



Lombard Street

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The collapse of the world's financial markets has resulted in intense examination of how to restructure and reform regulation for banking, securities, insurance, and other parts of the financial services industry. Various regulatory proposals are already being circulated in academic and public policy circles. Governments around the world are considering reforms. The conversation and decisions surrounding these proposals will fundamentally impact how financial services is structured and conducted across the globe throughout the 21st century.

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About Lombard Street

Lombard Street is the first ever e-journal focused exclusively on financial services regulation. Titled after the famous treatise on banking regulation authored by Walter Bagehot in 1873, this biweekly journal is filled with original pieces from prominent thought leaders across the globe.

Overseen by a multi-disciplinary editorial board led by David S. Evans of the University of Chicago and University College London, Lombard Street delivers original articles that will shape and chronicle the evolution of the impending 21st century financial services regulation reform.

Lombard Street leverages the power of the Web to provide germane and timely thought leadership to a broad and relevant audience. The online format works to fuel interaction between readers and authors, extending the dialogue beyond just the articles.

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The Government Wants to Set Your Pay

Marc Hodak¹

As the federal government contemplates broad, new regulations for the financial services sector, compensation is high on the agenda. The impact of such regulations will be significant. Human resource strategy is a key driver of value in any company; it is arguably the most critical driver for a company whose chief assets walk in and out of the front door every day.

I. Why Does the Government Care So Much About Pay?

The nominal reason for interest in executive compensation is its importance for corporate governance. Compensation strategy is used to attract capable managers, and to align their interests with those of the shareholders. Most observers agree that perverse incentives contributed to the recent demise of many financial institutions, arguably contributing to the resulting financial crisis. Regulators are understandably anxious to prevent a recurrence.

Unfortunately, the government also has a very different, and in many ways much more compelling reason to care about executive pay—popular sentiment. Policy makers are following the headlines in proposing legislation because that’s where the votes are. The resulting laws use the language of governance, but they mostly impose substantive restrictions that closely reflect general opinion about what is wrong with Wall Street pay.

For better or worse, we can’t disentangle governance and populist rationales for regulation of compensation. To the extent that they are aligned, popular anger can be a useful club for imposing needed governance reforms. Unfortunately, history shows that mob psychology generally contributes no more to governance than it does to government. Past regulations have caused many more problems than they solved. It’s frankly difficult to expect better results going forward.

II. A Brief History of Compensation Regulation

In 1980, the average multiple of CEO pay to that of the average worker was about 40 times. Compensation structures were fairly simple—a base salary plus a bonus opportunity that typically represented from 10 percent to 50 percent of salary. The main reform being touted by the good governance crowd was an increase in the proportion of pay at risk, i.e., more from

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bonus, and less from salary. Governance mavens were also advocating equity awards to improve the alignment of managers.

By the late 1980s, the burgeoning market for corporate control created a premium for better leaders. It also made the CEO's job riskier, leading to the wide adoption of golden parachutes. Every now and then, it became a value-creating proposition to basically bribe entrenched managers to surrender their poorly run companies. But "pay for failure" outraged ordinary citizens, so the tax on golden parachutes was born.

By 1990, pay for a growing number of Fortune 100 CEOs began to top \$1 million. Something about crossing the \$1 million threshold captivated the press and ticked off the public. "Who could be worth \$1 million a year?" people asked, especially as the economy began to slow down. So in 1992, the government's experiment in containing executive pay began in earnest. That year, it imposed enhanced disclosure rules for the five highest paid executives. The theory was that such disclosure would force a spotlight on this spending, and thus keep a lid on it. The next year, as CEO pay went up again, Congress passed a limit on the tax-deductibility of salaries over \$1 million.

These rules were intended to slow the growth of CEO pay. Their effect was exactly the opposite. Enhanced disclosure made the market for high-end talent more transparent and the competition for that talent more efficient. The limit on the deductibility of salary simply accelerated the shift of senior executive compensation toward variable pay, especially stock options, which benefitted from peculiarly favorable accounting rules. These elements happened to come together at the onset of one of the biggest bull markets in history. Some would say the newly souped-up incentives had something to do with that. In any case, CEO pay went through the roof.

True to the historical pattern, the burst of the dot-com bubble and ensuing economic difficulties landed the spotlight once again on the richest CEOs. The excesses of titans like Dennis Kozlowski, Bernie Ebbers, and even successful CEOs like Jack Welch rankled the populace. Additional changes in accounting, tax, and disclosure rules soon followed.

