Kevin Warsh: Regulation and its discontents

Speech by Mr Kevin Warsh, Member of the Board of Governors of the Federal Reserve System, at the New York Association for Business Economics, New York, 3 February 2010.

The original speech, which contains various links to the documents mentioned, can be found on the US Federal Reserve System’s website.

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Thank you to the New York Association for Business Economics for hosting me.

We remain in a period of great consequence for the U.S. economy. The policy judgments currently being considered are as significant as those made during the darkest days of the Panic.1 And here, I am not only referring to the appropriate conduct of monetary policy.2 Fiscal, trade, and regulatory policies may turn out to be no less determinative to the path of the U.S. economy.

On fiscal matters, what size government is desired, and how should it be funded? Will low sovereign funding costs and accommodative financial markets make policymakers lax in developing a credible, fiscal exit regime? And, will the costs of implicit guarantees add to sovereign debt burdens?

On matters of international trade, will policymakers push to extend the post-World War II bipartisan consensus favoring free trade? If the United States declines to talk and act forcefully on the merits of open, competitive markets, who will? Will our quiet be deemed acceptance by those pushing the false promise of protectionism?

And, as I will explore in the balance of my remarks, are the financial regulatory policy prescriptions proposed during the past year sufficient for meaningful reform? Will these policies mitigate the risks of future financial crises? Will they support long-term economic growth? Now is not only a time of consequence for regulation and the U.S. economy. It is also a time for choosing.

A time for choosing

Nearly 30 years ago, at another critical time of choosing – in a period of economic malaise – policymakers were reminded from many quarters of the need to keep their wits about them in making policy.

A leading intellectual of the time, Irving Kristol, remarked: “Our economic problems are not intractable... Economic policies that are just a bit more sensible, especially in the areas of taxation and regulation, can make a lot of difference for the future. On the other hand, once the idea gets around that we are in a profound crisis and that only “drastic action” by Washington can save us – then it will be time to head for the storm cellars.”3

The financial crisis conditions of the past two years have substantially abated. Those that headed to the storm cellars have returned to see what lies in its wake. And Washington has placed itself centrally in the clean-up efforts, seeking to repair the regulatory system. This is

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a wholly worthwhile task. Improvements in regulatory policy – if part of a broader review of
the financial architecture – could herald greater prosperity for future generations.

But, efficacy, not convenience, should be the foremost goal of policymakers. And we will
have done ourselves no favors if what is billed as “comprehensive regulatory reform” over-
promises and under-delivers. We need a broader understanding of what occurred, more
basic changes in our financial architecture, and more useful tools in our arsenal for reform
efforts to be worthy of the name and equal to the challenge.

**Prevailing theory of the case: empowering regulators**

The prevailing theory has it that financial firms, particularly the largest and most systemically
significant, engaged in practices that begat the financial crisis. To redress these wrongs,
regulatory powers should be substantially expanded, the theory goes. The incumbent
regulators lacked sufficient authorities, or were not up to the task. But the structure in which
their successors operate will purportedly make them masters of the craft. Apparently, a new
grant of broad and sweeping regulatory powers will treat the infirmities that ail us. In my view,
this theory has some understandable appeal – and begins to shed light on some important
truths – but the narrative and recommended reforms are still deficient. Let me explain.

First, the Panic of 2008 that exacerbated the recession is the result of a multitude of flawed
private and public practices, with regulatory error being only one part. Some meaningful
blame should be placed at the doorstep of regulators, here and abroad. But the investigation
should not cease at the first signs of fault.

The mortgage finance system is owed far stricter scrutiny to gather a fuller appreciation of
the causes of the crisis. The government-sponsored enterprises (GSEs), Fannie Mae and
Freddie Mac, for example, were given license and direction to take excessive risks. They
were granted conflicting missions and governed by competing masters. And their funding
backstop was predicated on “constructive ambiguity,” which turned out to be neither
constructive nor ambiguous. Money market mutual funds, too, managed their liquidity risks in
an environment of unclear support. Ultimately, if the diagnosis of the crisis fails to account for
some of the broader failings of public policy, of which the GSEs are just one part, the
prescription is unlikely to be effective.

