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Regulatory Reform

A Practitioner's Perspective

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The events of the past several years make a compelling case for comprehensive, fundamental reform in the oversight of financial firms.

But I worry that the Dodd-Frank Act may not be equal to this critical task. As currently envisaged, Dodd-Frank seems premised on the notion that more regulators from more agencies with more funding, power, and discretion will stop financial firms from getting into trouble. That enhanced regulatory discipline alone—more "boots on the ground" and more exacting checklists to police financial firms—will ensure that financial firms remain safe and sound. If this theory has it right, next time will indeed be different.

My experience at the Federal Reserve informs my views on prudential oversight, leaving me with three key takeaways: First, most banking regulators are very knowledgeable, highly dedicated professionals with the utmost integrity. Second, the business of banking can thrive with clear rules of the road that prejudice no particular firm or function. And, third, the paradigm that leaves the overwhelming burden of prudential supervision on the judgments of regulators and supervisors alone is bound to disappoint.

Regulatory discipline has an important role to play, of course. But two other essential, complementary pillars of prudential supervision must be resurrected rather than relegated: capital standards and market discipline. As I discuss subsequently, neither clearer capital rules nor effective market discipline can be made operative when the largest U.S. firms are deemed "too big to fail." Of course, Dodd-Frank nominally purports to end the "too big to fail" doctrine, but in practice—now more than ever—it is viewed by market participants as *de facto* government policy. The window of opportunity to eradicate this problem is fleeting, so the time for more rigorous scrutiny of the new regulatory regime is at hand.

A more robust reform agenda—including but not limited to the introduction of Chapter 14 as an amendment to the Bankruptcy Code—should be targeted at ridding us of "too big to fail" firms. Clearer, tougher, and more assured treatment of stakeholders in large financial institutions—known and understood prior to the onset of distress—would go some distance toward mitigating the "too big to fail" problem at the core of our financial system.

If true reforms were implemented, the three independent pillars of prudential supervision—regulatory discipline, capital standards, and market discipline—could be revived to better serve their essential, complementary roles. This would go a long way toward reenergizing the U.S. banking system and providing the impetus the U.S. economy needs to flourish.

We cannot have a durable, competitive, dynamic banking system that facilitates economic growth if policy protects the franchises of oligopolies atop the financial sector. And our government—short of fiscal space—should not put itself in the position of directing policy through quasi-public banking utilities.

CAPITAL STANDARDS

The proposed capital regime suffers from some infirmities—each of which may ultimately undermine this important prudential pillar from being made durable and effective. As a result, I worry that recent capital rules are at some risk of being gamed, feigned, or deferred in the years ahead.

First, U.S. regulators, working with their international compatriots as part of the Basel Committee, established a joint accord (Basel III) for capital, ostensibly with full implementation set for 2019. Surely, a mutually agreed international framework is a noble and worthwhile objective. But the banking model of many foreign sovereigns is fundamentally different from that to which the United States should aspire. Some advanced foreign economies tend to be dominated by near-permanent oligopolistic banking systems, sanctioned and supported by their sovereigns. And most of those firms tend to be far larger relative to their home country's gross domestic product (GDP) than is the case in the United States. As a result, many of those with whom the United States negotiates implementation of capital standards may hold very different preferences and priorities. This makes a robust global accord problematic—especially at a time when many foreign banks are thought to be undercapitalized and their economies underperforming—and likely subject to continuous revision and reinterpretation.

Second, the current Basel capital-setting regime—like its predecessors—may lead to massively complex and opaque capital standards. This makes capital levels difficult for regulators to calibrate among regulated firms, infeasible for international bodies to assess across countries, and almost impossible for investors to understand and rely upon in evaluating individual firms. "Regulatory capital" is a less-reliable bulwark against economic weakness than actual shareholders' capital that can absorb actual losses. Consequently, I prefer a simpler, more straightforward, risk-sensitive, and more readily reviewable capital standard.

