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Regulatory Reform: A Practitioner's Perspective

Kevin Warsh

Distinguished Visiting Fellow, Hoover Institution
Lecturer, Graduate School of Business
Stanford University

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The events of the last several years make a compelling case for comprehensive, fundamental reform in the oversight of financial firms.

But, I worry that the Dodd-Frank Act (DFA) may not be equal to this critical task. As currently envisaged, DFA seems premised on the notion that more regulators from more agencies with more funding, more power and more discretion will stop financial firms from getting into trouble. That enhanced regulatory discipline alone – more 'boots on the ground' and more exacting checklists – will ensure that financial firms remain safe and sound. If this theory has it right, next time will indeed be different.

My experience at the Federal Reserve informs my views on prudential oversight, leaving three key takeaways. First, most banking regulators are highly knowledgeable, highly dedicated professionals, with the utmost integrity. Second, the business of banking can thrive with clear rules of the road that prejudice no particular firm or function. And, third, the paradigm that leaves the overwhelming burden of prudential supervision on the judgments of regulators and supervisors alone is bound to disappoint.

Regulatory discipline has an important role to play, of course. But two other essential, complementary pillars of prudential supervision must be resurrected rather than relegated: capital standards and market discipline. As I will discuss, neither clearer capital rules nor effective market discipline can be made operative when the largest U.S. firms are deemed too-big-to-fail (TBTF). Of course, DFA nominally purports to end the TBTF doctrine. But, in practice, TBTF -- now more than ever – is viewed by market participants as *de facto* government policy. The window of opportunity to eradicate the TBTF problem is fleeting, so the time for more rigorous scrutiny of the new regulatory regime is at hand.

A more robust reform agenda should be targeted at ridding us of TBTF firms. This would include the introduction of Chapter 14 as an amendment to the Bankruptcy Code. Clearer, tougher and more assured treatment of stakeholders in large financial institutions – known and understood prior to the onset of distress -- would go some distance to mitigating the TBTF problem at the core of our financial system.

If real, fundamental reforms were implemented, then the three independent pillars of prudential supervision – regulatory discipline, capital standards, and market discipline – could be revived to better serve their essential, complementary roles. This would go a long way to re-energizing the U.S. banking system and providing the impetus the U.S. economy needs to flourish.

We cannot have a durable, competitive dynamic banking system that facilitates economic growth if policy protects the franchises of oligopolies atop the financial sector. And our government – short of fiscal space --should not put itself in the position of directing policy through quasi-public banking utilities.

Capital Standards

The proposed capital regime suffers, in my view, from some infirmities – each of which may ultimately undermine this important prudential pillar from being made durable and effective. As a result, I worry that recent capital rules are at some risk of being gamed, feigned, or deferred in the years ahead.

First, U.S. regulators, working with their international compatriots as part of the Basel Committee established a joint accord for capital –so-called Basel III -- with full implementation set for 2019. Surely, a mutually-agreed international framework is a noble and worthwhile objective. But, the banking model of many foreign sovereigns is fundamentally different from that to which the U.S. should aspire. Some advanced foreign economies tend to be dominated by near-permanent oligopolistic banking systems, sanctioned and supported by their sovereigns. And most of those firms tend to be far larger relative to their home country's GDP than is the case in the United States. As a result, many of those with whom the U.S. negotiates implementation of capital standards may hold very different preferences and priorities. This makes a robust global accord problematic, especially at a time that many foreign banks are thought to be undercapitalized and their economies underperforming. And suggests any accord may well be subject to revision and reinterpretation.

Second, the current Basel capital-setting regime – like its predecessors – may lead to massively complex and opaque capital standards. This makes capital levels difficult for regulators to calibrate among regulated firms, difficult for international bodies to assess across countries, and almost impossible for investors to understand and rely upon in evaluating individual firms. 'Regulatory capital' is a less reliable bulwark against economic weakness than actual shareholders' capital that can absorb actual losses. Consequently, I prefer a simpler, more straight-forward, risk-sensitive and more readily reviewable capital standard.

