m sorry that [we] could not see the unprecedented market collapse that lay before us.*”

Part 1

Systemic failure of financial regulatory governance

What caused the crisis?

- “100 years flood” / “Euphoric bubble”
  - Global savings glut and capital imbalances

Valid, but incomplete

  - Too little information
  - Knowable: If, only, regulators had more power

Also, a failure of governance

- Senator Carl Levin:
  - “The recent financial crisis was not a natural disaster; it was a manmade economic assault.”
  - No, I do not agree with the “murderous” tone

- Rather, regulators failed to adapt prudently
  - Allowed avoidable dangers and risks to continue
  - Innovation + old (good) regulations → reckless regulations

Outline of Part I

- 4 policy examples, U.S focused
  - But, many more examples
  - “Guardians of Finance: Making them Work for Us”
  - Made in the USA, bought by many

- 1996-2006 !!!!!!!!!!!!!!!!!!!!! NOT 2007 – 2010

Examples of governance failures

credit rating agencies (CRAs)

Credit rating agencies

- How did they become so pivotal?

Credit rating agencies

- SEC invents the Nationally Recognized Statistical Rating Organizations (NRSRO) designation in the 1970s to establish capital requirements on broker-dealers.

- Cascade:
  - Bank regulators around the world
  - Insurance and pension regulators around the world
  - National, local, quasi-governmental agencies …
  - All major purchasers of securities MUST use ratings

- NRSROs start charging issuers instead of buyers.

Conflicts of interest: 1

- Credit rating agencies sell “licenses,” not ratings.

- Regulation and law protects CRAs from market discipline
  - Regulation mitigates reputational capital concerns
  - Legal liability not an issue because of law

Conflicts of interest 2: Why things deteriorated

- Structured product boom late-1990s → quantity!
  - Rating agencies paid to structure: Consulting
  - And, then to rate those structures: Rating

- The profits were enormous
  - Regulatory protections
  - + <u>invention</u> of structured products
  - + combining consulting and rating
  - = enormous profits … operating margins over 50%

Credit rating agencies knew …

- *"These errors make us look either incompetent at credit analysis or like we sold our soul to the devil for revenue ..."*
  - Moody's MD in 2007

- *"Let's hope we are all wealthy and retired by the time this house of cards falters."*
  - *S&P employee in 2004*

This was a failure of governance

- CRAs created and protected by regulators
  - No monitoring of rating methods.
  - Maintain unique designation and reliance

- Problems were well-known years before the crisis:
  - Accounting scandal… VERY similar.
  - There were conferences and articles.

- Policymakers recklessly endangered the global economy

Examples of governance failures

Credit default swaps and bank capital

Credit default swaps

- Fed allows banks to reduce capital (1996) via CDS
  - Reduce bank credit risk
  - Free-up regulatory capital for more lucrative investments
  - Not a bad idea in principle

- Explosive growth:
  - By 2007, notional value of $62 trillion
  - Banks use CDSs to reduce capital
  - AIG writes many CDSs to banks.

Next decade: Well-known growing problem

- Geithner was very concerned
  - Formed task force headed by Corrigan (NY-Fed / Goldman)
  - Tried to negotiate with banks

- Accumulating evidence, 1996-2007, made Fed concerned
  - Counterparty risk associated with CDS
  - Risk to banks associated with mortgage-related instruments.
  - FBI warns of an “epidemic of fraud” in sub-prime mortgages, on which many CDSs were based.
  - Internal reports at Board indicate very well-known.

Regulators knew of growing problems,

- *but chose not to act.*

FED could have argued the following

1. FED does not have ability to assess counterparty risk.
   - … neither, does it have confidence in credit rating agencies.

2. FED is responsible for safety/soundness of banking system

3. Therefore, the FED will not allow banks to reduce capital.

✧The issue is not the 1996 decision.
✧The issue is the Fed maintained its policies.

Examples of governance failures

More on CDSs

The Warning by Brooksley Born

- OTC derivatives – including CDSs -- subject to
  - Fraud, Manipulation, Failure, Opacity
  - E.g., Orange county, Gibson Greeting Cards, Proctor & Gamble,
  - E.g., exploitation of unsophisticated school districts & municipalities,
  - E.g., LTCM, impossible to assess systemic ramifications.

