GENERAL DISCUSSION

Financial Regulation after the Crisis: How Did We Get Here, and How Do We Get Out?

Chair: Mark Spiegel

Mr. Spiegel: Jerry do you want to take a minute or two to respond to the discussant comments?

Mr. Caprio, Jr.: Just a couple of points. I'd like to thank the discussants very much for their comments. Since the idea of a sentinel over the financial system attracted so much attention, let me just clarify that neither I nor my coauthors think this is going to be easy. Obviously regulators are human, and all humans may talk about accountability but they don't like it for themselves. Banks also don't want regulators who are accountable, because then they'll be a whole lot tougher. So we understand the political economy is against this. Moreover, to set up a truly effective sentinel, as Ashoka was suggesting, it really has to be independent, which the International Monetary Fund (IMF) is not. The IMF wasn't even able to set up a Financial Sector Assessment Program (FSAP) for the United States before the crisis, because the U.S. didn't want one, and even though they should have had one for the U.S., it wasn't done until it was too late. And the people who are overseeing the Fund, who are going to be assessed, are on the IMF's board. So it would be like having an FSAP with Citibank and Morgan Stanley on the oversight board. It would not be very effective. There are a host of conditions that need to be satisfied for it to be effective. You've got to get a diverse group of really highly trained financial experts, a mix including forensic accountants and lawyers. You've got to pay a lot more than anybody in the United States wants to pay public officials. I don't believe even the IMF has that mix of talent. On Takeo's point, there are two countries, Sweden and Ireland, that have formed sort of a sentinel. They call them fiscal councils, and their job is to look for any possible off-balance-sheet liability that could blow the government's budget out of the water. Actually, both countries are obviously doing it because of their experiences with a banking crisis. Now the reason I say it's "sort of" a sentinel is because they're not staffed by a bunch of financial experts, and they really need that expertise to be able to do an effective job of monitoring.

Mr. Spiegel: Okay, we have time for some questions. First, Ric Mishkin.

Mr. Mishkin: I really want to commend you on a terrific paper. I wanted to dig into a few issues you've raised and amplify them. One is the issue of transparency about compensation, which I think is key. One of the things that's most frustrating to me as a policymaker is the focus on irrelevancies. In particular, Glass-Steagall is brought up all the time as a source of the crisis. When you actually look at what happened and where the epicenter was in the crisis, particularly in the U.S. context, it was in two investment banks that were completely unaffected by Glass-Steagall, Bear Stearns and Lehman Brothers. Beyond the disastrous regulation by the Securities and Exchange Commission, which was a business practices regulator and not a safety and soundness regulator, one of the key reasons this happened was that the nature of the compensation scheme changed when these two banks changed from a partnership framework to a corporate structure. To counter, people may say there still were incentives not to tear down this risk because top management lost a lot of money. But the level below that, all the people who got huge bonuses, really created the crisis. What's interesting is that we all thought the hedge funds were going to be the big problem before the crisis, because there are tremendous incentives for them to take on risk. But their transparency offset it. Nobody invests in a hedge fund unless the owners have put almost all their own wealth into it. That's where the transparency issue comes in. I think one of the things you talked about, this transparency about compensation, is a critical element in terms of preventing the next crisis. The other thing I agree with you on is that Basel has headed the wrong direction, and its complexity is a huge part of the problem. One further thing that is very important is that part of this crisis was from reduced transparency. Complicated securities in a sense decreased information in financial markets. And Basel actually decreased information in terms of what the regulators were doing. So this principle of "keep it simple, stupid" is really important, because if you keep it simple then you can actually monitor what the regulators are doing in a much better way. But I think it's going to be hard to get people to move away from the old way of doing things. I actually am not optimistic that we can redo Basel and hit the reset button.

Ashoka, you mentioned the issue of the Swiss National Bank, which has been extremely innovative. But one of the things it shows is that people will work very hard to prevent some of these reforms, in this case the political parties. I think the key issue here is, how do we get the kind of reforms that Jerry is talking about? I'm not sure what the answer is. But this thinking outside of the box is just terrific. And I hope it'll have some impact, but I'm not that optimistic.

Mr. Spiegel: I have a list of people with questions, let's take them all first, and then I'll let the presenters respond. Martin Wolf next.

Mr. Wolf: I'm going to make a very quick series of comments. First of all, I love this discussion, and it relates to a lot that I've been thinking about. I was on the independent commission on banking in the United Kingdom, so I've been through a lot of these things, and I agree with pretty much everything.

