Financial Reform at the Crossroads

Digging out from 2008: What's Next?

Financial Reform at the Crossroads

- "From its earliest years down to the present, a capitalist system has been uncommonly difficult to organize and maintain. The appropriate balance between unfettered markets and societal restraint has never been self-evident…Successful capitalism requires the active promotion of entrepreneurship, but also constant monitoring by government to ensure that the system does not spin out of control. Entrepreneurs, obsessed with future profits, are forever pushing the envelope, moving into gray areas and forcing government regulators to play catch-up. Business scandals have become so frequent that they must be regarded as endemic to capitalism itself, especially in finance."

  – Thomas McCraw *The Founders of Finance*

Financial Reform at the Crossroads

- I. The Depression Era Regulatory Legacy
- II. Transformation of the U.S. Financial System
- III. The Dodd-Frank Act
- IV. What Is To Be Done?

Financial Reform at the Crossroads

- Three Essential Questions:
  - 1) Should the government be responsible for preserving the safety and soundness of the financial system?
  - 2) If so, to what extent should the government intervene?
  - 3) How to deal with the moral hazard government intervention creates?
  - Do the costs of non-intervention (financial crises) out-weigh the costs of intervention (constraints on markets)?

- The Depression Era Regulatory Reforms (I)
  - America: A country of serial bank failures and banking crises
  - The historic legacy: 1814, 1818-19, 1836-38, 1841, 1857, 1861, 1864, 1873, 1884, 1890, 1907, 1914, 1929-33
  - Depression 1929-1933: Over 9,000 banks failed, 1/3 of the entire U.S. banking system

Financial Reforms at the Crossroads

- Depression Era Regulatory Reforms (II)
- Reduce the risk of bank runs and bank panics
- Creation of Federal Deposit Insurance Corporation (FDIC)
- Guaranteed deposits creates risk of moral hazard
- How to protect depositors from the tendency of bankers to take unwarranted risks?

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- Depression Era Regulatory Reforms (III)
- Glass-Steagall Act of 1933

- Strict separation of commercial banking and investment banks

- Investment banking seen as carrying far greater risk

- Creation of the Securities and Exchange Commission

- # Depression Era Regulatory Reforms (IV)
- Regulatory system in place 1933-1999
- Plethora of regulators emerged from political compromise
  - Federal Reserve Bank (Bank holding companies)
  - Office of Comptroller of the Currency (National banks)
  - Federal Deposit Insurance Corporation (Insured banks)
  - Securities Exchange Commission (Investment banks, brokers)
  - Office of Thrift Supervision (Savings and Loan banks)
  - Commodity Futures Trading Commission (Futures exchanges)
  - Federal Housing Finance Agency (Fannie Mae, Freddie Mac)
  - State insurance regulators

- Depression Era Regulatory Reforms (V)
- Regulators organized by type of institution, based on the financial system as it was in the 1930s

- Parts, but not the whole: No regulator of the financial system

- Depression era regulatory system served tolerably well for much of the period

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- Transformation of the Financial System (I)
  - New competition for commercial banks
  - Savings leaving banks for other investments
  - Borrowers find cheaper sources of financing than bank loans
  - Creates the “Shadow” banking system:
    - Investment banks, hedge funds, private equity funds, mortgage companies, finance companies
    - Commercial paper market, Repo market, derivatives market
  - Shadow banking system is lightly regulated and highly profitable

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- Transformation of the Financial System (II)
- Commercial banks have declining profits: what do they do?
- Aggressive expansion
- Relentless pursuit of higher earnings
- Demand less restrictive regulation

- Transformation of the Financial System (III)
- Deregulation: Progressive removal of regulatory constraints after 1970
- Culmination: Graham-Leach-Bliley Act 1999
- Allowed consolidation of financial firms, creation of financial conglomerates
- Created large, complex multinational financial institutions (LCFI) with greatly enhanced market power

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- Transformation of the Financial System (IV)
- Rise of the SIFI: Systemically Important Financial Institutions
- Too Big To Fail Doctrine
- Removal of regulatory constraints on moral hazard
- Deposit insurance and Too Big To Fail remained

- # Transformation of the Financial System (V)
- Free Market Ideology and the Efficient Market Hypothesis
  - Free market ideology: markets should not be constrained by government : Milton Friedman and the Chicago School
  - Efficient Market Hypothesis: market prices are the best guide to the value and risks of investments: thus, self-regulating
  - Regulation interferes with market efficiency and is unnecessary
  - Reaganism: Government is not the solution to our problem, Government is the problem.