- OTC derivatives involve hundreds of trillions of dollars

- Commodity Future Trading Commission
  - Calls for greater transparency
  - Concerns (obvious concerns) about systemic risk

The Response by the “Oracle”

- Stop move toward transparency
  - Commodity Futures Modernization Act of 2000
  - Exempted OTC derivatives from oversight
- Policy enforced ignorance of systemically important market
  - This was not a lack of information, nor power
  - This was bad choice by the financial governance system

Examples of governance failures

The SEC and investment banks

Total failure

- All five major investment banks “fail” in 2008.

- “We have a good deal of comfort about the capital cushions at these firms at the moment”

    - Christopher Cox, SEC chairman, 3/11/2008.
    - 3 days before FED provided emergency $25 billion loan to Bear Stearns.

3 Coordinated SEC policies in 2004

- Exempt 5 major broker-dealers from net capital rule.
- SEC to provide consolidated supervision of big 5
  - Consolidated Supervised Entities (CSEs)
  - Holding company and all affiliates.
  - Complex, systemically important responsibility
- Decide not to build capability
  - 7 people to oversee holding companies with $4 trillion
  - Eliminate risk management office
  - Fail to complete any inspections in18 months before Bear Stearns
  - Weaken enforcement

And, they ask Congress to lay-off

"The bill should be amended to recognize the unique ability of the Commission to comprehensively supervise the consolidated groups … the Commission has established a successful consolidated supervision program"

- **SEC's Deputy Director testimony before the U.S. House of Representatives Financial Services Committee, 4/25/2007.**
- **18 months later, all of the "consolidated groups" vanished.**

My verdict

- There was NOT an absence of
  - … power
  - … clear authority
  - … information
- This was not simply the results of
  - … unsustainable global capital flows
  - … toxic financial innovations
- Rather, there was a colossal failure of decision making
  - Willful blindness &
  - Reckless endangerment

Lessons

Systemic failure of financial regulatory governance

Lessons for policymakers

- There is a <u>systemic</u> problem with financial regulation
  - The crisis was not only an accident or bubble
  - Nor primarily a lack of information or regulatory power
  - Financial reform proposals are incomplete.

- Policymakers implemented and maintained bad policies

- <u>Systemic</u> problem requires systemic change

Part II

The Sentinel

Who is the public' sentry on financial policy?

- Independent of politics?
- Independent of financial institutions?
- Informed & expert?

