Regulators' Incentives

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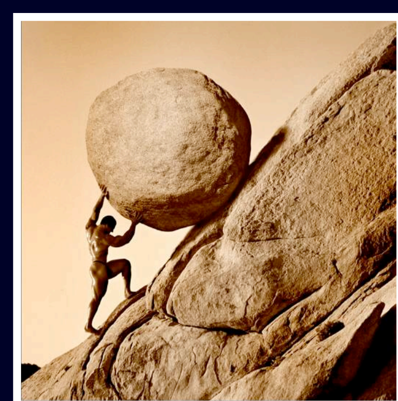
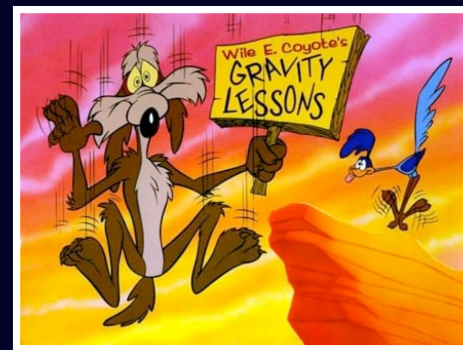
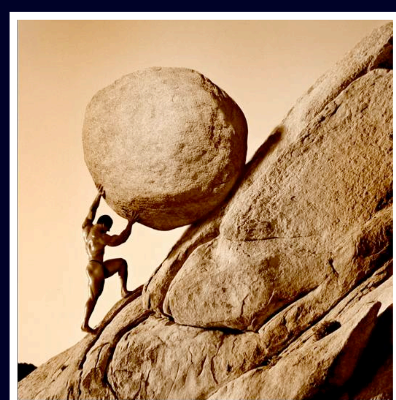
Regulators' Incentives

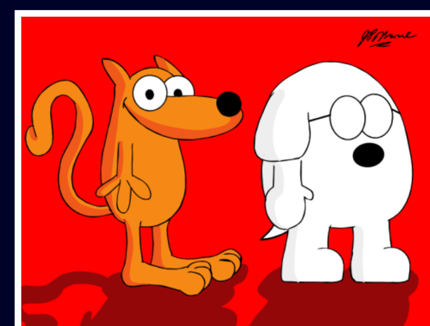
What Have They in Common?



Keep
making
same mistake


Wile E. Coyote's
GRAVITY
LESSONS

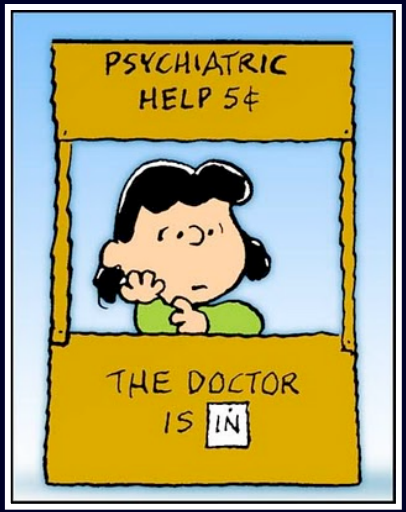




Uncle Sam

- Suffers recurring financial debacles
- Vows reform!
- Does what <u>expert regulators</u> recommend
- Suffers another debacle
- Vows reform!

Reform



Key Points

- Regulators:
  - Had ample powers to keep banks safe
  - Did not adequately use their powers
  - Faced perverse incentives to be lax in good times
- No political constituency for bank soundness regulation—until it's too late
- To fix system, we need to deal with regulators' incentives


THE
10 CENTS
Shadow Banking System
LOOPHOLES RULE!

