



A Step Forward on Financial Regulation

Morris Goldstein, assessing the merits and defects of the US Treasury Department's financial regulatory proposals, finds the balance on the positive side.

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Steve Weisman: This is Steve Weisman at the Peterson Institute for International Economics. Morris Goldstein, senior fellow at the Institute, has written extensively about the issue of reform in the financial system. Morris is here to talk about the recent proposal to overhaul the national and international systems put out by the United States Treasury in mid-June.

Thanks for joining us, Morris.

Morris Goldstein: Well thank you, Steve, for having me.

Steve Weisman: The proposal issued in the middle of June has drawn a lot of comment, criticism and praise. What's your overall assessment?

Morris Goldstein: I think it's a good plan overall. It's worthy of support. There are some holes and some disappointments but the pluses far outweigh the minuses.

Steve Weisman: Let's go through the pluses first. What's the biggest one?

Morris Goldstein: Certainly one of the biggest is the plan for an orderly resolution mechanism for systemically important non-banks and for bank holding companies. We have already a resolution mechanism for banks under the Federal Deposit Insurance Corporation Improvement Act.

Steve Weisman: What do we mean by a resolution mechanism?

Morris Goldstein: This is a way of dealing with systemically important financial institutions when they're teetering on the edge of insolvency and the question is how to close them in a way that makes sense for financial stability and also makes sense for the taxpayer.

Steve Weisman: The FDIC does that with banks all the time. I think since this crisis began, twenty or thirty banks have folded.

Morris Goldstein: That's right. But as we saw in the case of Bear Stearns, AIG, Lehman, there's a problem when you come to important non-banks. And the difficulty was, without such a mechanism, you are faced as a policymaker with two unpleasant

choices. Either you would put the institution into Chapter 11 bankruptcy, and then you would have creditor stays and other things that could lock up markets, or alternatively, you could make the decision over the weekend to bail out the institution with a very large amount of money. You didn't have sufficient time to do proper due diligence and that wouldn't necessarily be good for the taxpayer so you were damned if you did, damned if you didn't.

And what this mechanism does is give you a third option where the government can take it over. It can run it under a bridge bank and so you get continuity of operations and at the same time, you get what economists call good moral hazard properties because you contact the shareholders, change the management and you may be able to pay off some of the bondholders at estimated recovery costs rather than at par. So it's a third way that's good for market stability and I think good for countering moral hazard.

Steve Weisman: Where would this new authority reside?

Morris Goldstein: It's not absolutely clear, but perhaps it might be operated by the FDIC or it might be operated by the Treasury. But some government receiver would run it. And what's not clear is how it's going to be funded. I mean we either could have a fee on universal systemically important firms or...

Steve Weisman: Which is the FDIC model?

Morris Goldstein: Yes, right. We have deposit insurance and we have insurance premium on that. That probably wouldn't be sufficient for a very large amount. You would have to get a loan from the Treasury, sort of like the TARP. I think you don't want that to be unlimited. I think it's better to put some amount on it, make them go to Congress and then come back if they need more than that.

Steve Weisman: Under the proposal, it is unlimited though, isn't it?

Morris Goldstein: That's right. But I think that could be revised, fixed. But if you did that, then I think the proposal makes sense.

Steve Weisman: What else strikes you as a contribution here?

Morris Goldstein: A second important thing is to have higher capital and liquidity requirements for banks and for other systemically important financial institutions. I mean, we've seen that the government had to put large amounts of money in to recapitalize institutions and that shows that they just didn't have enough capital. The Treasury report acknowledges that.

They also didn't have enough liquidity, as we can see by the large-scale liquidity injections, unprecedented, that the Fed has had to do. So we need to toughen those up, we need to make those requirements higher. And the Treasury report acknowledges that. It doesn't tell us exactly how much higher they're going to make them but they're certainly moving in the right direction.

On top of that, they favor--as I do--a leverage ratio internationally so instead of just basing capital on risk-weighted assets, you would also have an unweighted scheme, which prevents leverage from building up so much during the upswing of the cycle. You would make the capital requirement a countercyclical...

Steve Weisman: Which means?

Morris Goldstein: Which means that it would be lower during the recession, it would be higher during the boom period so it would help to stabilize things. We would have a higher capital requirement for systemically important institutions than we would for those that are not systemically important under the argument that there's larger spillover cost to the economy if those institutions fail. So all those I think are good things.

Steve Weisman: Who would enforce those propositions?

Morris Goldstein: In the Treasury plan, the Fed is the regulator, the sort of main prudential regulator. But this would have to be done internationally, in the Basel Committee on Banking Supervision, which set the higher capital and liquidity requirements, assuming we can get international agreement on that.

Steve Weisman: Does it have to be the Fed or is there another route to take?

Morris Goldstein: This raises the general question of who should be the prudential regulator in the system, who should be looking after all the systemically important institutions, and the report nominates the Fed for that.

Steve Weisman: And what do you think of that?

Morris Goldstein: I disagree with that. I think the Fed should be the market stability regulator. That is, they should be in charge of handling systemic risks. They should have a double-O license to go wherever they need to go to investigate and to make recommendations. But I don't think they should also be the main prudential regulator.

Steve Weisman: Who should?