These accumulating compensation rules contributed to another bane of governance critics—increasingly complex pay plans. Like squeezing a balloon, as soon as a rule to clamp down on one perceived source of excess was implemented, new pay popped up in another place. The clampdown on salaries led to higher bonuses and more equity. The spotlight on bonuses and options led to more perks. The jam on perks led to greater deferred compensation and sweetened pension-related rewards. Every time the policy makers thought they were closing

the loopholes, the market found another way. By 2000, the multiple of CEO pay versus the average worker climbed to 400 times.

III. Why Did Regulation Fail So Badly?

So, if a patient gets treated for a condition, and still exhibits symptoms, one can suggest that the treatment didn't take for any number of reasons. If a patient gets treated multiple ways for an ailment, across years or decades, and the symptoms get worse, one should at least begin to question the original diagnosis.

One diagnosis stood behind every one of the government's failed attempts to limit CEO pay, the diagnosis to which they unquestioningly cling to this day: managerial power.

According to this thesis, CEOs take advantage of their influence over boards to get what they want, regardless of performance. Critics see directors as the CEO's golfing buddies unable to say "no" to any proposal the boss floats regarding his or her pay. Or directors are clueless codgers, able to be hoodwinked into giving the CEO much more than they realized, until after the contracts are signed and the money is out the door. Or, worst of all, the board is perceived as actively conspiring with the CEO in a mutual back-scratching exercise, where CEOs on the board of one company vote for higher pay in the expectation that other CEOs on their board will increase their own pay in a kind of web of privilege.

Managerial power is a real phenomenon. There is, in fact, plenty of empirical as well as anecdotal evidence linking managerial influence and CEO pay. The problem is that, 20 years later, all of this evidence undermines the managerial power thesis of growing CEO pay. Even the most strident corporate critics acknowledge that, since the early 1990s, boards have become far more independent, more vocal, and otherwise less willing to tolerate an imperial CEO. So, if managerial influence is such an important driver of pay, why hasn't CEO pay declined, or at least grown more moderately, as power has unquestionably shifted from the CEO to the board?

IV. A Less Conspiratorial Framework

Occam's razor provides us with a much simpler explanation than managerial power. This explanation doesn't assume, against actual experience with real boards, that directors are systematically lazy, stupid, or corrupt; rather, that the effective demand for executive talent has sharply increased, largely as a result of the complexities and risks of the job, some of which is government-created.

Belief that executive pay is driven by supply and demand or risk and reward factors doesn't deny that some CEOs are "imperial" and some boards are "captured." It certainly doesn't suppose that the market for talent works perfectly. But it neatly explains the rise of CEO pay in a way that managerial power can't, based on all the available evidence, especially for those willing to accept that a buyer of executive talent can tell the difference between a \$2 million executive and a \$10 million executive as surely as a real estate buyer can tell the difference between a \$2 million building and a \$10 million building.

It also suggests an economic framework upon which to better understand the dynamics of executive compensation, and to propose remedies more likely to improve governance. In particular, compensation policy involves trading off three corporate governance requirements:

- Attracting and retaining necessary talent,
- Aligning managerial interests with those of the shareholders, and
- Obtaining retention and alignment benefits at a reasonable cost to the company.

As with any trade-offs, you generally can't get more of all three at the same time. The best way to increase alignment is to make pay more variable, deferred or conditional, all of which reduce the value of compensation to the employee. At that point, a firm must either accept a greater risk of losing their talent to alternative employment, or increase the total compensation opportunity.

There is no point arguing that CEO X is overpaid in the absence of specific knowledge regarding the original retention and alignment trade-offs contemplated by the board at the time the plan was conceived.

This is the first in a two-part series by Marc Hodak on executive compensation and financial service regulation. Part two examines the current crop of executive pay proposals with a view to their likely effectiveness in regulation reform.

The Chess Game of Financial Regulation

Arnold Kling²

The financial crisis that began in the sub-prime mortgage market is at least the third major financial crisis to include a breakdown in the United States housing finance sector. During the Great Depression, banks and balloon mortgages were involved in a collapse. In the 1980's, we experienced the Savings and Loan Crisis. Currently, we are dealing with the aftermath of a boom-bust cycle in house prices that was exacerbated by risky lending practices.

A sobering fact is that the response to each of the first two crises helped to lay the groundwork for the next – and current -- crisis. It turns out that financial regulation is not like a math problem, which can be solved once and stays solved. Instead, financial regulation is like a chess game, in which moves and counter-moves proceed continually, eventually changing the board in ways that players have not anticipated.

The Great Depression produced two major lessons concerning housing finance. One lesson is that short-term “balloon” mortgages are dangerous. When the borrower must refinance the mortgage every five years, a shortage of credit can prove disastrous. Government policy under President Franklin D. Roosevelt's New Deal instead encouraged the thirty-year amortizing mortgage.