Regulators
had ample powers
to keep banks safe

Examples

- Total access to information
- Scrutinize operations
- Deny applications
- Take enforcement action:
  - Issue cease & desist orders
  - Impose fines
  - End bankers' careers

Gets your attention

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PREFERRED STOCKS
LEHMAN BROTHERS HEAD
BEAR STEARNS HEAD
MERRILL LYNCH HEAD
BANK OF AMERICA HEAD
Citigroup HEAD
AIG HEAD
MIKE LUCKOVICH

Challenge

Identify any significant U.S. bank soundness problem that regulators lacked power to prevent, constrain, or correct

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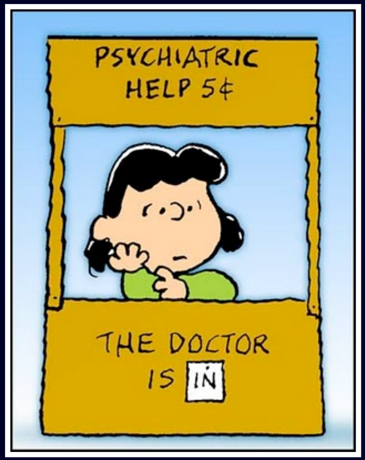
Dance of the Powers

- Congress: How could this happen?
- Regulators: Who’d have expected a bubble? We need more powers!
- Congress: Have a dozen! And don’t let this happen again
- Regulators: You can count on us next time!

More of the Same



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Regulators Should Have . . .

- Increased required capital levels
- Used risk-based capital standards to:
  - Limit banks' investments in riskiest MBS
  - Curb other concentrations of credit risk
- Limited banks' exposure to largest financial firms
  - So large firm's failure would not tank other banks
- Required largest banks to hold additional capital

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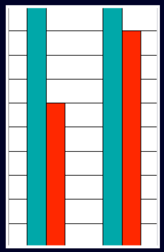
Required Capital Levels

- Set in 1988 during crisis
  - Regional recessions
  - Lots of troubled loans:
    - Oilpatch; farmland; developing countries



- Regulators never increased required levels
  - Despite 2 decades of prosperity & record profits

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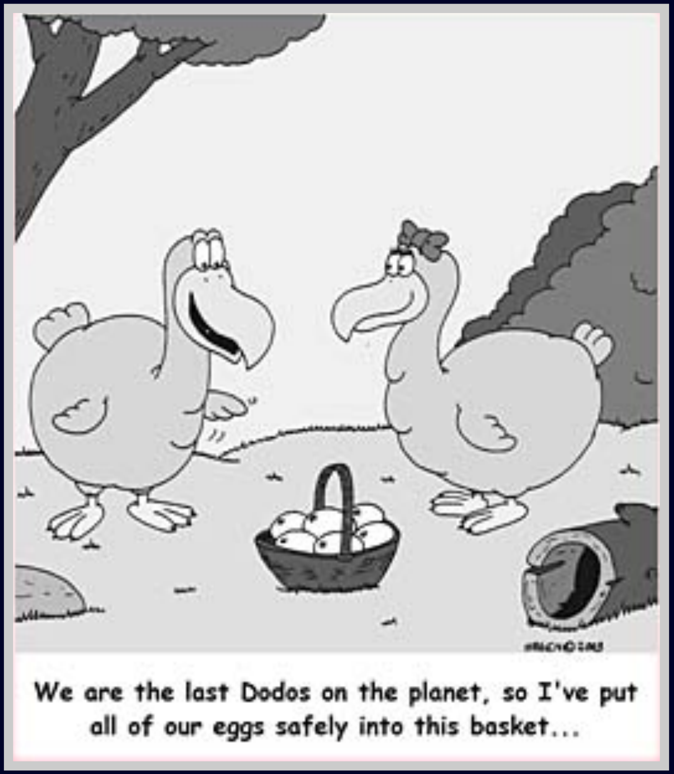
Excessive Inter-Firm Exposure



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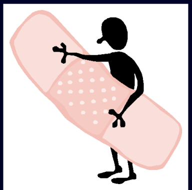
Risk of Cascade

- Failure of large bank could bring down other banks to which failed bank owed money
  - One bank would topple another

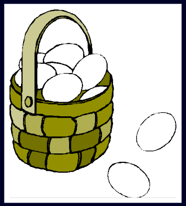
- Risk creates pressure for too-big-to-fail treatment

Statutes Subverted

- Congress required Fed to make rules limiting banks' exposure to each other (1991)



- Fed adopted mushy, ineffective rules
- Nor did OCC properly limit banks' exposure to large nonbank financial firms (e.g., AIG)
- Regulators actually subverted prudent statutes



