Discussion: **Redoing the Financial Architecture**

Deborah Lucas
Congressional Budget Office

Questions posed to the panel

- What is the role of Basel and the overall regulatory structure in creating risk over the cycle?

- Have we come out of this crisis more at risk?

- How do we protect against too-big-to-fail entities and provide credit over the cycle?

What is the role of the overall regulatory structure in creating risk over the cycle?

- Seems there is some basic agreement…
- Various manifestations of moral hazard from the safety net
  - Incentive to become too big and essential to fail
  - Incentive to extract rents by assuming risk
  - Incentive for public officials to duck hard decisions
- Lack of transparency
  - Arcane accounting rules
  - Complicated structures created to circumvent regulations

Have we come out of this crisis more at risk?

- Biggest banks are even bigger
- Moral hazard may be exacerbated by the government's responses
- The federal government has assumed a much more central role in financial markets without a clear exit strategy
    - Fannie and Freddie
    - Autos
    - FDIC
    - Fed actions

Have we come out of this crisis more at risk?

- ...but...
- Housing bubble is popped
- Other weaknesses have been exposed
  - E.g., counterparty risk in derivatives
- Investors are likely to be more averse to risk for some time
- There is an opportunity to rationalize and modernize regulation

How do we protect against too-big-to-fail entities and provide credit over the cycle?

- Lots of ways to describe them
  - too difficult to fail and unwind (TDFU)
  - Too big or too complex to fail (TBTF or TCTF)
- Some general prescriptions
  - Better incentives (managers and regulators)
  - Ethical makeover (managers and regulators)
  - Simplify (regulations and institutions)
  - Improve monitoring (by markets and regulators)
- And a specific recommendation
  - More reliance on prepackaged bankruptcy
    - How does this avoid the crisis of trust that froze the financial markets during the height of the panic?
      - How do we know who is bankrupt?

How do we protect against too-big-to-fail entities and provide credit over the cycle?

- Should more direct actions be taken to prevent TBTF?
  - Should large financial institutions be broken up?
  - Should large financial institutions be taxed?
    - To provide an incentive to shrink
    - To compensate taxpayers for cost of systemic risk
    - Maybe by way of higher capital requirements
  - Are regulatory improvements likely to be an adequate alternative?

My two cents

- Some of the proposed reforms appear to be a step in the recommended directions, e.g.,
  - Systemic risk is not precisely defined, but the proposed Office of Financial Research has discretion to collect data to monitor building systemic risks
  - Federal resolution authority prohibits subsidizing unsecured debt holders and retaining managers, reducing moral hazard
- Most unfortunate that regulation/reform of the housing finance system is likely to remain segregated from regulation/reform of other financial institutions.
  - Fannie and Freddie (or any large mono-line successors) are the ultimate TBTF institutions
    - Undiversified
    - Opaque
    - Susceptible to regulatory capture