Third, capital levels post-DFA are being tasked with a role well beyond their traditional remit of ensuring safety-and-soundness. Supervisors are being asked to assign extra capital cushions to 'systemically important financial institutions' (SIFIs) so that larger, more interconnected institutions hold commensurately more capital to compensate for the greater risk to the financial system. These so-called SIFI buffers are an understandable attempt to level the playing field. But, it is a very distant next-best to ridding the U.S. financial system of large, quasi-public utilities atop the sector. In practice, a couple of percentage points of incremental regulatory capital at inception are unlikely to persist as memories of the crisis fade. And by acknowledging that some select firms are 'systemically important', I worry that it will only memorialize TBTF firms at the core of banking. And reinforce the notion to creditors and counter-parties that the government is unwilling to let them suffer losses.

Instead, the U.S. and other willing countries should begin from a first-best foundation with strong, simple, transparent capital standards appropriate for a dynamic, competitive banking system. This type of capital regime would be well-positioned to attract customers and counterparties from around the world. As progress is achieved, I would expect an international coalition to join these efforts.

Market Discipline

In addition to improved regulatory discipline and clearer capital standards, the third and final pillar of prudential supervision – market discipline – must be revived. Market prices of financial firms *should* reveal much about their standing. Markets can help discipline the behavior of firms by re-pricing funding costs as perceived risks change. And stakeholders – that is, shareholders, creditors and regulators alike – can use changes in market prices to evaluate the changing financial position of firms.

But, market discipline will only prove effective if stakeholders gain information to compare firms' exposures against one another in a timely and effective manner. The Federal Reserve's most recent stress tests – particularly the enhanced disclosure -- are a step in the right direction. Still, disclosure practices by the largest financial firms remain lacking and the periodic reporting overseen by the Securities and Exchange Commission (SEC) tends to obfuscate as much as inform. I favor a far more sweeping transparency initiative so that the financial statements and associated risks of large, complex firms can be monitored effectively by market participants.

But, even if market participants possessed the information to better assess firms' standings, market discipline might still be unable to exert influence. Repeated government interventions during the past several years, however advisable or not in the crisis, revealed a set of policy preferences. Expectations hardened -- in the U.S. and elsewhere – that governments will come to the rescue of large failing firms. The result is a U.S. banking system that in which the government's support on our largest banks is even more assured. These expectations must be unlearned by market participants. If not, market discipline will never be operative.

Bigness in financial services is not badness. But, our largest financial firms must be able to persuade regulators that their failure would not endanger the financial markets and broader economy. In my view, some of our largest banks are likely to survive this heightened scrutiny, and would turn out to be more successful without implicit government support. Others, however, might not pass muster. Hence, the scale and scope of some firms would likely diminish. So be it.

Those 'interconnected' firms that find themselves dependent on implicit government support do not serve our economy's interest. Their continued existence should not be countenanced. The risks associated with our largest firms must never again be underwritten by taxpayers. Those of us who were long worried about the systemic risks posed by Fannie Mae and Freddie Mac should be no less troubled if our largest banks are effectively backed by the U.S. government.

Eradicating the notion of TBTF firms is the *sine qua non* to bring about real reform of financial services. Some progress has been made by the FDIC in preparing protocols to resolve large firms. I am also particularly impressed by the work being done by Financial Stability Board's Resolution Steering Group. But, other regulatory initiatives strike me as going in a less constructive direction. For example, by sanctioning some list of too-big-to-fail firms – and treating them different than the rest --- policymakers are signaling to markets that the government is vested in their survival.

Orderly Liquidation Authority

When the regulatory reform debate began, Congress appeared keen to ensure that there would be no more bailouts and no institutions would be TBTF.

Title II of DFA establishes the option of an Orderly Liquidation Authority ("OLA"), presumably to resolve failing financial firms that are determined to pose a significant risk to financial stability. If OLA is invoked by the Secretary of the Treasury, based on the recommendations of the Federal Reserve and the FDIC (or in some cases, the SEC or the new Federal Insurance Office), extraordinary powers are granted -- including the ability to obtain bridge funding from the Treasury -- to preserve franchise value and facilitate a transfer to a purchaser. Of note, DFA also allows the FDIC to make payments to certain creditors.