Regulatory Failure

- Needless, costly & huge
  - Including failure to use discretionary powers
  - Cf. regulatory failures during 1980s
- Granting more discretionary powers won't suffice

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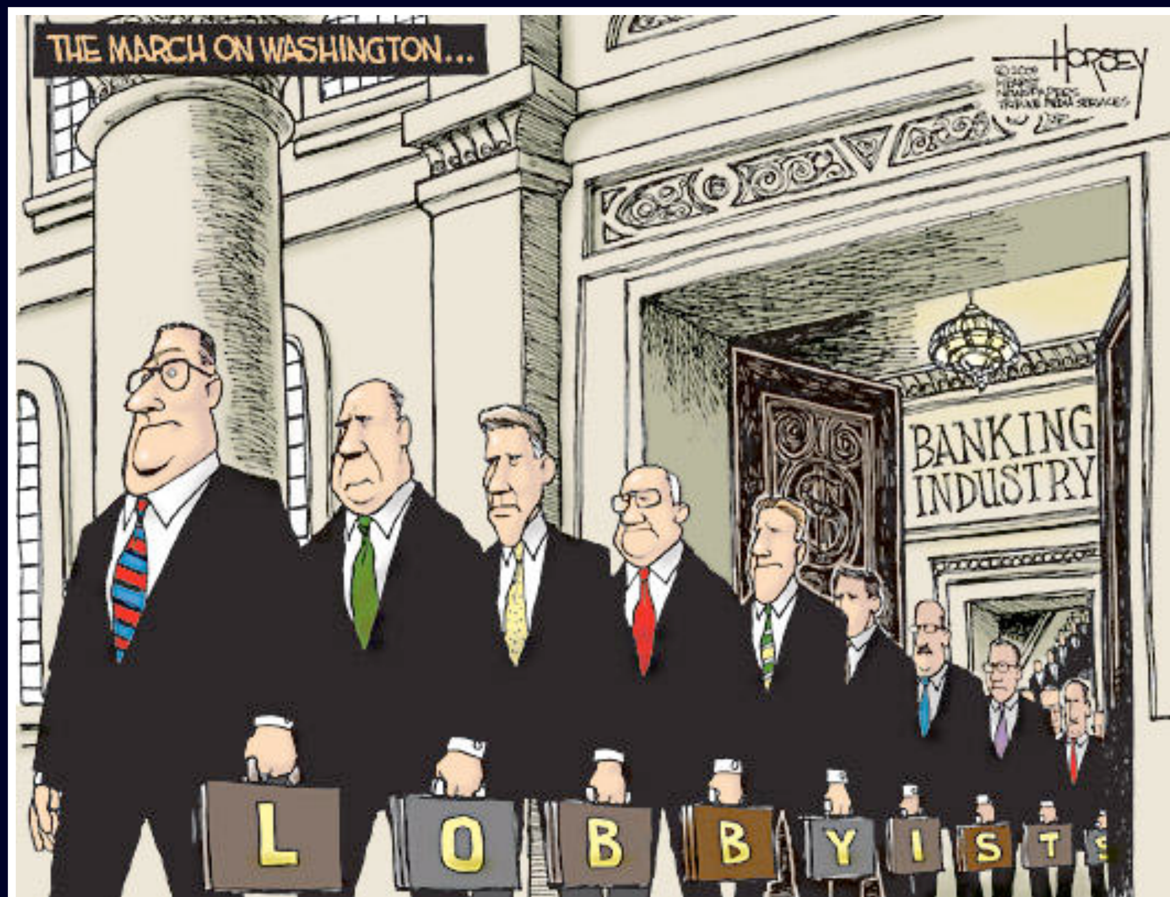
Regulators' Perverse Incentives

Perverse Incentives

- Arise from:
  - Special interest politics
  - Nature of banking
- Discourage strong, timely action to protect bank soundness, insurance fund & taxpayers

Special-Interest Politics

- Risky banking confers immediate benefits concentrated in risky banks' owners, managers, counterparties & borrowers
- Costs of risky banking show up slowly & are widely spread
  - Taxpayers are unorganized & usually pay little attention
- Organized, motivated few exert more influence than unorganized many


