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**Panel Discussion: New Directions in Financial Regulation**

William Poole\*  
Senior Fellow, Cato Institute  
Distinguished Scholar in Residence, University of Delaware

Macroeconomic Advisers, LLC  
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\* The views expressed are my own and do not necessarily reflect those of Macroeconomic Advisers, LLC. I take full responsibility for any errors.

## **Panel Discussion: New Directions in Financial Regulation**

I spoke at this same event exactly one year ago. My title then was, “Have the Fed and the Treasury Gone too Far in a Bid to Maintain Financial Stability?” I discussed moral hazard arising from the Bear Stearns and GSE bailouts. On September 10 of last year, little did any of us suspect that just five days later 9-15 was a day that would live in financial infamy. The failure of Lehman Brothers that day sent shockwaves through the financial markets that turned the recession into the Giant Panic and Great Recession.

Lehman was, arguably, a consequence of the workings of moral hazard created by the bailout of Bear Stearns. David Wessel, in his fine new book, *In Fed We Trust*, says that “... Paulson and Bernanke assured each other ... that all the companies and traders that did business with Lehman had been given time to protect themselves from a possible Lehman bankruptcy.” (p. 11). In fact, it seems more likely that those doing business with Lehman expected that if the firm got into trouble the government would bail it out as had been done with Bear Stearns. Given the Bear Stearns bailout, the failure to treat Lehman the same way produced an enormous flight to safety, which cut off credit to any firm at all suspect.

Wessel also says this: “Paulson had stated unequivocally that he would not publicly support spending taxpayers’ money—the Fed’s included—to save Lehman. ‘I’m being called Mr. Bailout,’ he said. ‘I can’t do it again.’ ” (p. 14). In fact, Paulson had it backwards. *Because* of Bear Stearns, he *had* to do it again.

It is impossible to replay history with much confidence. Even if Bear Stearns had not been bailed out, a substantial decline in house prices was inevitable and one firm after another would have faced the threat of insolvency because default rates on prime mortgages as well as subprime ones would have risen. Thus, bailing out commercial and investment banks, and AIG, would

have been unavoidable. Perhaps the bailouts could have been engineered in a more orderly way, and the recession might have been less deep. But “perhaps” is the right word; when an asset as important and highly leveraged as residential real estate becomes grossly mispriced, it is not possible to be very confident about managing the consequences.

We can be sure, incontrovertibly, that the bailouts and capital infusions in 2008-09 are a source of moral hazard for years to come. The issue now is what to do. In my discussion, references to “banks” will apply to large nonbank financial firms as well.

### **Question Mark?**

The title of this session is “New Directions in Financial Regulation.” I would add a question mark to the title. What new directions? No new directions have been enacted into law. Nor is the administration discussing promising new directions. In my presentation here a year ago I noted that it was extremely unfortunate that six months after Bear Stearns there was no plan to deal with moral hazard. Now I can say the same thing, except that it is 18 months after Bear Stearns.

Financial policy going forward must deal with five facts.

- 1) Moral hazard will not go away on its own. At present, the largest 19 banks are federally protected. The number 19 comes from the list of banks subjected to the special stress tests last spring. Other large firms, such as large insurance companies, are probably also subject to protection.

- 2) After Lehman, policymakers will not dare to let a large bank fail, unless its structure is quite different from the structure of large banks today.
- 3) Federal protection of large firms is not a viable situation indefinitely in a market economy. The distortion of incentives and mispricing of risk will create further problems.
- 4) An exit from too big to fail requires that a substantial block of bank creditors be at risk. It is not enough for shareholders alone to be at risk.
- 5) The economy as a whole is overleveraged, which makes it unstable in the face of unpredictable shocks. Federal policy needs to discourage leverage in general and not just in financial firms.

Financial reform draft legislation does not deal adequately with these five facts. The Treasury and the Fed seem to be pursuing two main approaches. One is to establish a new resolution procedure for systemically important financial firms and the other is to increase capital requirements.

The creation of a systemic risk regulator will broaden the number of firms regarded as too big to fail. Moreover, a new resolution procedure will do nothing to rid the economy of moral hazard because policymakers will not be willing to put a firm into the procedure in a way that forces some creditors to take a hit. For years to come, policymakers will fear a Lehman-like result from imposing losses on creditors.

If Treasury were serious about making the economy more stable by reducing leverage, it would propose to phase out the deductibility of all interest on personal and business tax returns. On business tax returns, deductibility of interest but not dividends creates a bias in favor of debt. Eliminating the deductibility of interest and cutting the statutory corporate tax rate from its current level of 35 percent to the 10-15 percent range would yield a revenue-neutral outcome for corporations. Yes, I know that the idea is politically unacceptable. Reforming the corporate tax system has been discussed for years, and this is one of the reforms often advocated. If we cannot put through a reform like this, then we can expect to live with the instability of too much leverage indefinitely.

Over the next few years, banks will be cautious about excessive leverage. But the caution will fade, in the face of aggressive new managers and the incentive to boost returns through leverage. Already there are reports of substantial returns from new trading strategies, substantially financed with short-term debt.

