

# The Case for Simpler Financial Regulation

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May 13, 2010

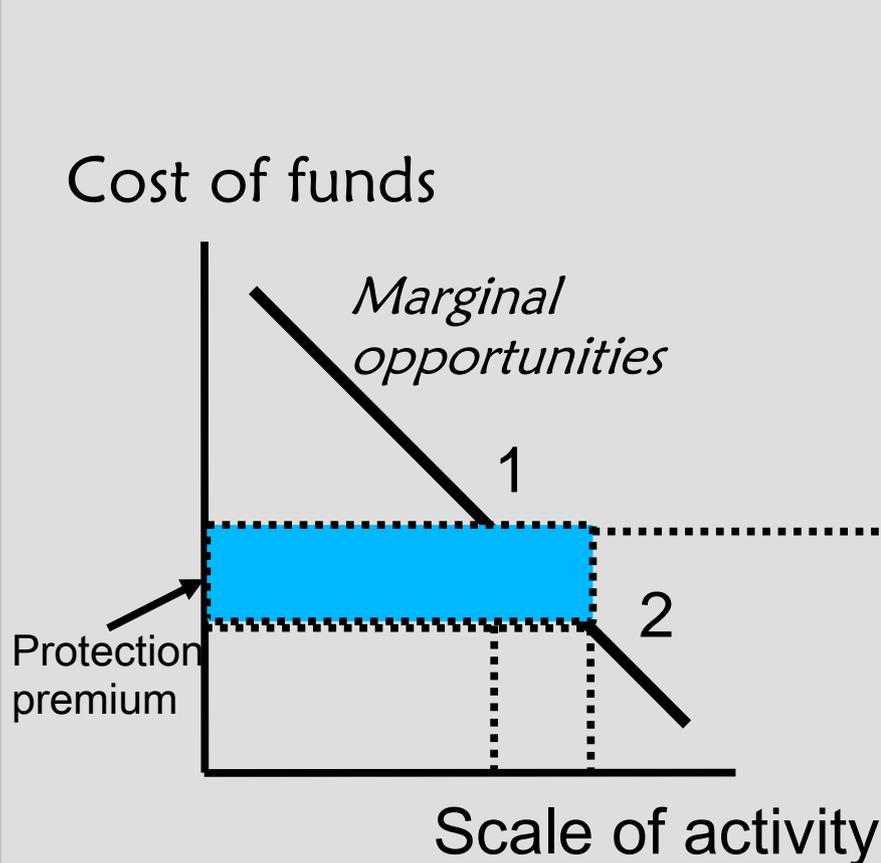




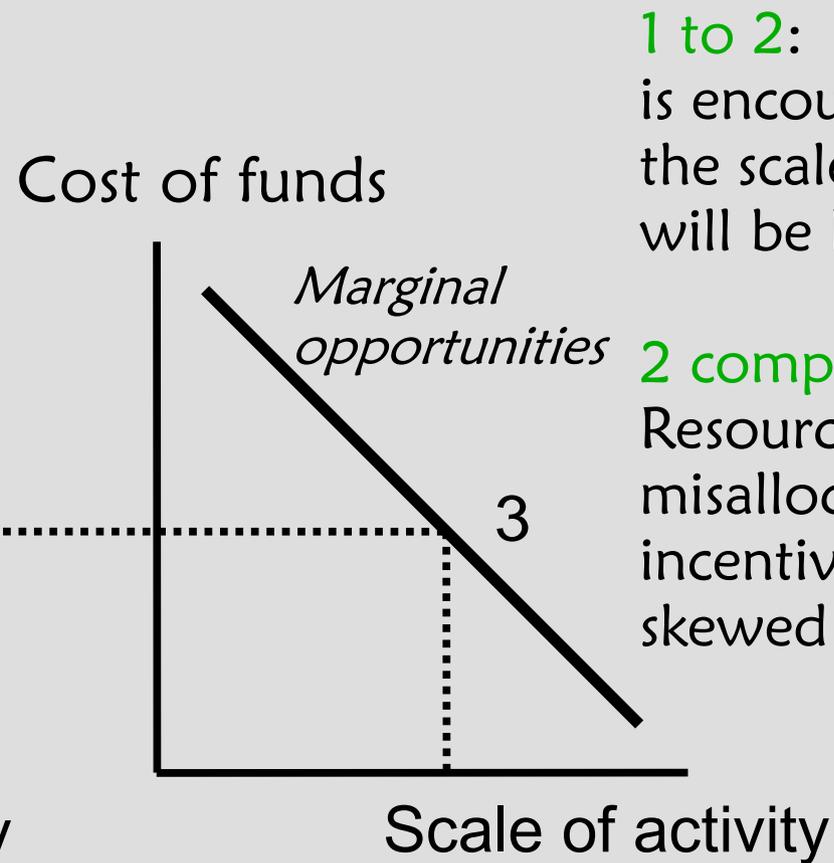
## 2. The financial system has gotten too complex

- Multiple federal and state regulators
- Multiple charters
- Elaborate, overlapping, and sometimes contradictory regulation
- Intricate tax system in various jurisdictions
- Varying litigation risks
- Byzantine accounting rules

# Perhaps the greatest incentive to complexity is TBTF or TCTF



Complex sector



Not complex sector

1 to 2: Risk taking is encouraged and the scale of failure will be larger

2 compared to 3: Resources are misallocated and incentives are skewed

# The protection premium does not all go to owners

- **Rent seeking** as firms spend resources to keep their special status by
  - Going slow on industry initiatives that limit risk
    - Netting of swaps, central clearing houses
  - Weaving systemically important activities into the firm's structure
    - Clearing banks
  - Resisting regulation that would make closure easier
    - Uniform insured depositor list
- Making their balance sheets more intricate and their instruments more complicated

### 3. As a result of this complexity, large institutions

- Cannot be **supervised** effectively
  - Basel II was already an admission of failure
- Cannot be **disciplined** by markets
  - Creditors looked to the family name
  - Equity owners did not look past CEOs
    - A hint comes from the lack hostile takeovers in finance
- Cannot be **managed**
  - Managers did not understanding risk-taking of employees
    - Suitability abuses
    - Compensation misalignments
    - Short-termism

## 4. The current legislation

- Is not the right way forward
- Makes the system more, not less, complicated
  - Adds boxes to the supervisory org chart
  - Enshrines TCTF
    - The government's ability to price that protection is suspect
- Does not lower, and may raise, the probability of future crises

# 5. Ole Kirk Christiansen's modular solution

- The whole of a financial holding company can be made of parts that can be disconnected and reassembled
  - LEGO is formed from the Danish words "LEg GOdt" meaning "play well"
- Any part of the firm that is systemically important can be protected in bankruptcy
  - With haircuts in the event and
  - Infrastructure developed over time to limit the perimeter of systemically important activities
- But the rest can be turned over to the market

## *Playing well* also involves

- **Reducing** the number of corporate charters and agencies
- **Enforcing** consolidation of balance sheets
- **Placing** guard rails on the consolidated entity in terms of
  - Capital requirements
  - Leverage restrictions

# *Playing well*

- Over time should
  - Make pre-packaged bankruptcy a viable option for any large financial entity
  - Increase discipline on management because hostile takeovers are more likely when entities can be carved up
  - Improve monitoring within a firm
- Facilitates international cooperation
  - Because the module in a foreign country can be supervised by the host (consider the Turner Report)
- Works overall to improve economic efficiency

