Whither Financial Reform?

ROBERT E. LITAN

It is little more than a year since the financial world seemed like it was coming to an end—on the heels of the Lehman collapse, the rescues of AIG, Fannie Mae and Freddie Mac (the two giant housing government-sponsored enterprises), and the creation of the $700 billion fund for troubled assets (TARP). Although we are far from out of the woods on the economic front, and the numbers and costs of bank failures continue to rise, consumers, investors, and politicians are far less nervous about the state of the financial system today than they were twelve months ago. And ironically, that is the main reason that much of the urgency about reforming the financial regulatory system—a subject that was at the top of policymakers' 'to-do' lists only a few months ago—seems to have waned.

In fact, much reform already has happened or will likely be undertaken by regulators in the near future. The 'match' that lit the financial fire—the explosive growth in subprime mortgage lending—has been essentially taken away. The Federal Reserve, together with Fannie Mae and Freddie Mac, has tightened rules on mortgage origination. Investors don't trust the ratings agencies that unwisely stamped their approval on more than $1 trillion in complex securities backed by subprime mortgages, and as a result simply won't buy such instruments.

At this point, unless you can meet the requirements of the Federal Housing Administration (which still insures mortgages for lower income households under certain conditions), you need to put 20 percent down before you can get a mortgage; no more of this "no doc, no money down" lending at low initial teaser rates.

Had the big banks and the formerly independent investment banks had larger equity cushions and (in the case of the investment banks) not been so heavily dependent on short-term financing, far fewer or conceivably none of them would have failed or required a federal rescue when subprime mortgage securities began to sour. Here, too, regulators and the market already have done much, and almost surely will do more, to address both the large increase in leverage and the liquidity imbalances among our largest financial institutions, which in combination enabled the subprime mortgage fire to turn into an economic conflagration.

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Regulators here and around the world are already studying ways to raise capital standards for banks (and to make them less pro-cyclical). The off-balance sheet structured investment vehicles that the large banks used to park large volumes of the mortgage securities they created have been shut down; going forward, regulators are likely to consolidate such entities to prevent banks in the future from using them or variations thereof to circumvent capital standards. Furthermore, no large, independent investment banks are left, though it is possible that Goldman Sachs and Morgan Stanley (the two surviving entities) may some day (perhaps soon) convert back to this organizational form from their current bank holding company status. Even if that happens, it is likely that the market will require one or both entities to be much more liquid and/or to rely less on short-term money than was the case before the crisis.

THE REMAINING AGENDA

In short, the market and regulators are doing much to 'fix' the main problems—excessive subprime mortgage lending and securitization combined with excessive leverage—that led to the financial crisis of 2007–09. What then is left for Congress to do, and why should it act at all?

Several factors still argue in favor of some legislative reform:

- Memories are short in the financial world and, as the pain of this crisis fades, financial institutions and investors (some of them new, having not experienced the current pain) will be tempted to take the same or similar risks that got us into so much trouble. Well-crafted legislation (this doesn't have to be an oxymoron) could prevent this outcome or at least make it less likely.
- Gaps in financial regulation remain. No single regulator or group of regulators is charged with monitoring (let alone regulating) potential systemic risks; instead regulators continue examining institutions as if they were silos. This is not a structure that is well suited to responding well to the new instruments or organizations that could contribute to future financial crises.
- The securitization pipeline (apart from securities backed by prime, conforming loans, which are on autopilot at Fannie Mae/Freddie Mac) clearly is broken, and it is conceivable that more certainty about the rules would help fix it.
- Although the Fed has toughened its mortgage origination rules, the current system of protecting consumers from financial abuses would benefit from at least some attention to legislation. At a minimum, more resources are required to enforce existing laws by the current regulatory bodies. Given the failures of those agencies to prevent abuses in the run-up to the recent crisis, there is also a strong case for creating a new agency to oversee financial products for consumers, as the Administration has proposed, or at the least consolidating this authority in a single existing agency (such as the FTC) and giving it adequate resources to do the job.
- Although there is now broad consensus that regulators should reduce systemic risks by encouraging standardized financial derivatives to be cleared through central clearinghouses, regulators still lack sufficient legal authority to impose margin and capital requirements on dealers and market participants in customized financial derivatives. This

gap in regulation should be remedied, without chilling the use of and innovation in such instruments, which remain useful tools for hedging risks.

In addition, more harmony should be brought to the regulation of central clearinghouses than is envisioned in the Administration's reform proposal, which would give clearinghouses and exchanges in financial derivatives a choice of regulator, the SEC or the CFTC. In the absence of merging the two agencies (a political impossibility), Congress could require the two Commissions to form a 'regulatory joint venture' to oversee such clearinghouses and exchanges with a single set of rules (in parallel, Congress can have both its financial and agriculture committees oversee such a joint regulatory entity).

- Some permanent disposition of Fannie Mae and Freddie Mac is required, and this almost certainly will require legislative action.

