Faith, Judgment, and Rigor: The Role of Capital and Supervision in Post-Crisis Financial Regulation

Thank you very much for the opportunity to be here, and for the chance to address such esteemed company. The Federal Reserve has a special place among regulatory bodies the world over for its commitment to academic discourse. Few agencies have its devotion to scholarly research and to the use of evidence in the regulatory process. The Chicago Fed particularly stands out for placing regulatory and supervisory issues in a broader program of stability and growth. This conference is a testament to that program, and Charlie Evans, Doug Evanoff and their peers should be commended for it.

I also want to recognize two of my fellow speakers, Chairman Ben Bernanke and Acting Chairman Marty Gruenberg, for whom I have a great deal of respect. They are a consistent source of thoughtful, actionable proposals for financial regulation and reform; they have dedicated themselves to the public good, and they should be commended for it.

Today, I hope to take a high-level look at some of the regulatory requirements that have been discussed over the last three days. I will speak briefly on the roles that faith, rigor, and judgment play in the health of financial institutions, and describe how, in light of that role, capital requirements and prudential supervision must grow alongside one another. I will then offer some considerations for the ongoing process of regulatory reform, especially in the area of bank supervision.

It has been more than four years since the collapse of Bear Stearns; nearly four years since the passage of TARP; and almost two years since the signing of the Dodd-Frank Act. Yet we are still, even now, in the midst of a roiling debate over the nature and extent of financial reform in the U.S. and abroad.

Above all, this is a testament to the breadth and depth of the crisis. U.S. household assets have recovered slightly, but are still 10% lower than they were in 2007. $5.2 trillion in real estate value has been destroyed[1]; unemployment is nearly double its 2006 low, and is 13.2% among those in their early 20s.[2] Policy-making in this environment is a perilous and difficult exercise.

But the prolonged debate is also a testament to the political tumult of the last four years. This goes beyond the deepening partisan divisions in Congress and the country, and into the machinery of policy. The financial sector is facing more change than at any point since the Great Depression. There is broad consensus on the reasons for reform, but little agreement on the proper path ahead.

Counterintuitively, perhaps, this has not been the case with other recent financial reform. Roll-call votes are a crude measure, but they show how policy-makers have found common ground on earlier efforts. When the Sarbanes-Oxley Act was introduced—after much hand-wringing and consternation[3]—it passed a divided House with only three nay votes, and cleared the Senate 99-1.[4] Less than seven months after

[1] Source: Federal Reserve Balance Sheet of Households
[2] Source: Bureau of Labor Statistics (1, 2)
[3] See eg. NYT
[4] Sources: House clerk, Senate LIS

the impeachment debacle, the House passed the Gramm-Leach-Bliley Act by a 4:1 margin, and President Clinton hailed it as "historic legislation," supported by "an overwhelming, bipartisan majority."[5] The FDIC Improvement Act of 1991 passed the House by 260 votes and the Senate by 53.[6]

Dodd-Frank is a stark contrast. First, it passed largely along party lines, something not seen in major banking legislation since the 1930s. Second, the sheer scope of it ushers in a sea-change in bank regulation. And third, much of what the Act will do is, in very important ways, still unwritten. Roughly 400 new rules and 87 agency studies are required by the law, ranging from the impact of capital surcharges to the dissolution and creation of new agencies.[7] Agreement on these issues, and the rules to address them, has been hard to come by, whether among government bodies, Congressional leaders, or private sector interests. The Volcker Rule proves the point—a 29-page statutory provision, which led to a long and complex proposed regulation, and in turn, to more than 17,000 comment letters. And it is just one provision of hundreds, each with the capacity to alter the structure of the U.S. banking industry.

Discord on these matters is a concern for financial institutions, investors, and the American public, whose trust in banks has plummeted since the crisis.[8] And while some of that discord stems from sincere, principled disagreements, much of it comes from

[5] Sources: House clerk, Papers of WJC
[6] Source: Thomas (1, 2)
[7] Source: Davis Polk

[8] Gallup: 36% of Americans lack confidence in banks (link)

confusion and misunderstanding about the nature of bank activities, the efficacy of regulatory and supervisory practices, and the terms of reform.