Second, the regulatory reform discussion of the past year seems overly preoccupied with
questions of institutional design. There are doubtless efficiencies to be gained in sharing best
practices, integrating operations, and minimizing regulatory gaps among regulators. But, it is
far from obvious that real regulatory reform hinges on figuring the optimal number of
regulators, or the precise composition of an oversight council.

I happen to believe that the Federal Reserve should play a critical role in the supervision of
financial firms, but that should not obfuscate the larger point. If real reform were chiefly about
the number of financial regulators in Washington – or even the precise relationships between
financial regulation and the role of the central bank – we should find an institutional design
among major financial centers around the world that lived up to its promise. We find no such
example. Policymakers, in my view, should be more focused on what constitutes effective
prudential supervision, rather than be diverted to the less consequential discussion as to who
should perform it.

Third, some of the reform measures advocated over the past year could risk re-creating the
status quo ante. But the status quo ante will no longer do. There is no going home again. If
policymakers had gone into the crisis with the resolution authority to shut down non-banks
and complex bank holding companies quickly, we might well have had better options to
ensure an orderly disposition of failing firms. Placing this arrow in our quiver now, however, is
not enough to arm us for the challenges ahead. Granting new powers to resolve failing firms
in the discretionary hands of regulators is unlikely, in the near-term, to drive the market
discipline required to avoid the recurrence of financial crises.
To be clear: New resolution authority is a welcome step forward, but its efficacy should not be overstated. And this authority could be made more credible by replicating, as much as practicable, well-understood bankruptcy protocols. This replication would provide clearer rules of the road for classes of creditors in advance of any resolution. Still, the financial architecture requires additional reforms to mitigate the too-big-to-fail problem.

Preferred theory of the case: resurrecting market discipline to redress too-big-to-fail

Moral hazard in the financial system is higher than any of us should countenance. There is a high burden on policymakers to mitigate it. Some newly-empowered and untested regulatory structure is not likely – in and of itself – to be sufficient to tackle institutions that are too-big-to-fail, particularly as memories of the crisis fade. Regulation is too important to be left to regulators alone.

We must resurrect market discipline as a complementary pillar of prudential supervision. Otherwise, the too-big-to-fail problem – exacerbated by recent events – could undermine our financial system and do long-term harm to the real economy. The growing specter of government support threatens to weaken market discipline, confuse price signals, and create a class of institutions that operate under different rules of the game. This state is not acceptable.

We need a system in which insolvent firms fail. Market discipline only works if governments can demonstrably and credibly commit to allow firms to fail. This system isn’t just about giving government officials better options on Sunday nights. It is about making sure that market discipline is operative in the prior months and years to avoid altogether the proverbial Sunday night judgments.

I don’t preach the infallibility of market discipline in policing risks. Market discipline, like regulatory discipline, is imperfect. It too has a tendency to become lax late in economic booms and excessively tight in busts. But, a system must be designed so that market discipline works – not to the exclusion of regulatory discipline – but in support of it. They should serve as complementary pillars, bolstering one another as needed.

So, how do we design a new financial architecture that – in addition to improved resolution authority – more squarely confronts the too-big-to-fail problem? It isn’t simple or easy or ripe for a quick-fix. But, we cannot afford to be discouraged. The stakes are too high.

First, in order to resurrect market discipline from the ash-heap of the recent crisis, stakeholders – that is, shareholders, creditors, and regulators alike – need better, more timely information about financial firms. Information-sharing is growing exponentially in all aspects of human endeavor. Financial firm disclosures should be no exception.

Asset quality and funding sources for financial firms must be more understandable and readily comparable among peers. Stakeholders can then make better informed judgments of potential risks and rewards. Markets can help effectively discipline the behavior of firms by re-pricing funding costs as perceived risks change. And regulators can use market prices and changes in funding mix, among other information, to evaluate whether firms are being evaluated independent of government backing.

The stress tests led by the Federal Reserve in early 2009 were testament to the need for improved public information about firms’ financial position. Market functioning and credit and capital availability improved markedly after the Federal Reserve’s detailed, cross-firm comparisons were made public. This is no coincidence.

