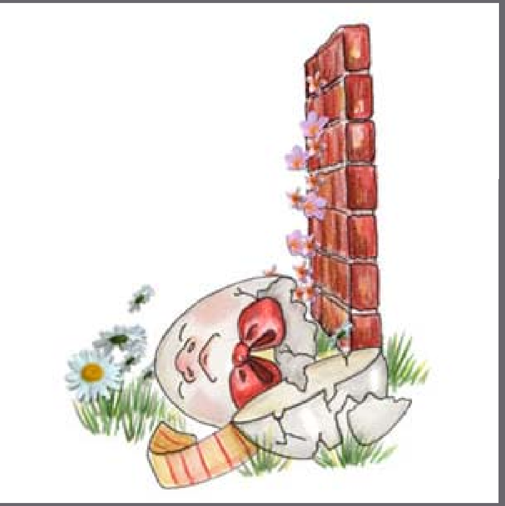
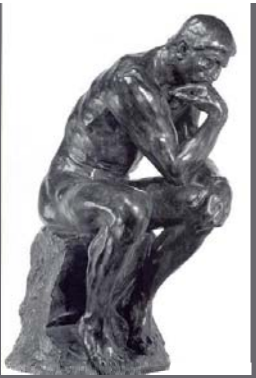
# IT'S BROKE, LET'S FIX IT: RETHINKING FINANCIAL REGULATION

**Alan S. Blinder**
**Princeton University**
***IJCB* conference**
**Madrid**
**18 June 2010**

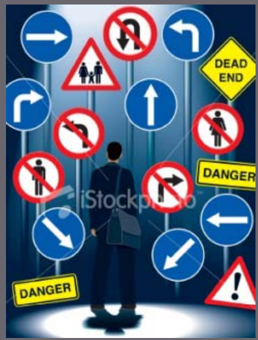


# *Uber* assumptions



- Finance does not appear to be self-regulating.
  - Whoever thought it was?
- The costs of this calamity were huge—so *macro-prudential regulation* now looks more important than ever.
- We haven’t done much macro-prudential regulation up to now. → We need to do more, and better.
- We won’t get rid of TBTF (or TITF) institutions (“SIFIs”), so we have to deal with them.

# Principles of sound regulation

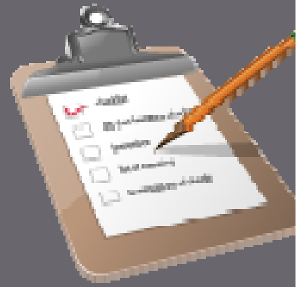



1. *Regulation should be designed to mitigate some **well-articulated problem**.*
2. *Regulations should almost certainly concentrate on **"safety" issues** rather than on "price" issues.*
3. *Regulation should not stifle valuable* innovation.
4. *Regulation should be **efficient** (e.g., work with, rather than fight, **incentives).***
5. *Regulation should be, and be seen to be, **fair**.*
6. *The regulatory system should not leave large **gaps**, whereby important activities that should be regulated escape regulation.*
7. *Regulatory **overlap** should not leave firms confused or needing to satisfy one regulator at the expense of another.*

8a. *Regulation should be* **by function or instrument***, that is, the same activity should be regulated by the same regulator, regardless of the type of institution that performs it.*

8b. *Regulation should be* **by institution***, that is, all of the potentially disparate activities of a single financial institution should be regulated by the same regulator.*

# List of major recommendations



1. Create a systemic risk regulator
2. Create a special resolution mechanism for SIFIs
3. Regulatory consolidation
4. Fill regulatory gaps
5. Change dysfunctional compensation incentives
6. Fix the capital-adequacy standard (“Basel III”)
7. Create a parallel liquidity-adequacy standard (also “Basel III”)
8. Empower risk managers
9. Wake up corporate boards
10. Create a consumer protection agency
11. Ban or discourage proprietary trading in SIFIs? (“the Volcker Rule”)

# 1. A systemic risk regulator

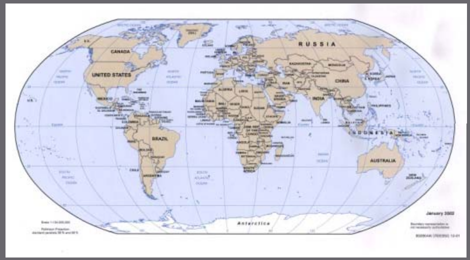
- Hard job? Yes. Impossible job? No.
- Why it should be the central bank:
  - Accountability requires one agency, not a consortium.
  - Financial stability is a first cousin of macro stability, and hence should be joined at the hip to monetary policy.
  - The CB is the only lender of last resort.
  - The CB is already (and must be and will be) in the business.
  - Only the CB is likely to have enough political independence. (But a political check on the Fed's Section 13.3 powers is reasonable.)
- US looks about ready to anoint the Fed.

