Discussion: Redoing the Financial Architecture

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The opinions expressed are not necessarily those of the 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