So here are the questions. Leverage ratio, I agree, but how much equity? Let's be precise, what numbers are we talking about? It makes a lot of difference. Three percent, 30 percent? Second, how worried are you about the regulatory arbitrage consequences of high equity requirements for formally regulated institutions. That seems like a really big issue to me. The innovative capacity of the system is incredible. Third, it seems to me you cannot underestimate the significance of fundamentally mistaken views about the world. I could have made millions of dollars on bets with very distinguished American economists—I will not list the names—who told me that house prices could not fall in the United States, as a general proposition. Which as a Brit I found rather astonishing, having been through three massive collapses. Fourth, do not underestimate the significance of the belief in a number of countries, including my own, that banking was a profit center for the economy, and regulators' job was to support it. Fifth, I have a lot of sympathy, but I think the idea that we can just have somebody with a $10,000 deposit in JP Morgan police it is fairly nuts. So surely the alternative is to change seniority, which is what we recommended. Just make insured depositors the senior creditors. The creditors who should monitor the bank are the ones who have large claims. And the final point, whose interest does it all serve? The banks' and regulators' and nobody else's.

Mr. Spiegel: Okay, I have Anil Kashyap next.

Mr. Kashyap: Great panel. So I don't know the Calomiris and Herring details, but what was interesting to me is that you didn't really go after pay. So my favorite proposal on contingent capital (CoCo) requirements is to invest the bonus pool in CoCos, and I wonder why you would prefer any form of CoCo to that?

Mr. Spiegel: Okay, Barry Eichengreen, and then Peter Hooper will have the last question.

Mr. Eichengreen: It's easy to be a purist if you're not currently a policymaker. I want to suggest that Jerry is not being pure enough here. You started with a simple leverage ratio for a lot of capital, and then you said that it's not politically possible to get enough capital, so we're going to be a little less pure and a little more complex, and add CoCos. But it's probably not politically possible to get enough CoCos, so we're going to be a little bit less pure, and a little bit more complex, and add loan-to-value ratios. Isn't this a slippery slope? And isn't it important to identify what the political constraint on having enough capital is, and attack it directly?

Mr. Hooper: Let me add to the slippery slope question. Jerry, what is your capital ratio recommendation? Certainly going from risk-weighted assets to leverage reduces complexity, but at the same time doesn't it incentivize intermediaries to move towards higher risk, higher return assets? Especially if we're considering going from 3 percent to Martin's 30 percent on capital.

Mr. Spiegel: Thank you very much. I'm going to give Jerry a chance to respond to all the questions, and then we'll have a short opportunity for the discussants if they want to respond as well.

Mr. Caprio: On the last point, since that hit several of the questions, yes, there is literature that argues that it's theoretically ambiguous which way a higher capital requirement is going to go. That's one of the reasons why I would not put all the eggs in one basket. It's not just because of political issues. There have been empirical studies that can't identify any impact from varying capital in a relatively narrow range. Now I believe most sensible proposals would call for a much higher range—I'm drawn to the number 20—but we don't have a scientific basis for determining this range and we are worried about affecting people's behavior. It also depends critically on how concentrated vs. how diversified the ownership is. Luc Laeven and Ross Levine have a good paper on that. So I think it is a slippery slope to decide what rules you use, and I hope my paper would help in the discussion of what number of sensible simple rules is manageable. I was not trying to write the definitive paper or draw up the blueprint.

Anil, I like the proposal of having bonuses invested in CoCos. We'll have to talk more about the differences between your proposal and that of Charlie (Calomiris) and Dick (Herring). On Martin's questions about regulatory arbitrage, I am really worried about that. Charles Goodhart has written far more eloquently than I have on this issue, and after Hyun's talk last night, I'm even more worried about it. That's why I find Charles's recommendation about not having on-off buttons as one way to go. But I realize that if the sum total of your interventions pushes people out of the sector to do the same business elsewhere, then you have to follow them in effect, just like we should be regulating money market funds in this country as banks. Obviously, that's really hard to do politically. Martin, I agreed with your points completely.

I would end with a comment that, a year ago in the Wimbledon final, there was a blatantly bad call in favor of Andy Murray, and even before they showed the instant replay the referee immediately reversed the call. And as a commentator, John McEnroe said, with instant replay you might as well call it right the first time. That's the incentive system we want. I have no illusion that having a sentinel will always lead to better regulatory decisions, but I think it could make a difference.

Mr. Spiegel: Just briefly Takeo.

Mr. Hoshi: Very briefly on a couple of points. On simple leverage ratio regulation: No matter how high we set the capital ratio or simple leverage ratio, I think the banks can find a way to get around it and achieve whatever level of risk they want. So I think the necessity for bank supervision won't go away. The second point related to Martin's point, I agree with you. The problem is not so much deposit insurance for small depositors, but rather the protection of the large debt of the bank; it would be a good idea to get rid of the protection of those debts.

Mr. Spiegel: Okay, please join me in thanking our speakers for a very excellent session.