



Financial Regulatory Reform Moves Ahead

Morris Goldstein rates the new legislation offered by Senator Christopher Dodd as a positive step, especially in its proposal to establish a tough new prudential regulator.

Edited transcript, recorded November 16, 2009. © Peterson Institute for International Economics.

Steve Weisman: This is Steve Weisman at the Peterson Institute for International Economics. Morris Goldstein, senior fellow at the Institute, has been studying the progress of financial reform on Capitol Hill and is here to talk about the latest developments, including a new bill presented by the chairman of the Senate Banking Committee. Thanks for joining us.

Morris Goldstein: Delighted to be here, Steve.

Steve Weisman: The chairman of the Senate Banking Committee, Christopher Dodd, has introduced his own version of sweeping financial regulatory reform. Morris, on balance, was it a step forward?

Morris Goldstein: I think definitely it's a step forward. It's a pretty good bill, all things considered. If one were giving it a grade, I'd say it's somewhere between a B and a B+.

Steve Weisman: You're always a tough grader. You don't grade on the curve. What do you think is the most distinctive and positive, maybe not the same thing, feature of the legislation?

Morris Goldstein: Well, I think the most distinctive feature is the effort to create a single national, financial prudential regulator. So you would fold into one the responsibilities of the Federal Reserve, the FDIC [Federal Deposit Insurance Corporation], the OCC [Office of the Comptroller of the Currency], and the Office of Thrift Supervision and you just create a single financial regulator to do bank inspections and the like.

Steve Weisman: And this new prudential regulator would be a brand new entity of some kind and not the Fed, as I believe the House is heading toward doing.

Morris Goldstein: Yes, it would be a new agency so it wouldn't be marred by past failures. I mean, I agree with this effort because I think the Fed simply didn't do a very good job in supervising the largest US banks. We also had charter shopping going on, where financial institutions were looking for the softest regulator they could find. And on efficiency grounds, there's no reason why we need four or five bank regulators; one will suffice.

Steve Weisman: When you say the Fed fell short, let's make clear, you're talking about the years leading up to the current crisis and not necessarily how it handled the crisis in the last 18 months.

Morris Goldstein: That's right. I mean, I'd give the Fed very good marks for their crisis management. But in terms of crisis prevention and in particular, in terms of the prudential authority and what

they did in disciplining banks and in monitoring systemic risk that was developing in the financial sector, there I think they didn't do a very good job.

Steve Weisman: Just to be clear, when you say prudential, in other words they have twin duties. One is to monitor the health of individual financial institutions but also the health of the system. And they did a bad job, in your view, on both?

Morris Goldstein: I think on both of those, in the run-up to the crisis, they didn't see the systemic risk building because of bubbles that were building in credit and asset markets, property markets, and equity markets. And they didn't do a good job at supervising risk in the largest financial institutions.

Steve Weisman: What about the monetary policy area? Are you among the critics who feel that the Fed kept interest rates too low for too long, or are you talking about other kinds of supervising capacities?

Morris Goldstein: I think more generally, we would have needed to see some corrective actions taken sooner. Some of that was interest rates but it was also bank capital, liquidity requirements, loan-to-value ratios, and mortgage markets; there's a group of tools that could be employed. That wasn't done. And that's, I think, one of the valid criticisms.

Steve Weisman: Tell me more about what Senator Dodd's bill would do in terms of setting up this new regulatory entity. Would it replace the Fed entirely or would the Fed continue in some new kind of subordinate role?

Morris Goldstein: The Fed would of course retain its monetary policy responsibilities; it would still be lender of last resort. So really what we're taking away is what economists call the microprudential authority of the Fed; that is, its authority as a bank regulator to look at individual institutions and determine their safety and soundness.

Steve Weisman: And would this legislation also supplant the FDIC, the OCC, and the other regulatory entities?

Morris Goldstein: Like the Fed, they would lose their prudential authority over banks that they currently regulate. The FDIC would still be in charge of resolution for banks; that is, when banks fail, they would still be in charge of that. But we would now have a new agency that would really be responsible for monitoring both banks and systemically important nonbanks.

Steve Weisman: Were there any other positive parts of the bill?

Morris Goldstein: I think there are a number of them, and let me go through them quickly, that I think I would count as pluses. The bill would create a systemic risk council of regulators to monitor systemic risk, share information, try to coordinate better on what to do when systemic risk was building. So I think this is useful because you'll get information from various authorities that's helpful to pool those, yet somebody has to be responsible. And this would kind of be an expansion of the sort of President's Working Group on financial stability. The bill confronts "too big to fail" in a number of ways that I think are useful. It would impose higher capital, liquidity, and leverage requirements on large

and complex financial institutions, be they banks or nonbanks. It would also require these institutions to file and keep current wind-down plans in case they were failing.

Steve Weisman: This is the so-called “living will” thing.