Another lesson was that banks are subject to sudden mass panic withdrawals. The New Deal also established government-backed deposit insurance in order to prevent future bank runs.

From the end of the Depression through the 1970s, the mainstay of the housing finance system was the thirty-year fixed-rate mortgage, provided by savings and loan associations (S&Ls) funded with insured deposits. It was exactly these institutions that blew up during the S&L crisis of the 1980s, costing taxpayers more than \$150 billion.

The S&L Crisis arose because high rates of inflation and interest rates drove up the rates that S&Ls had to pay to keep deposits, while they were stuck with lower earnings on mortgages that had been issued in earlier years. The costs of the crisis were exacerbated by the reckless

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behavior of many insolvent S&Ls, who took desperate gambles knowing that the down side would be borne by the taxpayers.

Policymakers learned three lessons from the S&L crisis. One lesson was that funding long-term mortgages with short-term deposits was unsafe. Instead, mortgages should be securitized, so that they could be sold to insurance companies and other institutions better able to hold long-term assets.

A second lesson was that historical value accounting deceived regulators, preventing them from identifying and shutting down insolvent institutions in a timely fashion. Policymakers who had been burned in this fashion came out of the S&L crisis committed to market value accounting.

The third lesson was that regulators needed a structure of capital requirements that was formal and risk-based. Another concern during this period was harmonization of bank capital requirements throughout the industrial world, so that capital requirements were set in an international agreement known as the Basel Accord. (The late 1980's also were a time when everyone feared Japanese competition, and one of the goals of the Basel Accord was to raise the capital requirements in Japan, in order to stem the threat of Japanese banks.)

I. The Subprime Crisis

The three solutions to the S&L crisis—securitization, risk-based capital, and market value accounting—all are heavily implicated in the current financial crisis. Mortgage-backed securities fueled a housing bubble. When the bubble collapsed, these securities became “toxic assets,” leading to bankruptcy, government conservatorship, or bailouts for companies like Lehman Brothers, Freddie Mac and Fannie Mae, and AIG.

The boom in securitization was fueled by risk-based capital regulations. A mortgage-backed security could be held by a bank with less than half the capital that would have been required in order to hold the underlying mortgages. In fact, Wall Street's financial alchemy became so effective that high-risk, subprime mortgages could be transformed into AAA-rated securities, resulting in high apparent return on equity at banks. This was true around the world, because under harmonized capital requirements, banks everywhere could benefit from holding mortgage securities made in the USA.

When the crisis hit, the problems were exacerbated by market value accounting. To meet capital requirements, one bank might have to sell its mortgage-backed securities in an environment with few buyers. The low price on this sale then became the “market” benchmark that other banks had to use to value their portfolios. This in turn undermined the capital positions of those banks, forcing them to sell their own mortgage-backed securities. The result

was a vicious spiral, and there were even proposals to back away from market value accounting.

II. The Next Moves in the Game

Current proposals for regulatory reform reflect perceptions of the most recent crisis. One main issue is that regulators did not “see” the crisis coming. This is being blamed on regulatory fragmentation. For example, AIG's financial products unit, which wrote hundreds of billions of dollars of credit default swaps that helped fuel the rise in mortgage securitization, was regulated by the Office of Thrift Supervision, away from the auspices of the Federal Reserve or the Federal Deposit Insurance Corporation. Credit default swaps as financial instruments seemed to fall outside of any agency's regulatory jurisdiction.

A natural reaction has been to call for a “super-regulator” or a “systemic risk regulator.” Such an agency would be expected to examine the financial system holistically in order not to leave any gaps.

Another issue in the current crisis is that of systemically important institutions, known colloquially as “too big to fail.” Policymakers want the ability to supervise such institutions closely. Treasury Secretary Timothy F. Geithner and others believe that policymakers need the ability to seize such institutions when their condition presents a risk to the financial system as a whole.

Once again, it seems that policymakers are focused on what would have been useful in the last crisis. The implicit assumption is that by doing so they can create stability. In fact, these reforms probably will produce another system that is subject to severe breakdowns.

III. Why Regulatory Systems Breakdown

Regulatory systems break down because the financial sector is dynamic. Financial institutions seek to maximize returns on investment, subject to regulatory constraints. As time goes on, they develop techniques and innovations that produce greater returns but which can also undermine the intent of the regulations.

This is a normal, human response to attempts to influence behavior. Any CEO who designs an incentive bonus system for the company's sales force knows that over time employees will learn how to “game” the system. The only solution is to constantly adjust the incentive structure in order to realign incentives with the behavior that is in the long-term interest of shareholders.