Third, capital levels post-Dodd-Frank are being tasked with a role well beyond their traditional remit of ensuring safety and soundness. Supervisors are being asked to assign extra capital cushions to systemically important financial institutions (SIFIs) so that larger, more interconnected institutions hold commensurately more capital to compensate for the greater risk to the financial system. These so-called SIFI buffers are an understandable attempt to level the playing field. But it is a very distant next-best to ridding the U.S. financial system of large, quasi-public utilities atop the sector. In practice, a couple of percentage points of incremental regulatory capital at inception are unlikely to persist as memories of the crisis fade. And by acknowledging that some select firms are systemically important, I worry that it will only memorialize "too big to fail" firms at the core of banking and reinforce the notion to creditors and counterparties that the government is unwilling to let them suffer losses.

Instead, the United States and other willing countries should begin from a first-best foundation with strong, simple, transparent capital standards appropriate for a dynamic, competitive banking system. This type of capital regime would be well positioned to attract customers and counterparties from around the world. As progress is achieved, I would expect an international coalition to join these efforts.

MARKET DISCIPLINE

In addition to improved regulatory discipline and clearer capital standards, the third and final pillar of prudential supervision—market discipline—must be revived. Market prices of financial firms should reveal much about their standing. Markets can help discipline the behavior of firms by repricing funding costs as perceived risks change. And stakeholders—that is, shareholders, creditors, and regulators alike—can use changes in market prices to evaluate the changing financial position of firms.

However, market discipline will only prove effective if stakeholders gain information to compare firms' exposures against one another in a timely and effective manner. The Federal Reserve's most recent stress tests—particularly the enhanced disclosure—are a step in the right direction. Still, disclosure practices by the largest financial firms remain lacking and the periodic reporting overseen by the Securities and Exchange Commission (SEC) tends to obfuscate more than inform. I favor a far more sweeping transparency initiative so that the financial statements and associated risks of large, complex firms can be monitored effectively by market participants.

But even if market participants possessed the information to better assess firms' standings, market discipline might still be unable to exert influence. Repeated government interventions during the financial crisis, whether advisable or not, revealed a set of policy preferences. Expectations hardened—in the United States and elsewhere—that governments will come to the rescue of large, failing firms. The result is a U.S. banking system that is now more concentrated, and the government's support of our largest banks is even more assured. These expectations must be unlearned by market participants. If not, market discipline will not be operative.

Bigness in financial services is not badness. But our largest financial firms must be able to persuade regulators that their failure would not endanger the financial markets and broader economy. Some of our largest banks are likely to pass this test, and would turn out to be more successful without implicit government support. Others, however, might not pass muster. Hence, the scale and scope of some firms would necessarily diminish. So be it.

Those "interconnected" firms that find themselves dependent on implicit government support do not serve our economy's interest. Their continued existence should not be countenanced. The risks associated with our largest firms must never again be underwritten by taxpayers. Those of us who were long worried about the systemic risks posed by Fannie Mae and Freddie Mac should be no less troubled if our largest banks are effectively backed by the U.S. government.

Eradicating the notion of "too big to fail" firms is the *sine qua non* to bring about real reform of financial services. Some progress has been made by the Federal Deposit Insurance Corporation (FDIC) in preparing protocols to resolve large firms. I am also particularly impressed by the work being done by the Financial Stability Board's Resolution Steering Group. But other regulatory initiatives strike me as going in a less-constructive direction. For example, by sanctioning a list of "too big to fail" firms—and treating them differently than the rest—policy makers are signaling to markets that the government is vested in their survival.

ORDERLY LIQUIDATION AUTHORITY

When the regulatory reform debate began, Congress appeared keen to ensure that there would be no more bailouts and no institutions would be "too big to fail," but even today the doctrine persists. Hence, the three pillars of prudential supervision are not being deployed most constructively to oversee financial firms.

Title II of Dodd-Frank establishes the option of an Orderly Liquidation Authority (OLA), ostensibly to resolve failing financial firms that are determined to pose a significant risk to financial stability. If the OLA is invoked by the Secretary of the Treasury, based on the recommendations of the Federal Reserve and the FDIC (or in some cases, the SEC or the new Federal Insurance Office), extraordinary powers are granted—including the ability to obtain bridge funding from the Treasury—to preserve franchise value and facilitate a transfer to a purchaser. Of note, Dodd-Frank also allows the FDIC to make payments to certain creditors.