Morris Goldstein: I would favor creating a new institution to do that because the other candidates, the FDIC and the Treasury, I think have weaker credentials even than the Fed to do that. But I don't see any reason why we can't create a new prudential regulator, staff it with some of the more qualified people we have in the existing agencies. But there's no reason why we need to have three of them. We don't have to have the Fed and the FDIC, and the Treasury.

And furthermore, I don't think the Fed is the right choice, because the Fed has done a very bad job in supervising bank holding companies. I mean, they were the ones responsible for Citigroup, for example. And I think they

have enough to do with monetary policy, and if we make them the market stability regulator, they don't need to be doing everything.

Steve Weisman: What are the chances of Congress creating something new? They don't seem to be moving in that direction.

Morris Goldstein: I think it remains to be seen what they're going to do. I think there is some opposition to the idea of concentrating too much power in the hands of the Fed.

Steve Weisman: You saw that a little bit with the skepticism toward Bernanke at the hearings in June.

Morris Goldstein: Yes, and I think the Congress has to be persuaded yet that having the Fed do all these things is the best option. And as I suggested, I don't see why we can't consolidate all the prudential supervision over the important institutions, what the report calls the Tier 1 financial holding companies. Let's have that done by a new banking regulator and that will eliminate the overburdening of the Fed.

Steve Weisman: Let's move on to the major defects of the Treasury proposal.

Morris Goldstein: There's a number of them. First of all, one we've already alluded to. This really would have been the occasion to streamline the organization of financial supervision in the United States. And we didn't get really far. They eliminated the Office of Thrift Supervision but they still proposed three banking regulators.

So we should have taken this opportunity to reduce that to a single prudential regulator. We should have also consolidated the SEC [Securities and Exchange Commission] and the CFTC [Commodity Futures Trade Commission]. There is no reason why we needed two of those. We should have created a national regulator for insurance, instead of keeping it 50-state regulators and just having this office that's going to overlook. So that was I think one missed opportunity. We could have gone a lot further on consolidation, streamlining the regulatory structure. And because apparently there was some opposition in Congress, the Treasury, they really ducked on that one.

Steve Weisman: What else?

Morris Goldstein: They didn't identify the important issue of how to identify and prick asset price bubbles. After all, that's a key element in the crisis...

Steve Weisman: But a lot of economists say that, and of course the Fed, that you can't use monetary policy to prick asset price bubbles. How do you do that?

Morris Goldstein: You need to get both the central bank and the regulators to agree. If one doesn't act, then the other must act. For example, we have to adjust loan-to-value ratios with mortgages, the regulators have to be much tougher on loan concentration and consolidation.

And I think the Fed can lean against the wind. I think they can see some of these bubbles as they're building. It's interesting that Bill Dudley, the president of New York Fed, recently made a speech suggesting that we're going to have to get more involved in doing that.

Steve Weisman: That really ran counter to orthodox view at the Fed.

Morris Goldstein: That's right, but I think it was welcomed and I think, given that this is at the heart of the ongoing crisis, I think the report should have looked at that and recommended tougher action.

A third area I think where the report was weak is that it didn't really go very far in suggesting a solution to global payments imbalances. This is a big problem because that had an important influence on low long-term real interest rates in the United States.

Steve Weisman: You're referring to the current account imbalance?

Morris Goldstein: That's right. The large current account deficit of the United States, the large surpluses that we have in many emerging economies, particularly Asia, particularly China. If you don't do something about that, particularly in the surplus countries, you create the conditions again for the huge capital inflows, for low real interest rates, which lowers mortgage rates, which adds to the pressures for leverage.

Steve Weisman: Of course, the IMF is supposed to be looking at issues like exchange rates, which are affected by those imbalances. But they haven't done a good job I think, in your view. So who's going to be the authority that's going to monitor this?

Morris Goldstein: I think it has to be the IMF. They have to take this more seriously and the US Treasury should push harder for getting the Fund to do that. I mean, we are seeing some temporary fall in the US current account deficit. We've seen some fall relative to the size of the economy and the Chinese surplus. We have a long way to go and if we don't make progress on that—again, that's one of the underlying contributors to the crisis. So that's another area we didn't do much.

Two additional ones, I mentioned just in passing. They kicked the can down the road on reform of Fannie and Freddie. I think that too, we need to move away from the public-private model. We're going to have to break those up and privatize them.

Finally on the reform of the credit rating agencies, they've proposed some steps there that I think are useful, separate ratings for structured products, reducing their old credit ratings and the regulatory process. But they don't go far enough on conflict of interest, in particular we need to prohibit those firms from doing consulting business. They should just stick to their rating business. So those I think are the main minuses.

Steve Weisman: A final question: is it really possible to create a regulatory structure that is entirely insulated from the politics of the moment?

Morris Goldstein: No, but this is our best chance in decades. That's why it's important I think that we make as much progress as we can on this occasion because this is the time when you have the public outrage, when memories are fresh of what went wrong, and when you're going to have the greatest support for doing these things.

So again, I think that the Treasury report is worthy of support. I think it's a good plan but it could be improved.

Steve Weisman: Morris, thanks very much for taking the time to talk about this.

Morris Goldstein: Thank you.