Within regulated industries, another source of breakdown is special interest lobbying. For example, if a firm is designated as “systemically important,” it is safe to predict that such a firm will make an effort to lobby Congress and the regulators to maximize the advantages and minimize the disadvantages of such a label.

IV. Hard to Break or Easy to Fix?

Legend has it that during World War II, German Tiger tanks were better engineered and hence broke down less often than the Soviet T-34. However, the T-34 was such a simple machine that it often could be repaired on the spot by the tank crew. When Tigers broke down, they required expert maintenance. In battle, the T-34s that were easy to fix were more effective than the Tigers that were harder to break.

Instead of trying to make the regulatory system harder to break, we might think in terms of making it easier to fix. Ideas such as functional regulation or regulatory consolidation might make our financial system harder to break, but they also could make it harder to fix.

Under functional regulation and regulatory consolidation, all mortgage lending would have to conform to the same set of rules. From a hard-to-break perspective, this might seem like a good thing. However, if the set of institutions involved in mortgage lending breaks down, there is no easy way to fix it.

Instead, suppose that we retain a “messy” structure in mortgage lending, with a lot of institutional overlap and regulatory duplication. If one regulator's mortgage lenders fail, a different set of institutions will be available to pick up the slack.

European countries tend to have financial systems and regulatory structures that are more consolidated than ours. The results in this crisis have not demonstrated the superiority of these neater organizational structures.

The best way to make our financial system easier to fix would be to reduce the incentives for high leverage. We promote home ownership by subsidizing mortgage indebtedness. It would be better to provide subsidies and encouragement toward saving for a reasonable down payment. Likewise, in the corporate sector, our tax structure tends to penalize equity finance and to reward debt finance. Changing the system to tilt more in the direction of equity finance would go a long way toward reducing the vulnerability of our economy to crises at banks, insurance companies, and investment banks.

Do We Need A Systemic Risk Regulator, and If So, Who Should It Be?

Robert E. Litan³

In late March, in the wake of the worst financial crisis since the Depression, Secretary of the Treasury Timothy F. Geithner outlined the first installment of the Obama Administration's plans to reform laws and regulations governing the financial industry. Each of the elements of this initial plan was advanced in the service of a common objective: to reduce the exposure of the financial system and the economy to systemic risk.

This hardly came as a surprise. It was the fear of systemic risk, after all, that induced the Treasury (enabled by the Congress), the Federal Reserve, and the FDIC to take a series of extraordinary measures to protect the creditors of a number of well-known financial institutions that failed during this crisis. Given the huge cost of these operations, there seems to be broad agreement that something ought to be done to reduce systemic risk in the future, although consensus does not yet appear to exist on exactly what those measures should be.

The most extreme option favored by some is to have the government proactively nationalize the large weak banks, strip out the toxic assets, and then break them up before selling the healthy shells back to the private sector. The main purpose would be to prevent systemic risk in the future by constraining the size of the financial institutions themselves.

We may eventually get to some significant number of nationalizations – if the economy continues to weaken and/or the banks' true worth is publicly recognized. But even a major bust-up campaign will not totally solve the systemic risk problem. Even if banks above a certain size are not permitted to merge, lawmakers or regulators cannot stop their internal growth. Over time, successful institutions would then grow into becoming systemically important. Meanwhile, other large financial institutions that do not fall into the government's web already may pose systemic threats of their own, risks that will grow over time.

More is clearly needed. One additional measure would be to implicitly "tax" – through higher capital and liquidity requirements – financial institutions above a certain size or degree of financial interconnectedness. Such a regulatory tax would help offset the "systemic risk externality" such institutions impose on the economy. In light of recent events, it is unlikely that

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such a systemic risk tax would be greater than the expected cost (magnitude times probability) of having to bail out the creditors of these institutions in future crises.

Another sorely needed reform is to extend the system of prompt corrective action we now have to curtail the taxpayer cost of resolving troubled banks to large, systemically important non-banks. The Treasury's proposal in this regard – to give it, the Fed and the FDIC authority to make this determination, and the FDIC the authority to carry it out – is a sensible way to do this.

I. Regulatory Enforcement Options

The question then becomes: who would administer and enforce a more rigorous regulatory regime for systemically important financial institutions (SIFIs)? The basic choices comes down to vesting this authority in a single regulator; in a collection or body of regulators, such as the banking, securities and futures regulators represented currently on the President's Working Group on Financial Markets; or in each of the various current financial regulators separately (federal and state, in the case of insurance).

