Redoing the Financial Architecture

William W. Lang

May 13, 2010

FEDERAL RESERVE BANK
OF PHILADELPHIA

Disclaimer: The views expressed are my own and do not necessarily reflect the views of the Federal Reserve Bank of Philadelphia or the Federal Reserve System.

Correct Diagnosis of the Crisis Is Essential

Current “Theory of the Case”

- Too-big-to-fail => moral hazard => crisis
- Theory fits with public anger
- Popular among economists
- Leads to clear solution path
  - Credible resolution regime
  - Improvements in regulatory oversight

Theory Doesn't Seem to Fit Important Facts

- Many of the firms at the heart of the crisis may not have been perceived as too-big-to-fail prior to the crisis.

- Evidence suggests that many high level managers did not understand their true exposures to residential mortgages.

Private Market Failures Were Major Contributors to the Crisis

- Corporate governance breakdowns and distorted internal incentives at large firms

- Excessive complexity was a symptom

- Lang and Jagtiani: Wharton Financial Institutions Working Paper #10-12 (March 2010)

Reasons for Healthy Skepticism of Reform

- Systemic risk and too-big-to-fail are not new issues.
- Won't know if new resolution authority is effective until next crisis.
- Significant improvements to supervisory process are underway but it is difficult to supervise very large and complex firms.

Alternative Approaches to Reform

- Discretionary supervisory oversight plus regulatory rules, e.g. capital minimums, mandatory convertible debt
- Severe constraints on activities, e.g. narrow banking
- Restricting size and complexity—the anti-trust model