Governance in theory

The Public

↓

Representatives

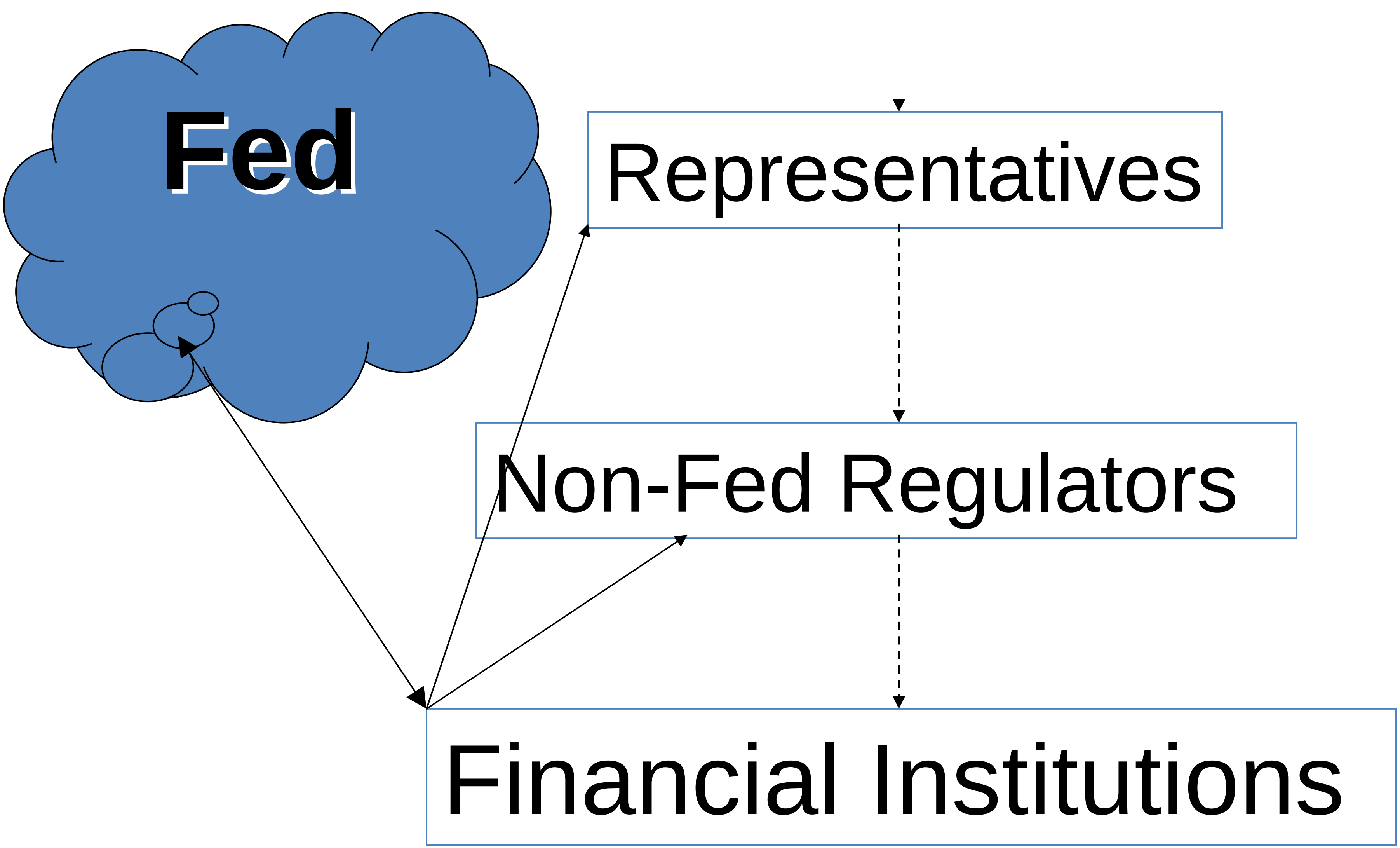
↓

Regulators

↓

Financial Institutions

Governance in practice



The Sentinel

- Power: Demand information
  - Transparency
  - Check and balance
- Responsibility: Report its evaluation of financial policies
  - No regulatory responsibilities
  - No supervisory responsibilities
- Organization
  - Politically independent
  - Independent of financial markets
  - Align staff's personal ambitions with accurate assessment of financial regulations

Really, another regulatory institution?!

- Yes.
- No, other institution …

1. Independent of politics and markets

- Incentives matter in regulation too.
- Revolving door – agencies/banks/politics – spins rapidly.
  - Good reasons to have individuals with private sector expertise help with regulation.
  - Good reasons to have politically-skilled individuals help with regulation.
  - Similarly good reasons to worry about conflicts of interest.
- An independent, informed evaluation will enhance the governance of financial regulation.

2. Monopoly regulators are dangerous

- Monopoly on financial information & expertise in publicly unaccountable officials
  - breaks the democratic lines of influence
  - gives too much power to a narrow elite
- A Sentinel
  - Could challenge authorities
  - Shine an illuminating light
  - No other entity can currently provide this public service

Going back the examples …

- The existence of a Sentinel would have reduced the probability that:
  - The FED maintained such poor policies with respect to capital and CDSs
  - The SEC and Congress maintained such poor policies with respect to CRAs
  - The SEC did such a negligent job in supervising investment banks
  - The FED & SEC ganged up to keep OTC derivatives opaque.
  - Fannie, Freddie, and CRA would have had such distorted incentives on housing for so long
  - The UK’s FSA systematically missed the boat …

The Sentinel

- Not a panacea
- But, a mechanism for improving the governance of financial regulation
- Without dealing with the systemic, underlying institutional causes of the crisis, our current efforts represent only superficial and partial solutions.