In retrospect, could bank regulators and administration officials have employed the OLA to handle Bear Stearns or Lehman Brothers more effectively? This sort of authority might well have proven useful during the recent financial crisis. If we had gone into the crisis with the resolution authority outlined by the OLA, there may well have been better options to ensure an orderly disposition of failing firms. I suspect that the OLA would have been an attractive—but highly debated—alternative. Those favoring its use would have had a more compelling argument if it had long been the law of the land and understood by market participants to be an integral and preferred part of policy makers' tool kit. But if this form of liquidation were only a newly established authority in an unpracticed statute, some other policy makers might have considered it too risky to invoke. Still, if nothing else, the OLA could have strengthened the regulators' negotiating posture with certain financial firms.

Many supporters of Dodd-Frank argue that the OLA would have substantially mitigated the harm inflicted by the financial crisis. Even if they are correct about its effects in war-gaming the last crisis, this new grant of discretionary authority is unlikely to be up to the task going forward. There is no going home again. The status quo *ante* will no longer do.

Placing this arrow in the quiver of policy makers now is not sufficient to arm them for the challenges ahead. Granting new powers to resolve failing firms in the discretionary hands of regulators is unlikely to drive the market discipline required to avoid the recurrence of financial crises. The significant regulatory discretion built into Dodd-Frank is unlikely to dissuade investors from their learned view—however debatable it might be—that the government will stand behind its largest banks. Creditors will be protected, they will figure. And they might turn out to be correct.

We have to stop fighting the last war. As Governor Mark Carney, the head of the Financial Stability Board, reminds us, too often policies are put into place that would have mitigated the last crisis, but leave policy makers exceptionally vulnerable to the next one.

CHAPTER 14

There is no single panacea to deal with financial crises, but invoking a new Chapter 14 of the Bankruptcy Code would be a very useful step forward, particularly as part of a true reform package to strengthen the dynamism and resiliency of the banking system.

The Bankruptcy Code brings with it precedent, case law, and well-understood protocols to provide substantial clarity as to the rights and obligations of each class of stakeholders. It has a deep history of respect for the rule of law without favor or prejudice. In fact, reliable treatment under our Bankruptcy Code—and respect for the rule of law—distinguishes us from some foreign economies and attracts capital to our shores.

A new chapter of the Bankruptcy Code—applicable to all financial institutions—would bring much-needed credibility to the murky issues involving the government's support of large financial firms. A Chapter 14 amendment to the code would go some distance toward reminding creditors and counterparties that the government has fine, effective, and well-understood options to unwind a financial firm and, in the long run, to promote financial stability.

The benefits associated with Chapter 14 go well beyond establishing clarity about how failing financial firms would be unwound. It is about ridding markets of "too big to fail" expectations in the near term. It is about changing behavior in good times so that the bad times are less bad. Early assessments of financial firms—and vibrant competition among them—will better ensure that we do not find ourselves in another banking crisis. Hence, the tougher, clearer, less-discretionary measures, including invoking Chapter 14, would represent a substantial improvement in existing law.

So, what if Chapter 14 were available to policy makers alongside the OLA? To achieve meaningful benefits, Chapter 14 would have to be understood as the prevailing, dominant option. If investors believed that the OLA was more likely to be used by policy makers than the "tough love" of Chapter 14, its benefits would quickly dissipate.

Ultimately, my preference for Chapter 14 versus a newfangled liquidation authority is based, in part, on my strong bias that the existence of large, quasi-public utilities atop the financial sector is growth-defeating for the U.S. economy. Those who prefer the OLA put greater emphasis on wanting to preserve optionality and flexibility going into the next crisis.

I, however, am more willing to constrain discretion and return to a clearer, more rules-based oversight regime that relies more on real capital and true market forces. In so doing, the United States will have a stronger, more dynamic and competitive banking system to serve the interests of consumers, businesses, and the broader economy.