- # Transformation of the Financial System (VI)
- "It is most important to recognize that no market is ever truly unregulated in that the self-interest of participants generates private market regulation...Thus, the real question is not whether a market should be regulated. Rather, it is whether government intervention strengthens or weakens private regulation, and at what cost."

  – Federal Reserve Bank Chairman Alan Greenspan, April 1997

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- By 2007 we have:
- Vast increase in the Financial sector
- Increase in complexity of financial products, markets, and institutions as a result of deregulation
- Complexity compounded and obscured risks within the financial system
- A fragmented and weakened regulatory system
- No systemic regulator or mechanism to deal with SIFI failure

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What, me worry?

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- The Dodd-Frank Act (I): The Background
  - The Financial Crisis: A colossal failure of regulation
  - The bank bailouts of 2008: preventing catastrophe
  - The regulators' ad hoc response to the crisis
  - Private gains, socialized losses

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- The Dodd-Frank Act (II)
  - The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010
  - Attempt to address the regulatory failures of the crisis
  - Objectives of Dodd-Frank Act
    - 1) Create a framework for dealing with systemic risk
    - 2) Place restrictions on SIFIs: Volcker Rule, capital and liquidity requirements
    - 3) New regulatory oversight on certain markets, activities
    - 4) End Too Big To Fail doctrine, no more bailouts
    - 5) Greater protection for consumers

- The Dodd-Frank Act (III)
- Critiques: The financial services industry view
  - Too complicated, too costly: "Confused and bloated law"
  - Cumulative weight of rules will: restrict economic growth and availability of credit, increase the cost of financial services, decrease international competitiveness
  - The sector is stronger post-crisis, so rules are too strict
  - Uncertainty is causing banks to pull back from lending, causing slower job growth
  - Arguments reflect free market ideology

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- # The Dodd-Frank Act (IV)
- Critiques: A framework with potential, but…
  - Dodd-Frank creates a framework, but far from clear how effectively the pieces will work
  - The Act is complex, with many rules still to be determined: 225 rules over 11 Federal agencies: <u>lots of push-back</u>
  - Fails to address regulatory consolidation
  - Focus remains narrow, not system-wide
  - Financial firms do not pay for tacit government guarantees
  - Important segments of the shadow banking system remain unregulated

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- What is to be done? (I)
- Three options:
  - 1) Continue with Dodd-Frank as it is intended
  - 2) Do less, back off
  - 3) Do more, go farther

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- ## What is to be done (II)
- 2012 Democratic Platform:
- “A strong middle class can only exist in an economy where everyone plays by the same rules, from Wall Street to Main Street. That's why President Obama and Democrats in Congress overcame fierce opposition from the financial industry to pass the most far-reaching Wall Street reform in generations…Today Democrats are holding Wall Street accountable, bringing new transparency to financial markets, and ending taxpayer-funded bank bailouts and the era of "too big to fail."

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- What is to be done (III): Democrats
  - Protect and preserve Dodd-Frank reforms
  - Complete implementation of Dodd-Frank
  - Limited new initiatives: Fannie and Freddie
  - Political appointments

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- What is to be done? (IV)
- 2012 Republican Platform:
- "Regulations must be drafted and implemented to balance legitimate public safety or consumer protection goals and job creation. Constructive regulation should be a helpful guide, not a punitive threat...But no peril justifies the regulatory impact of Obamacare on the practice of medicine, the Dodd-Frank Act on financial services, or the EPA's and OSHA's overreaching regulation agenda. A Republican Congress and President will repeal the first and second, and rein in the third."

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- What is to be done (V): Republicans
  - Fewer options available
  - House and Senate leadership
  - Limit or weaken Dodd-Frank
  - Drag out the process

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- What is to be done? (VI)
- Do more, go farther:
  - 1) Glass-Steagall 2.0
  - 2) Breakup the mega financial conglomerates
  - 3) Impose an assessment tax on all LCFI/SIFIs
  - 4) Consolidate regulators and expand regulation of the shadow banking system

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