CURRENT CONGRESSIONAL LEGISLATION

Legislation also carries with it risks, the principal one being overreaction—which I and others believe happened with Sarbanes-Oxley, legislation that was rushed through the Congress after the failure of Worldcom. Yet precisely because of the slowdown in congressional consideration of the various financial reform plans proposed in the wake of this crisis, there is less danger of overreaction now—although all laws and regulations have unintended consequences, and whatever reform legislation eventually emerges next year almost certainly will fit this pattern. On balance, given the enormous costs of financial crisis of 2007–09, the benefits of legislated reform are still likely, in my view, to outweigh the risks.

At this writing, the House and Senate are taking two very different approaches to reform. The House, working through the Financial Services Committee, is taking things piecemeal, with consideration of a new Consumer Financial Protection Agency at the top of the list. The Senate Banking Committee has been taking a more comprehensive approach, and seems inclined to wait for the pieces passed by the House to reach the Senate before molding some or all of them into a single bill.

At the current rate, it is unlikely that a major congressional reform package will be ready for President Obama's signature until the summer or fall of 2010. It is also conceivable that Congress could take another crack at financial policy reform in 2011–12 after it receives an official report from the commission that Congress created to investigate the causes of the financial crisis and to make recommendations for change. The appetite for change then is likely to depend on the number and cost of future bank failures, the pace of the recovery, and any other financial problems that surface between now and then.

BANKRUPTCY PROCEDURES, TOO BIG TO FAIL & SYSTEMIC RISK

I have outlined above some of the key elements a legislative reform package should contain. Above all else, the most important goal of a future reform bill should be to cost-effectively minimize the likelihood that in the future, creditors of our largest, most complex and interconnected financial institutions, or those deemed to be 'systemically important,' will be fully protected by the federal government. Minimizing the *Too Big To Fail* (TBTF) problem is important for both substantive reasons (to reduce moral hazard) and political reasons (given the likely negative views of even meritorious government spending generally generated by the bailouts).

Note that I have stated the goal as one of 'minimizing' but not *eliminating* TBTF. The distinction is important. The recent decisions by federal authorities protecting the uninsured depositors of some of the largest banks (through mergers or injection of government capital) and the creditors of such large non-banks as Bear Stearns, AIG, and the GSEs set a precedent that I believe cannot and will not ever be reversed (notwithstanding the failure to rescue Lehman, which is widely believed by private market participants to have been a mistake). At the very least, short-term creditors and uninsured depositors (or those most able to run in the event of trouble) of systemically important (Tier 1) financial institutions now have ample reason to believe they will always be protected under any circumstances, and hence it is unrealistic to expect that the TBTF problem ever will be eliminated.

A more feasible, and necessary goal is for policymakers is to find ways to convince *long-term* unsecured creditors of bank holding companies and non-banks (some of which also received protection in the recent bailouts) that they are at risk in the event of failure (this is not a problem for shareholders, who have been largely or totally wiped out in each of the 'bailouts'). Short of proving this to be the case in a future crisis—something that hopefully will not be tested for a long time—three steps seem worth a try.

First, systemically important financial institutions (and yes, I would designate them in advance, but subject them to a tougher set of capital and liquidity standards, along with special resolution procedures to offset any moral hazard from the designation) should be required to submit to their primary regulator (or any designated 'systemic risk regulator') a 'wind-down' plan for prompt resolution of creditors' claims in the event of future financial difficulties. Such plans not only can underscore to longer-term creditors the risks they run, but encourage managers of the institutions regularly to think and plan for the worst case, an exercise that should make it less likely to occur.

Second, government should facilitate the execution of the wind-down plans through a special resolution process that gives authorities and managers of troubled systemically important financial institutions (Tier 1 institutions) considerably longer than the weekend to achieve a resolution—merger, piecemeal sale or full liquidation—that preserves as much franchise value as possible.

The Administration has proposed replicating the FDIC's bridge bank authority for non-bank Tier 1's. It is conceivable that a similar, positive result could be achieved through a special new chapter of the bankruptcy code that would permit bankruptcy courts to obtain the functional equivalent of 'debtor-in-possession' (DIP) financing from the Treasury to keep the institution afloat while efforts at a resolution are pursued. Whichever process is chosen, having a special resolution procedure in place should provide the authorities and investors sufficient breathing room so that some kind of haircut could be imposed on long-term creditors without posing a wider systemic risk.

Finally, a group of academic scholars, financial practitioners and former regulators has suggested the creation of a data gathering and financial analytics entity, tentatively titled the *National Institute of Finance*, which could help financial regulators across the board keep up with and understand what Wall Street wizards and other private financial sector powerhouses are continuously inventing, marketing and using. The NIF ideally would be an independent body, with a Presidentially-appointed director (confirmed by the Senate), and would report to and work with whatever entity is charged with monitoring systemic risk. It is a good idea that, if all else fails, should be adopted.

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