Morris Goldstein: Sort of the “living wills” provision. And if those were not deemed by the regulator to be adequate, let’s say they were too complex; those institutions could be required to sell off assets, to sell off division so they could be broken up at least in part. It has a resolution authority to wind down those institutions once they fail. It requires that if there’s a cost of that beyond an initial assessment on financial institutions, we would have an exposed assessment so that the taxpayer doesn’t wind up funding those things.

Steve Weisman: And not an assessment in advance, setting aside a pile of money for that.

Morris Goldstein: I think there would be both. Some, what you might think of as ex-ante assessment and then ex-post assessments. But the idea would be to have the industry pay for bailouts. I think another positive feature of the bill is that it would have some reforms in the over-the-counter [OTC] derivatives market; that would include registering all these trades in a central place and most important, you would be moving the standardized derivatives to organized exchanges and central clearing parties so that you reduce the risk relative to where it is now. Another feature is it would create a consumer financial protection agency to eliminate abuse of practices on consumer protection and make sure consumers got adequate information.

Steve Weisman: Some people say this legislation would have the effect of making the financial sector in the United States less profitable and consisting of smaller, weaker institutions at a time when they have to compete globally with big institutions. What’s the answer to that?

Morris Goldstein: I think there’s very little evidence that scale in banking—that is, banks larger than, let’s say, \$100 billion in assets—have advantages for consumers or for the economy as a whole. I don’t think we ought to be reluctant to try to limit how large these institutions get and to make sure that the structure is in keeping with what’s good for the American economy as a whole, not just what’s good for banks. Yes, it will mean that they’ll have slower asset growth and probably lower profits than they had in the run-up to the crisis, but those things are unsustainable.

Steve Weisman: What are some of the weaknesses of the legislation?

Morris Goldstein: I think the main weakness is that it doesn’t really require that the systemic risk monitor, this Council of Regulators and the Federal Reserve, take action to prick asset price bubbles before they get too large.

Steve Weisman: What are they supposed to do? What should they do?

Morris Goldstein: They should be taking action on capital and liquidity requirements, on leverage, on loan-to-value ratios to move those in a countercyclical way. So the bill is good on what we can think of as microprudential grounds but it’s not good on macroprudential and macroprudential is important.

Steve Weisman: That's how we got into this crisis.

Morris Goldstein: That's right. And so that, I would say, is a major defect. Another weakness is it limits the Federal Reserve's lender of last resort authority; they could do systemic operations but they can't provide assistance to individual institutions. I think that's a mistake. I think that you want to make sure that the Fed can at least provide temporary relief if we don't have some other source of funding in a crisis.

Steve Weisman: That's interesting. The Senate seems to regret maybe some of the actions that the Fed took in the last year and a half.

Morris Goldstein: I think given the alternatives, we want to make sure the Federal Reserve actions are approved. You don't want it to be allowed to be unlimited, but you don't want to tie the lender of last resort's hands too tightly. Two other things that I think are weaknesses in the bill: I think it should have been tougher on credit rating agencies and on executive compensation. What's missing on credit rating agencies is that we should remove those ratings from financial regulation. We can have them but we shouldn't say that they should be used for financial regulation because that's what drives the effort to inflate these ratings, so that firms can get a higher rating on their debt offerings and the like and that's something we don't need. On executive compensation, the bill would have nonbinding shareholder votes on executive pay and on parachutes—

Steve Weisman: Parachutes, meaning?

Morris Goldstein: Golden parachutes for executives. And it would increase the independence of compensation committees. But it doesn't really require that executive pay be tied to long-term performance and that where it's not, those firms face a higher capital charge than those with better arrangements.

Finally, I would also say that the bill would allow states to impose tougher consumer protection laws than the federal government. And I think it's better just to have a tough federal limit but not to have states going all over the place because I think then the compliance cost just gets to be too great.

Steve Weisman: A lot of the regulatory functions have been going on in New York among the Attorney General and the New York County District Attorney; everybody gets into the act in New York.

Morris Goldstein: You know sometimes that's good. Some of those, if you have a weak federal effort, it's helpful sometimes to have state attorneys general who go farther. But there's a risk on that side as well, that sometimes they may go too far or you get such a wide variety of laws that it makes it very difficult for firms. I would prefer just a single, very tough federal set of requirements.

Steve Weisman: Last question: What's the outlook for this legislation, particularly given that the House is moving in some cases in the same direction and in others not?

Morris Goldstein: I think in the end we'll get a compromise. We wouldn't get quite as much streamlining of the regulatory structure as is in the Senate-Dodd Bill. But we'll probably get more

than is in the bills coming out of the House. On some of these other things, like resolution authority, reform of OTC derivatives, some of these other things, the bills are more similar and I hope we get strong provisions, containing those elements.

Steve Weisman: Next year, do you think?

Morris Goldstein: I hope early next year at the latest.

Steve Weisman: Morris, thanks very much for joining us.

Morris Goldstein: Thank you, Steve.