Choosing a single regulator has several advantages. There are likely to be both economies of scale and scope in identifying and specially regulating SIFIs, which argues in favor of having one agency do the job. Splitting up the regulation and supervision of SIFIs among the different agencies that currently regulate financial institutions would run the risk of inconsistent and potentially conflicting rules or outcomes. Giving the authority to regulate SIFIs to a college of regulators entails a different set of risks: the need to obtain a consensus would likely slow and water down meaningful oversight, while creating ample opportunities for finger-pointing when things go wrong. Decision by committee also violates Harry Truman's "The Buck Stops Here" principle: when many agencies or individuals are responsible for action then no one is.

Which single agency should have the systemic risk regulatory responsibility? In my view, it would be best to consolidate all federal financial regulatory agencies into two – one for solvency and the other for consumer protection – and then to give SIFI oversight to the solvency regulator. This is the most logical approach, and one that would draw on the financial expertise of the solvency regulator to specially regulate and oversee SIFIs as part of the regulators' overall mission.

During his last year in office, former Treasury Secretary Henry Paulson suggested the consolidation of financial regulatory oversight into two agencies, but urged that the Fed have "free safety" powers to step in anywhere and at any time it saw fit. This kind of authority is both too vague and too sweeping, and a recipe for jurisdictional conflict between the Fed and

the agencies. If Congress were to muster the political will to implement the rest of Paulson's idea – consolidation into two regulators – then it could still involve the Fed in other ways. The solvency regulators should give the Fed the same data on SIFIs that the solvency regulator collects and even give the Fed a formal role as an adviser on regulatory and supervisory policy with respect to such institutions.

I am not holding my breath, however, for Congress to enact anything like the regulatory consolidation envisioned by the Paulson Treasury, and thus to give systemic risk regulatory authority to a new uber-solvency regulator. If this reform does not come to pass, then the sensible second-best option is simply to charge the Fed with being the systemic risk regulator.

This is not as far-fetched as some critics of the Fed assuming this role have made out. After all, in creating the Fed as a lender-of-last-resort, the Congress already has recognized that the Fed is the only institution we have for preventing a meltdown of the financial system. As it is now, the only tools the Fed now has to fulfill this mandate are its monetary policy and lending activities. Giving the Fed added regulatory tools – specifically supervisory oversight of SIFIs – would give it more ammunition to prevent systemic risks from arising in the first place. Rather than conflicting with its monetary policy functions, systemic risk regulatory authority thus would unburden the Fed from having only to rely on loose money to ward off a systemic threat, and thus would complement the Fed's existing monetary functions.

II. Worst Choice Scenario

The least desirable choice of a systemic risk regulator, in my view, would be to create yet another regulator charged only with this mission. There are already too many cooks in the financial regulatory kitchen and adopting this option would make it worse. It would also replicate much of the expertise that already resides within existing financial regulatory bodies.

Admittedly, designating a systemic risk regulator and imposing a more rigorous regulatory regime for SIFIs will not eliminate all systemic risk. Asset price bubbles are an inherent part of capitalism: break-through technologies typically attract a lot of capital and entrepreneurs at the outset, followed by a shakeout. Think of the railroad, auto, and Internet bubbles, among others, as examples of this process.

Nonetheless, there is no excuse for not doing a better job insulating our largest financial institutions whose failure could cripple the financial system from failure when their balance sheets or income statements are shocked by external events, such as the recent collapse of housing prices. In this way, regulators at least can mitigate the fallout – financial and economic – when the inevitable bubbles do pop.

Not surprisingly, there is already opposition to establishing a systemic risk regulator. One obvious objection is that by publicly identifying SIFIs, the government will create or worsen moral hazard by eliminating incentives of short-term and possibly longer-term creditors (all those who would be bailed out if the firm failed) to monitor the health of the SIFIs, and thus incentives for the managers of these firms to act prudently. Some advocates of systemic risk regulation would meet this objection by not publicizing the SIFI list. This approach is unrealistic, since most SIFIs (with the exception of large hedge funds) are publicly held companies, and thus any more stringent capital and liquidity (or other) standards to which they would be held would be readily evident from their financial statements.

The best answer to the concern about moral hazard is that precisely because SIFIs, by definition, pose a systemic risk if they fail, they would be regulated and supervised more closely than is the case for other financial institutions. Higher capital and liquidity standards, in particular, thus would be designed to offset any possible moral hazard effect. In addition, policy makers can further constrain risk-taking by large, publicly held SIFIs by requiring them to back a set percentage of their assets by long-term, unsecured debt – or the kinds of instruments that the government need not protect if the institutions run into financial trouble. Such a requirement would ensure some continuing role for market discipline.