I want to applaud the people in this room for working to reduce this confusion. The public sector is in desperate need of an impartial perspective on the proposals being put forward. The scholars at this conference are working in the right direction, clarifying first-principles, increasing intellectual rigor, and shedding light on underlying issues.

Independent, directed research is a tremendous public service. Without it, we're left only with hearsay, shorthand, and the word of interested parties. Just think of the important role the Federal Reserve Banks of San Francisco and Boston played in studying Community Reinvestment Act lending, to see if it materially contributed to the financial crisis (as the Fed studies show, it did not.) The Fed's scholarship has not wholly put an end to the debate, but it has greatly shaped it.

One of the many vital places where confusion still reigns is in the role of capital. As Anat Admati and her colleagues at Stanford have pointed out, capital is often wrongly said to be "withheld" or "set aside." Instead, the debate about capital ratios is largely a debate about the <u>sources</u> of bank funding, and especially about the advantages and disadvantages of equity over debt. Professor Admati and others have identified some of these advantages, such as equity's ability to bear losses so that creditors and guarantors—including the U.S. taxpayer—do not. Others have tried to address these benefits, measure them, and weigh them against their costs.

But there remains a genuine lack of consensus on the "proper" amount of capital that banks should hold for a panic. At the crux of it, I think, is a truth of crisis economics that is too often forgotten: In a panic, there is no such thing as "enough" capital or liquidity. Panics are defined not by the solvency or insolvency of an institution, but by the plausibility that it can honor its commitments and bear the losses that investors, rightly or wrongly, expect it to bear. Those two ideas are not the same. One is a matter of ability to post margin, repay debt, or provide liquidity at a given time; the other is a matter of expectations.

To some extent, this has become a truism: As the former chairman of Bear Stearns, Ace Greenberg, said, "Rumors are such that they can plain put you out of business."[9] Bear Stearns was no paragon of capital adequacy, but Mr. Greenberg's comment—and banks like Wachovia, which had more than $20 billion in cash-on-hand when it began to collapse[10]—illuminate the role that capital and other tools play in safety-and-soundness regulation: They stave off crises not by providing a scientifically correct amount of cushion against loss—arguably no reasonable amount is enough. Instead, they create **faith** among creditors and depositors, before the fact, that a financial institution will honor its commitments. They do so, not merely as some believe, by "setting money aside" for a rainy day; they reduce the downside obligations that an institution takes on while funding its business, creating faith that a company will remain solvent in bumpy markets.

[9] Sources: Vanity Fair, PBS Frontline

[10] Source: NYT

If banks and thrifts were like most other businesses, providing a single buffer like capital might well be the end of the story. In most cases, it would act as a cushion to protect the institution. In others, failing firms would collapse, shareholders would bear losses according to the risk they knowingly assumed, law-breakers would go to jail, and everyone would get their just desserts. And if regulators were only around to police market externalities, or repair informational asymmetries, as many scholars say,[11] then their job might well be complete.

But the health of financial institutions goes beyond the interests of shareholders to the interests of society. Financial institutions are not like other companies. Vast swaths of external economic activity depend on their undisturbed function; there are high frictional costs to removing assets from them in a time of strain; and above all, they have a vital role in the function of money and money-like instruments. <u>And each of these is window-dressing to the one fundamental difference: our collective intolerance for the disruptions that have historically accompanied their failure.</u>

We don't accept the idea that our life savings, our lines of credit, and our salaries should vanish into thin air. We regard these as public goods—not in an economic sense, but in a political one, as an integral part of our common lives. In this view, it's not enough that bank creditors bear the losses they agreed to accept, even if there are no spillover or "systemic" effects. When a water main breaks, the problem

[11] See eg. Ballesein and Moss 2010.

isn't that the water company bears its losses and takes its lumps—the problem is that people don't have water.

Many in the public and private sector are working to diminish these consequences of collapse, and allow institutions to fail without jeopardizing public well-being. These are vital, worthy efforts to preserve market discipline and tame its worst side-effects, including and especially those introduced by Chairman Gruenberg yesterday afternoon. But while an implosion is less perilous than an explosion, we should all prefer health and stability to either one.