THE MARCH ON WASHINGTON...
HORSEY
BANKING INDUSTRY
L O B B Y I S T S

Impaired Accountability

- Hard to be sure of banks' condition from outside
  → Hard for citizens to know if regulators are doing a good job
- Result: leeway for laxity
  – Regulators can do what's popular & expedient without (immediately) hurting own reputations
- During good times, laxity is more popular than stringency—until it's too late

Regulators’ Reputations

Your reputation suffers less
from problems that develop
on your watch
than from problems
that become public on your watch

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Upshot

- We have difficulty telling good banks from bad—until it's too late
- We have difficulty telling good regulation from bad—until it's too late
- Lax regulation is more popular than stringent regulation—until it's too late
- Risky banks & their allies exert more political influence than taxpayers—until it's too late

Bank soundness regulation has no political constituency —until it's too late

Banks Are Opaque

- Many bank assets lack ready markets
  - E.g., commercial loans
  - Management can manipulate valuation
- Result:
  - Hard for outsiders to tell bank's true financial condition
  - Hard for citizens to tell whether regulators are doing a good job

Incentives → TBTF

Regulators' perverse incentives promote too-big-to-fail treatment:

- Inadequate prevention
- Patterns of political expediency

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Inadequate Prevention

Laxity & complacency mean:

- Big banks more likely to fail
- Banking system more vulnerable to systemic shocks
- Neglect of systemic reforms
  - E.g., clearing & settlement systems; credit -exposure limits

Expediency

- Bailouts confer immediate, readily identifiable benefits concentrated in big banks' uninsured creditors
- Costs of bailouts:
  - More diffuse
    - Higher FDIC premiums; larger fiscal deficit
  - Longer term
    - Greater moral hazard & potential for future instability

Expediency

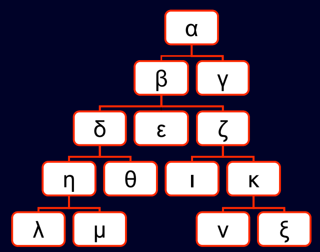
More broadly . . .

- If you have no backbone in good times, how will you acquire one during a crisis?
  - Invertebrate in peace → invertebrate in war

Regulatory Fragmentation

Heightens regulators' perverse incentives:

- Promotes interagency competition → unsound laxity
- Undercuts accountability
- Slows decision-making
- Divides authority over integrated banking organizations



- Leaves agencies weaker & more vulnerable to special-interest pressure

Aberration of U.S. Banking

- No other country has competing bank regulators
- No other U.S. industry has competing federal regulators

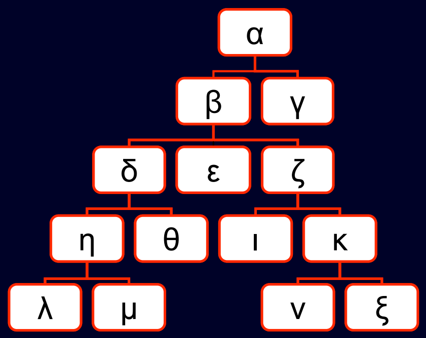
Solutions

Recommendations

- Make new independent agency responsible for all federal bank soundness regulation
- Give agency clear, focused, realistic goals
- Frame important statutes in ways that reinforce regulators' accountability
- Strengthen capital requirements
- Strengthen rules for dealing with capital deficiencies

Unified Regulator

- Would supervise all FDIC-insured banks & thrifts + their parent companies
  - Board would include Treasury, Fed & FDIC
- Result:
  - Maximize accountability
  - Curtail bureaucratic infighting
  - Facilitate timely action



- Could better supervise integrated organizations
- More independent from special-interest pressure

Realistic Goals?

- Regulating systemic risk?
- Controlling enormous potential for moral hazard by regulation?
- Overcoming incentives for bailouts?

Umbrella Regulation

Regulating umbrella

Umbrella Regulation

Regulation
by umbrella

Big Brella
is watching you

Conclusion