A second objection to vesting systemic risk regulation in a single agency is that it would concentrate too much power in that agency, especially if the designated agency were the Fed, which already has enormous power by virtue of its control over monetary policy. One answer to that concern is to point to the clearly inferior alternatives. Wait for the next explosions to occur and then spend trillions more cleaning them up? Split up regulatory authority in a college of supervisors where no single agency has a final say -- and a recipe for inaction or delay? A second answer is that if excessive concentration of power is a serious concern, then Congress should exercise oversight over the activities of the systemic risk regulator.

If these two answers do not suffice, then consider a third: we concentrate tremendous power in the hands of a single individual, the President, to launch war, nuclear if necessary, against foreign threats to our national security (I know that technically only Congress has the Constitutional authority to declare war, but in a nuclear emergency in particular, everyone knows there is no time for Congress to deliberate and vote on a response). SIFIs, if not properly constrained, can threaten our domestic economic security. It hardly seems inappropriate, therefore, to designate one agency with the authority at least to reduce the magnitude of that threat, especially given that we already have an agency – the Fed – we trust with rescuing us from financial disaster when the threats become too real.

A final objection is that we are being short-sighted if we think that a systemic risk regulator will protect against all future systemic meltdowns. But that erects an impossible test for any policy reform to meet. A set of reforms that helps prevent institutions from posing systemic risks, even if it does not eliminate all systemic risk, would leave us in a better position than we are now in. The perfect cannot be the enemy of the good.

In short, we must do a better job protecting our financial and economic system from systemic risk. Assigning that role to a single agency, with clear instructions of the types of authority it is expected to exercise, is the best way to assure that protection.

Issues for Systemic Risk Regulation

Arthur Long⁴

At the end of last month, Treasury Secretary Timothy F. Geithner laid out an ambitious agenda for regulatory reform. The agenda seeks to address many of the perceived weaknesses in the United States regulatory structure that have been thought to have contributed to the ongoing global economic slowdown. In doing so, the Treasury's agenda demonstrates a meticulous approach to the issues posed by the financial crisis.

With respect to the issue of managing systemic risk – the first component of the Geithner agenda – there are already competing visions of how best to implement reform. The challenge to enacting successful reform will be to ensure that whatever proposal is chosen, the regulator or regulators have full supervisory powers over financial institutions on a consolidated basis.

In its March 26 press release, the Treasury Department stated that “Comprehensive Regulatory Reform” would have four broad components:

- Addressing Systemic Risk
- Protecting Consumers and Investors
- Eliminating Gaps in Our Regulatory Structure
- Fostering International Coordination

The press release then outlined a six-point program for addressing systemic risk, by: assigning responsibility for all systemically important firms to a single independent regulator; requiring higher capital and risk management standards for systemically important firms; requiring SEC-registration of all hedge fund advisors with assets under management above a certain threshold; instituting a comprehensive framework of oversight for the OTC derivatives market; imposing new requirements on money market mutual funds; and creating a stronger resolution authority to protect against the failure of complex institutions. Each of these six points responds to the principal issues raised by the failure of Lehman Brothers and the government's intervention into the affairs of AIG in September 2008.

In the short period of time since the Treasury's announcement, there have been many questions raised about the first point – the single, independent systemic risk regulator: Who

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will that regulator be? Does it have the means to effect appropriate regulation? And can it regulate systemically without compromising other functions?

The obvious candidate is the Federal Reserve Board because it is the current supervisor of traditional bank holding companies as well as the “new” bank holding companies, those broker-dealers and other firms that became bank holding companies in the wake of Lehman and AIG. The Federal Reserve Board has a long history of mandating “comprehensive consolidated supervision” for companies under its purview and it is central to the functioning of the U.S. payment and settlement systems.

Certain critics, however, have raised practical issues with having the Federal Reserve Board assume this role. They note that the Federal Reserve Board’s role in the regulatory system has grown by leaps and bounds in the last six months, and question how many additional supervisory resources it has at its disposal. They also argue that the proposal could pose dangers for the Federal Reserve Board’s reputation over time: a single regulator charged with protecting against systemic risk would suffer a significant loss of prestige if another Lehman Brothers occurred on its watch. There is also a concern that magnifying the power of the Federal Reserve Board will almost certainly increase the political pressures that the institution must bear, particularly in the current environment, thus undermining its independence as a central bank.