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More understandable, frequent disclosures could also foster development of contingent capital securities. These securities could exert ex ante discipline on firms, and then convert to common equity to absorb losses if a firm’s capital position were to fall below a threshold.
Second, reforms must encourage robust competition. Market entry and market exit can be a more effective means of developing a stronger, more resilient financial system. The too-big-to-fail problem could be mitigated if smaller, dynamic firms seized market share from less nimble incumbents. This is no pipe dream in 2010. Many old relationships between firms and clients were uprooted during the crisis. Customers – institutional and retail – are seeking new ways of doing business and new firms with which to transact.

The financial services industry is ripe for a healthy dose of creative destruction. But, this won’t happen if policy divides firms that are too-big-to-fail from those that are not. It won’t happen if select incumbents have permanent funding advantages. And, it won’t happen if policy preferences deter would-be competitors from taking on the big guys. Policy for all firms must be anchored, not left adrift, for competition to take root.

Competition is undermined when a privileged class of financial firms has the implicit support of the government. No firm ought to be entitled to favored consideration by regulators or government policy. No rating agency. No mortgage finance entity. No dealer or underwriter. And no bank. The tempting top-down approach to level the playing field is to bully or co-opt our largest, most interconnected firms. In my view, however, robust competition from the bottom-up is the better way forward.

Third, stronger capital and liquidity buffers, more effective boards of directors, and more rigorous risk-management practices are important safeguards. And, here, there has been some substantial progress. But additionally, firms should have the burden of persuasion to demonstrate that they can fail without need for extraordinary government support. Simplifying corporate forms and structures so firms can quickly be unwound, particularly across borders, would be a welcome development.

In a global economy with integrated financial markets, big is not bad. But, greater dispersion of assets and liabilities demands unprecedented international cooperation. U.S. leadership is critical to establish the new rules of a new financial architecture. Policy coordination with our Group of 20 colleagues should not take a backseat.

**Alternative theory of the case: if too-big-to-fail prevails...**

We should not fool ourselves. Government interventions during the past couple of years, however necessary, revealed a set of policy preferences. Expectations hardened that governments will come to the rescue of large ailing markets and large failing firms. These expectations must be unlearned by market participants. And the government’s role must be explicitly delineated. These changes won’t happen overnight. But, eradicating the too-big-to-fail problem should be the predominant policy goal.

If we fail to achieve this critical objective, the next-best regime may involve choosing a point between two competing models for systemically-significant firms: regulating what financial institutions can do, and regulating how they do it.\(^5\) Clear rules – more focused on the “what” than the “how” – could liberate firms from the corridors of Washington so they can get back to business. Supervisors, of course, would still serve an important role, leaning against the prevailing winds, providing guidance to firms, and ensuring best practices. But, Washington would steer clear of managing the affairs of private firms.

Obscuring the choice altogether – both directing the “what” and ordering the “how” – strikes me as imprudent. Washington finds itself perhaps too interested in scrutinizing the day-to-day management and operations of financial firms. Are they loaning too little to small businesses? Too much to big developers? Are loans to large corporations too cheap? And

loans to consumers too expensive? The tendency by Washington to micromanage can harm an economy that desperately needs a competitive, vibrant, sustainable banking system.

Rule-based regimes on issues of capital and liquidity – even on scope – are inevitably crude and imperfect. And to be effective, these rules would need to reduce systemic risks meaningfully. Still, this regime strikes me as superior to one in which our financial firms are micromanaged as quasi-public utilities, subject to the changing preferences of Washington and immunized from real competition. The U.S. economy runs grave risks if we slouch toward a quasi-public utility model.

I worry that some systemically significant firms may end up willing to accept new, permanent government masters and supplementary public purposes in order to protect their status. Apportioning economic rents to appease the official sector may appear rational to some firms. But, it is destructive to the financial and economic system overall. We should not want clients of the state at the core of our financial system. We do not want some new social contract between government and large banks. Now more than ever, we need more private firms competing to serve client needs and make markets.

Conclusion

The standing of market-oriented principles is being severely tested. Our policy response must be worthy of this challenge, and so should necessarily be broader in scope than some new team of financial regulators with new powers. We need a new financial architecture, one in which improved regulation and supervision play an important but co-extensive role with greater market discipline. The new architecture must stoke competition, allow failure, and reward innovation and success. The new architecture should establish the rules of the game without micromanaging the affairs of private firms. And the new architecture should not give perpetual license to select, incumbent firms to dominate the financial landscape. For in the new regime, no firm should be too big to fail.