In pursuit of that goal, governments around the world have turned to ever-more-elaborate regulation, including examination and supervision of financial institutions. These are necessarily powerful tools, but far too little study has been devoted to the best ways to apply them. And like all tools, they can be misused.

James Landis, a dean of Harvard Law School and a forefather of modern regulation, knew the power and importance of the regulatory mechanism when he called it "the fourth branch of government."

He wrote:

> *"So much in the way of hope for the regulation of enterprise, for the realization of claims to a better livelihood, has...been made to rest upon the administrative process. To arm it with the means to effectuate those hopes is but to preserve the current of American*

living. To leave it powerless to achieve its purposes is to imperil too greatly the things that we have learned to hold dear."[12]

Even today, regulators are here to guard "the things that we have learned to hold dear." And they do so by building the same faith that capital builds. This is the biggest distinction between regulation and supervision on the one hand and law enforcement on the other. Law enforcement looks backwards to impose costs for wrongs already committed. Regulation looks forwards, and tries to both fix a company's failings, and build confidence that it is more than just a house of cards.

In banking, supervision—including, but not limited to, the inspection-and-verification function of examinations—is one especially important way to build faith. Despite the recent crisis, bankers are no worse at management than people in any other line of business. In many ways – and I know it is not popular to say – I think they are better. But the impact of their failings can be just as great as, say, a doctor who prescribes his patients the wrong medicine.

And finance is complex and dynamic. The most detailed rulemaking can only capture so many threats to the well-being of an institution, and it can remain up-to-date for only so long. Ensuring compliance, safety, and soundness requires **judgment**—judgment of which actions put a company in danger, and judgment of how best to fix them. Done properly, it can make banks safer and minimize the need for complex

[12] Source: Louis L. Jaffe, "James Landis and the Administrative Process," Harvard Law Review 78, 2 (Dec. 1964); Daniel Yergin, "The Rise of Regulation in the U.S.," from Commanding Heights, 1998.

rules. And unlike in other industries, candid supervision can fix problems with complex, evolving products, while avoiding the self-fulfilling concerns that destroy healthy institutions. Concerns about food poisoning don't cause food poisoning, but concerns about liquidity and capital can create problems with liquidity and capital.

However, supervisory judgment relies on flexibility—and there is a trade-off between flexibility and quality control. A regulatory system that relies entirely on discretion can become scattershot; supervisory outcomes can become wildly divergent, and in some cases, unfair. On the other hand, a system that relies entirely on enumerated rules will be too complex; either it will try to account for every negative eventuality and become too dense to implement, or it will fail to adapt to new problems in new forms. Either extreme can create a level of government intervention that runs in the face of free enterprise and the discipline of free market.

The dilemma is more acute now, since Dodd-Frank has only expanded the role of discretion in regulation. Almost every Dodd- Frank provision gives the agencies leeway in both interpreting the prescription and creating the ground rules for its application. And, several mechanisms have been set up giving government agencies uncommonly broad powers to set policy. Here are seven major examples:

- The Financial Stability Oversight Council has the responsibility to identify threats to the U.S. financial system, and in so doing, can require bank-holding companies to submit vast amounts of information on their activities. The Federal Reserve is charged with issuing a wide array of guidance on these institutions and

large banks, ranging from concentration, capital, and leverage limits to risk committees and governance structures.

- The new orderly liquidation authority charges supervisors with reviewing and auditing plans for a financial institution's demise.
- Supervisory stress-testing allows the Federal Reserve, OCC, and FDIC to set the parameters of acceptable bank performance during a crisis.
- Insurers, financial market utilities, investment advisors, and of course, a wide array of non-bank institutions are subject to enhanced supervision—and in some cases, are being supervised for the very first time.
- State attorneys general can now enforce regulations issued by the CFPB, giving them expanded authority over regional firms.
- The Volcker rule gives the regulatory agencies broad authority to determine what are permissible market making and hedging activities and what is impermissible proprietary trading.
- And regarding swaps activity, the CFTC now oversees a market that was, until recently, completely opaque.

The question before the house is: How much discretion is enough? Should flexible supervision be replaced with hard-and-fast rules? Or do complex rules actually undermine supervision by tying the hands of supervisors? How do we strike the right balance? And how do we refine Dodd-Frank – enacted in the midst of the crisis – to balance safety-and-soundness concerns with the need for financial vibrancy?