For these reasons (and others), some, like Connecticut Senator Christopher Dodd have suggested that the Federal Deposit Insurance Corporation is better suited for the role of systemic risk regulator, although this idea has not necessarily been welcomed by the FDIC itself. Comptroller of the Currency John Dugan, an FDIC board member, for one, recently expressed reservations about the FDIC being charged with the resolution of failing systemically important financial institutions, even though resolving bank failures is the FDIC’s principal area of expertise.

Other approaches to systemic risk regulation appear to make use of the third component of the Treasury’s comprehensive regulatory reform agenda – eliminating gaps in the regulatory system. Senator Susan Collins of Maine recently proposed legislation that would, in addition to establishing an inter-agency government council of regulators, the Financial Stability Council, as the systemic risk overseer, merge the Office of Thrift Supervision (OTS), which has been criticized for the Indymac and Washington Mutual failures, into the Office of the Comptroller of the Currency (OCC) and give the OCC the OTS’s powers over thrifts and thrift holding companies.

If such legislation moved forward, a better result would give the OCC supervisory authority over thrifts only, and the Federal Reserve Board supervisory authority over thrift holding companies, since the Federal Reserve Board is the banking agency that is expert in holding company regulation. Doing so would, in one fell swoop, make the Federal Reserve Board the consolidated supervisor of AIG, as well as a number of substantial insurance companies that either owned thrifts under the pre-Gramm-Leach-Bliley Act unitary thrift holding company loophole or acquired thrifts in order to participate in the TARP.

At the end of the day, whatever approach is chosen, it will be important for all systemically important financial institutions to be subject to comprehensive, consolidated supervision by a federal regulator with appropriate powers. The Federal Reserve Board has set forth the requirements of this type of supervision; namely, the supervisor must:

- Ensure that the financial institution has adequate procedures for monitoring and controlling its activities worldwide;
- Obtain information on the condition of the financial institution and its subsidiaries and offices outside the home country through regular reports of examination, audit and other reports;
- Obtain information on the dealings and relationship between the financial institution and its affiliates, both foreign and domestic;
- Receive from the financial institution financial reports that are consolidated on a worldwide basis, or comparable information that permits analysis of the financial institution's financial condition on a worldwide, consolidated basis;
- Evaluate prudential standards, such as capital adequacy and risk asset exposure, on a worldwide basis.

Such comprehensive, consolidated supervision is necessary if foreign offices and affiliates of systemically significant U.S financial institutions are to be appropriately monitored, and significant losses such as those generated by AIG Financial Products' London office avoided in the years to come.

Mandating comprehensive, consolidated supervision for all systemically important financial institutions may require regulatory powers similar to (and perhaps greater than) those the Federal Reserve Board currently exercises under the Bank Holding Company Act. For example, the Federal Reserve Board now has the authority to set capital standards for bank holding companies consistent with international supervisory accords, and the Fed also regularly examines and assigns ratings to particular bank holding companies' risk management practices.

Other Federal Reserve Board powers and responsibilities include the ability to issue written agreements, cease-and-desist orders, and more onerous penalties in egregious situations, as well as to approve mergers and acquisitions of bank holding companies, where the Fed must consider the “financial and managerial resources” of the acquirer. For this reason, the Federal Reserve Board has the legal authority to impose higher capital and risk management standards on bank holding companies and to limit their growth by acquisition if those standards are not met.

The Federal Reserve’s examination authority into nonbank subsidiaries of bank holding companies, however, is limited to subsidiaries that “could have a materially adverse effect on the safety and soundness of any depository institution subsidiary of the holding company,” and such a power could be required to be extended to nonbank subsidiaries that pose systemic risk. Comprehensive supervisory powers will be necessary if systemic risk regulation is to work well in practice, regardless of who the regulator is.

The Treasury’s regulatory reform proposal has thus begun an interesting, and necessary, conversation on systemic risk, but it is only the beginning. The debate over systemic risk issues in the weeks and months to come will require investigation into the core functions and abilities of each of the nation’s principal financial regulatory agencies, and in order to be successful, the path chosen must reflect core regulatory competencies and provide adequate regulatory powers.

Overcoming the “Too Big To Fail” Phenomenon

Ralph S. Tyler and Karen Stakem Hornig⁵

Treasury Secretary Timothy F. Geithner has given the broad outlines of the Obama Administration’s proposal for reform of the nation’s financial regulatory system. The Treasury Secretary’s announcement will raise the intensity and sharpen the focus of the debate about the scope and specifics of reform.

Among the important questions that must be addressed in the course of this debate is the “too big to fail” phenomenon, which has so infected the current crisis. A principal reform objective should be to minimize the number of systemically significant institutions that, in the future, would fall into this category.