In retrospect, could bank regulators and Administration officials have employed OLA authority to handle Bear Stearns or Lehman Brothers more effectively?

This sort of authority might well have proven useful during the recent financial crisis. If we had gone into the crisis with the resolution authority outlined by OLA, there may well have been better options to ensure an orderly disposition of failing firms. I suspect that OLA would have been an attractive – but highly debated – alternative. Those favoring its use would have had a more compelling argument if it had long been the law of the land and understood by market participants to be an integral and preferred part of policymakers' tool kit. But, if this form of liquidation were only a newly established authority in an unpracticed statute, some other policymakers might have considered invoking OLA too risky. Still, if nothing else, OLA authority could have strengthened the regulators' negotiating posture with certain financial firms.

Many supporters of DFA argue that OLA would have substantially mitigated the harm inflicted by the financial crisis. Even if they are correct about its effects in war-gaming the last crisis, this new grant of discretionary authority is unlikely, in my judgment, to be up to the task going-forward. There is no going home again. The status quo *ante* will no longer due.

Placing this arrow in policymakers quiver now is not sufficient to arm policymakers for the challenges ahead. Granting new powers to resolve failing firms in the discretionary hands of regulators is unlikely, in my view, to drive the market discipline required to avoid the recurrence of financial crises. The significant regulatory discretion built into DFA is unlikely to dissuade investors from their learned view – however debatable it might be -- that the government will stand behind its largest banks. Creditors will be protected, they will figure. And they might turn out to be correct.

We have to stop fighting the last war. As Governor Mark Carney, the head of the Financial Stability Board reminds us, too often policies are put into place that would have mitigated the last crisis, but leave policymakers exceptionally vulnerable to the next one.

Chapter 14

There is no single panacea to deal with financial crises, but invoking a new Chapter 14 of the Bankruptcy Code would be a useful step forward, particularly as part of a true reform package (as I outlined earlier) to strengthen the dynamism and resiliency of the banking system.

The Bankruptcy Code brings with it precedent, case law, and well-understood protocols to provide substantial clarity as to the rights and obligations of each class of stakeholders. It has deep history of respect for the rule of law without favor or prejudice. In fact, reliable treatment under our Bankruptcy Code – and respect for the rule of law –distinguishes us from some foreign economies, and attracts capital to our shores.

A new chapter of the Bankruptcy Code – applicable to all financial institutions – would bring much needed credibility to the murky issues involving the government's support for large financial firms. A Chapter 14 amendment to the code would go some distance to remind creditors and counterparties that the government has fine and effective and well-understood options to unwind a financial firm and, in the long-run, promote financial stability.

The benefits associated with Chapter 14 go well beyond establishing clarity about how failing financial firms would be unwound. It is about ridding markets of TBTF expectations in the near-term. It is about changing behavior in good times, so that the bad times are less bad. Early assessments of financial firms –and vibrant competition among them-- are a better way to ensure that we do not find ourselves in another banking crisis. Hence, the tougher, clearer, less discretionary measures, including invoking Chapter 14, would represent a substantial improvement in existing law.

So, what if Chapter 14 were available to policymakers alongside OLA?

To achieve meaningful benefits, Chapter 14 would have to be understood as the prevailing, dominant option. If investors believed that OLA authority were more likely to be used by policymakers than the 'tough love' of Chapter 14, its benefits would quickly dissipate.

Ultimately, my preference for Chapter 14 versus a newfangled liquidation authority is based, in part, on my strong bias that the existence of large, quasi-public utilities atop the financial sector is growth-defeating for the U.S. economy. Those that prefer OLA put greater emphasis on wanting to preserve optionality and flexibility going into the next crisis.

I, however, am more willing to constrain discretion and return to a clearer, rules-based oversight regime that relies more on real capital and true market forces. In so doing, the U.S. will have a stronger, more dynamic and competitive banking system to serve the interests of consumers, businesses and the broader economy.