The answer should take the best of both discretion and hard-line rules, not simply increase complexity and burden. We need to both simplify and strengthen our financial regulatory system, to create safety and soundness in both the public's eyes – that important element of faith – and in substance. I would propose a system of limited "picket-fence regulations." In it, a set of indicators—including, but going well beyond, robust capital and liquidity requirements—act as a set of outer-bounds triggers for greater scrutiny and tougher penalties. Short of those triggers, supervisors would have the responsibility to resolve issues through less formal avenues. This approach would give our idea of safety and soundness a strong foundation, eliminating the most egregious and dangerous practices; keeping taxpayer liability for risky activities to a minimum; and letting financial institutions innovate without unnecessary regulatory burden.

The lines we set should be far clearer than the ones we have today, extending beyond capital and liquidity to information systems, governance, error tolerance, and conflicts-of-interest vis-à-vis the customer. Earlier bright-lines approaches were not as broad—and vitally, they lacked a primary focus on customer interests. Ultimately, regulators and bankers face the same problem: Banks have lost credibility with their customers, credibility that is the lifeblood of financial institutions. As a result, the most powerful rules aren't always the harshest ones; they're the ones in which the public has the most faith. A crystalline, global set of customer-oriented regulations would go a long way towards improving bank safety and soundness. It would

also preserve financial innovation that, as economist Robert Shiller puts it, "supports the stewardship of society's assets."[13]

In establishing the precise nature of these boundaries, we need to combine academic, policy, business, and supervisory expertise. Social-science and analytic **rigor** has been lacking in so much of the rulemaking process. We need agencies, colleges, and universities to create chairs and centers of excellence in regulatory analysis. We need more data, and we need to carefully review the data we have. The new Office of Financial Research could be a great step forward, and it is one of the aspects of Dodd-Frank for which I have the greatest hope.

Importantly, this system would still leave plenty of room for supervision. We simply cannot regulate for every contingency, and modern claims to the contrary are fundamentally pernicious. Bigger is not always better. A bulging rulebook can actually undercut compliance, add unnecessary expense, and hurt public faith in the system. Ultimately, supervision and capital requirements—like every tool in the regulatory arsenal—are a way to build faith in the sanctity of firms. That faith demands sensitivity to the circumstances of different companies, and an understanding that flexibility can be the best way to safeguard the public interest. Stable minimums set clear, predictable expectations for the private sector. But within those boundaries, we should rely on our common law-traditions, which are more organic and less prescriptive than our civilian ones.

[13] Robert J. Shiller, Finance and the Good Society, Princeton, NJ: Princeton University Press, 2012 (xi).

In that context, however, we should make some much-needed improvements to bank supervision. Broader supervisory discretion should come with greater accountability, and specific expectations for examiners and agency heads. We should produce regular "supervisory report cards," measuring performance throughout the supervisory process, including the efficiency of bank regulation. These would go beyond current "material loss reviews," and gauge the quality of financial oversight before a failure occurs.

We should also provide far more professional opportunities for supervisors. The apprenticeship era is long over. Supervision should have the same stature as law and business, with its own professional criterion and independent body of literature. Universities should be a place where government and the private sector come together, to exchange knowledge about what regulation is, can be, and should be. In this regard, I am proud that Promontory has been working with McQuarie University in Australia to set up one of the world's first advanced degree programs in regulation and supervision.

Finally, in response to the expanded use of supervisory judgment, we should encourage safety valves in the supervisory process. Years ago, I established the first Ombudsman program at a federal banking agency, and similar programs have been set up at each of the other agencies since. More can be done. Ombudsmen contribute to both fairness and accuracy; they help regulators assess which of their practices work and which could work better. Regulators should review the stature and structure of their programs, and encourage banks to use them openly and freely.

The tumult of financial reform isn't for naught; the post-crisis debate will ultimately give us a safer and more robust financial system. But along the way, we must strive for a balance between rules and judgment, between bright lines and discretion, between intervention and innovation. Only in that balance will we find the faith our financial system and economy need to prosper and grow.

Thank you very much.