# 2. A special resolution mechanism

- The *status quo* won't do.
- We want to throw out management and wipe out stockholders of failing institutions.
  - That should get rid of *most* moral hazard.
  - Q: But what about (various classes of) liabilities?
  - A: Impose some losses on unsecured creditors. (But how?)
  - Require "living wills" (will it work?)
- Two main options (each has pros and cons)
  1. A special resolution authority for SIFIs ← US looks to be choosing (mostly) this one.
  2. "Chapter 16" bankruptcy
- My reasons for favoring resolution authority:
  - We want flexibility more than legalism--for financial stability reasons.
  - We want the option of early intervention (like PCA).

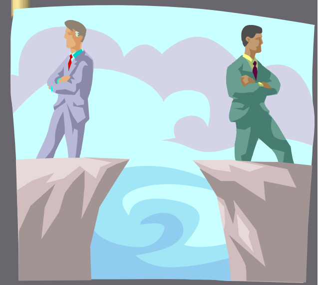
**And *charge* SIFIs for the privilege (which implies *naming* them).**

# 2. A special resolution mechanism (cont'd)



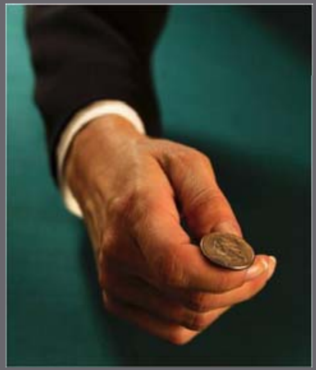

- And if you can manage to "solve" that problem, then try to devise a global mechanism!
  - If you don't, what happens to the giant multi-nationals?
  - Ring-fencing is a bit dangerous.

# 4. Some major regulatory gaps



- Derivatives: regulate and push *most* trading into clearinghouses or exchanges
  - "Lincoln bill" hanging fire in the US ← looks unlikely to make it
- Hedge funds: need regulatory transparency
- SIVs: bring them on balance sheet
- Securitization: require "skin in the game" (how much?)
  - But note: Some of the worst offenders had plenty at stake.
- Special US issues: a federal mortgage regulator and a CFPA

# 5. Dysfunctional compensation



- Both traders and CEOs had too much "heads I win, tails I don't lose."
  - Creates incentives to "go for broke"
  - Should be different (and better) outside the corporate sector, where it's MOM rather than OPM.
- But can legislation fix this?
- Solutions?
  - Regulate as a safety and soundness issue. ← Fed is about to do this.
  - Use "escrow" accounts with clawbacks.
  - Pay traders, CEOs, *and directors* mostly in restricted stock.

# 6. Fixing Basel

- More capital (but don't get carried away)
- Even higher capital charges on SIFIs
- Reduce procyclicality
  - Idea: reverse convertible debentures for SIFIs
  - Big question: At what interest rate would they sell?
- Less reliance on ratings agencies and on internal models
  - Use a standardized regulatory model instead?
- Higher capital charges against trading positions
  - This is an alternative to the Volcker Rule.
- A liquidity standard, too

**A key question: Should nations wait for international agreement or go their own ways?**

# 11. Should SIFIs do proprietary trading?


- Problem: Trading sheltered by the safety net can socialize losses but not gains.
  - But how do you separate prop trading from market-making and/or dealing for customers?
- Idea: push prop trading out of banks or out of SIFIs (for safety net, TBTF reasons).
  - How? By banning (Volcker Rule), or by high capital charges.
  - But then where does it go? (to unregulated sector?)
- Idea: segregate *all* trading into separately-capitalized affiliates—*and ban downstreaming of capital.*

# So what will actually happen?