Proposed increases in capital requirements are focused on equity capital. Larger equity capital does not solve the problem of structuring banks so that some creditors take a hit when a bank is resolved. I know of only one approach to achieve that outcome—a requirement that every financial firm with a bank charter maintain a substantial block of long-term subordinated debt in its capital structure. Small banks might be exempted, but all large banks should have to comply.

Long-term debt is necessary for stability, because such debt cannot run. The amount must be significant—large enough to create a substantial cushion to protect the deposit insurance fund and short-term obligations that can run. I favor a specification something like this: 10-year subordinated notes equal to 10 percent of total bank liabilities.

To stay in business, a bank would have to roll over maturing sub debt every year equal to 1 percent of its liabilities and to grow the bank would have to issue more than that. If the market were unreceptive, the bank would have to shrink by 10 percent to live within its existing sub debt. The bank and not regulators would manage the restructuring if a bank had to shrink.

Subordinated debt increases market discipline, which cannot be evaded through campaign contributions that lead Congress to poke holes in regulatory discipline. Banks hate the idea because sub debt would be expensive. That expense does not bother me; bank mismanagement was largely responsible for the financial crisis, which has been enormously expensive for the economy.

Yes, I know sub debt idea has been around for years and is regarded as politically impossible. As I repeat this “politically impossible” refrain, I am reminded of the refrain in Wessel’s book: “Whatever it takes,” which Wessel repeats every time he discusses a bold Federal Reserve initiative to create a new facility to provide credit to another group of borrowers. “Politically impossible” seems to be the refrain for any reform that would actually work.

What seems most likely is not a new direction but more of the same old direction. The country will rely on regulators’ discretion, fettered by the political realities of bank lobbying in Congress. It is a sad spectacle. This past spring, for example, banks and others pressured Congress over fair-value accounting, and Congress successfully pressured the Financial Accounting Standards Board. Capital requirements will be hung up in endless international negotiations. The Basel II negotiations serve as an example.

Congress will probably pass legislation at some point, and declare victory. The legislation will be complex, will add new regulatory burdens on banks and achieve little. The battle is likely to be drawn out, because a lengthy process is a way for members of Congress to harvest

substantial campaign contributions from interested parties. I guess I am becoming truly cynical about the legislative process as I observe what goes on year after year.

Investors should cast a skeptical eye at whatever supposed reform is put in place. Unless the reform creates a way for a weak firm to be resolved with losses to creditors, the reform will not control moral hazard. That means that firms too big to fail will have an advantage in the credit markets over smaller firms. Federal protection of large firms will be a spur to continuing bank consolidation, to achieve the scale required to be too big to fail.

In time, one of more large banks will get into financial trouble. The current financial crisis is not the first time big banks have made serious mistakes. Money center banks loaded up on Latin American loans in the 1970s, and had to be propped up in the 1980s. Continental Illinois nearly failed in 1984, primarily because of large losses on energy loans, and was bailed out. The time will come again because there is nothing in current reform approaches to stop banks from making large mistakes or to insulate markets from the consequences of the mistakes.

Lehman demonstrates the consequences of policymaker mistakes. Investors should keep in mind that the politics of another large bailout anytime soon might make a bailout politically problematic for a Treasury secretary or a Fed chairman. Investors may understand the economic logic of avoiding another Lehman but they should also be sure they understand the political logic. In the current crisis, the politics have focused on bonuses and executive compensation; next time, the politics may focus on taxpayer costs. Many voters understand how unsatisfactory is the situation in which risks are socialized and profits are private. "No more bailouts" may become a winning political slogan. That is a recipe for another huge expectational mistake in the markets, like the one that occurred with Lehman.

Reform emphasis needs to be on changing the incentives under which firms operate, as with ending the deductibility of interest and requiring a substantial block of subordinated debt. The reason is that financial crises are episodic and not continuous. In the context of the probability distribution of financial outcomes, a crisis is a fat tail event. Financial management ought to reflect such fat tail events, but does not seem to. When markets are operating smoothly, it is very difficult for firm managers and regulators as well to take full account of the possibility of a fat tail event. Positioning a firm for a crisis year after year when no crisis occurs is like crying “wolf.” After a while, no one listens. Meanwhile, the apparent profitability of leveraged strategies that do not take account of the possibility of a fat tail event creates a compelling incentive. The incentive applies to discretionary regulators as well as to firm managers. Regulators, after all, want regulated companies to succeed.

For this reason, we need to look for non-discretionary policies that build the right incentives into the structure of the economy. The structure should take account of the market defect of inadequate attention to fat-tail events, even when such attention is essential to the long-run viability of the firm. Despite my Chicago roots, I have become convinced that this market defect does exist and that it explains why the economy is vulnerable to episodes of financial instability.

So, where does the financial reform effort now lie? In the August employment report last week, payroll employment came in almost 7 million below the peak in December 2007. If a viral disease had caused 7 million Americans to be unable to work, having this devastating effect over only 20 months, there would have been a crash project to come to grips with the situation. I think we know a lot about the financial virus that caused this mess. Yet, there is no sense of urgency to deal with this destructive virus. We need to reduce the incentive for leverage and eliminate the

expectation of federal bailouts the next time a large bank gets into trouble. We need to be sure that this financial virus does not strike again. Unfortunately, Washington sees no sense of urgency. That is very much to be regretted.