What does “too big to fail” mean? Over the past year, this term has meant that certain institutions are perceived as so big that policymakers are afraid to see what happens were the institution allowed to fail. The difference in the federal response to investment firms Bear Sterns (saved from collapse) and Lehman Brothers (not saved) illustrates that this judgment is hardly a precise one.

American International Group, Inc. (AIG) is the poster child for the “too big to fail” phenomenon. In September 2008, on the verge of the company’s collapse, the Federal Reserve determined that AIG was too big to fail because of the potential national and international impact of such a failure. AIG’s collapse could have had devastating financial consequences to not only AIG’s stockholders and employees, but to the millions of average Americans who hold insurance policies through one of the many (approximately 72) AIG wholly owned insurance subsidiaries. It is estimated that in the United States AIG has issued 375 million insurance policies with face values of approximately \$19 trillion.

In the financial sector, changes in the legal regulatory structure actually encouraged the outsized growth of institutions. This “too big to fail” phenomenon did not just happen, nor is it entirely the result of economic forces over which we lack meaningful control. Instead, Congress authorized its occurrence. The good news is that can revoke that authorization.

As the culmination of a bipartisan effort to deregulate the financial services industry, Congress passed the Gramm-Leach-Bliley (GLB) Act in 1999. The purpose of GLB was to allow affiliation

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among banks, securities firms, and insurance companies. This gave financial companies the flexibility to set up new companies through a holding company or financial subsidiary. GLB repealed the Glass-Steagall Act of 1933, the depression era law that prohibited a bank holding company from owning other financial companies.

On November 12, 1999, the day that President Bill Clinton signed GLB, former Texas Senator Phil Gramm, one of the bill's sponsors (and now an executive for international financial giant UBS) said that the protections of Glass-Steagall were outmoded because in the 1930s, it was believed that stability and growth came from government overriding the function of free markets. "We have learned that freedom and competition are the answers," Senator Gramm said. "We have learned that we promote economic growth and we promote stability by having competition and freedom."

This wave of the future set the stage for the colossal corporate structures that blended traditional insurance business with banking and other higher-risk financial services with devastating consequences.

When Failure Is Not an Option

There is a considerable cost to allowing institutions to reach a scale where failure becomes "unthinkable" or "unallowable." That cost goes well beyond the billions of future taxpayers' dollars we are now using to prop up these institutions.

In the pre-bailout era, the operating assumption for most business enterprises was that failed businesses went out of business. The market extracted a steep cost for firm-jeopardizing bad judgments. That cost was bankruptcy. The theory of our system was that the market rewarded success and punished failure. This system, at least in theory, operated within a set of incentives that rewarded both individuals and firms for success. This incentive system also was supposed to discourage individuals and firms from taking such excessive risks as to jeopardize the viability of the enterprise.

This entire theory now sounds literally quaint. As we have seen, the road to federal subsidies in the present crisis is open -- if not entirely a smooth ride -- to only the truly large firms that have failed on a massive scale. While bailouts of these failures may be necessary to save the entire system from collapsing, they occur at the expense of the discipline that is at the core of our economic system. One cannot both believe in the theory of our economic system - we reward success and punish failure because that incentivizes success and disincentivizes failure - and deny that eroding this discipline is a substantial cost to saving failed firms from their failures.

Size is not the only issue. We must look carefully at the blurring of the line between insurance products and investment vehicles. Insurance is not just another financial service. The goal of insurance is to manage and pool risk, while investment is intended to reward those who take risk. The current crisis is an opportunity to readjust the regulatory system to recognize that the purchase of insurance and investment in securities are two quite distinct and fundamentally different things. The choices and risks involved with each must be plain to consumers. Consequently, Secretary Geithner and Congress should examine carefully the role that the passage of the Gramm Leach Bliley Act has had on confusing the difference between the two and ultimately putting consumers at risk.

Our point is not to criticize the decisions that have been made to bailout certain firms. Our point is that going forward our nation should avoid being compelled to save failed firms by a fear of what such failures would mean.

We now know beyond doubt the enormous risks of having firms of a size, scale, and complexity that the functioning of the economy depends on their continued existence. When firms are so embedded into the economic infrastructure that global prosperity may depend upon their existence, these firms need not fear failure because, as we have seen, the public treasury will end up having to own their failures. That kind of economic extortion cannot be squared with any reasonable notion of a regulated market economy.

In the future, the only way to avoid this trap is to discourage the creation of firms on a scale beyond a size safe to collapse. In the global economic world in which we live and in which we as a nation must compete, there will inevitably be such firms. But they should be few. We should not adopt regulatory policies that encourage their creation and we should repeal existing regulatory policies that paved the way for our present predicament.