Rebuilding a Healthy Financial System

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What I'd like to do today is talk about the functioning of a healthy financial system. You know, in many ways, we all take what the financial system does for granted. But if you had never thought about it before, you would think that it was something slightly remarkable.

In our society, we have millions of households who want to save for a rainy day, or for their retirement, or to send their children to college. We have businesses that need financing for their inventories, that have great ideas for entrepreneurial visions, or that want to refurbish a depreciating plant. And what the financial system does is perform the profoundly important task of bringing them together, of providing the business with the capital that it needs, while at the same time providing the household with an opportunity to hold their savings in a secure form, where it multiplies with the passage of time.

There are few more important questions in any economy than how well this job is done. When it is done better, households earn more on their savings and more investment can take place because businesses can borrow at lower cost. Think about this. In a typical economy, like the American economy, where the capital output ratio is three, improving the financial system even a little bit, so that projects invested in earn an extra 20 basis points, is enough to raise the GDP over time by 6 percent. And there aren't many economic issues that loom that large. And so the question of the financial system is of profound importance. The question of financial innovation and its management is critical.

Some time ago, when I was last in government, I compared the modern financial system with all of its innovation to a jet plane. The invention of the jet plane got people where they were going faster and more comfortably, and that was a clear improvement. But the crashes, when they happened, were that much more damaging and spectacular. And we're seeing something similar with financial innovation.

After the last two years, it's increasingly appropriate to ask whether this particular jet plane should be kept in service with the same set of controls, or at least whether our regulatory regime is adequate for the future, because we have been reminded of a great deal about financial instability.

To be sure, we have made enormous progress. When the president took office, the most salient question was whether the recession would become a depression. Today, the salient questions involve dating the end of the recession and envisioning the recovery. And so it seems a good time to take stock.

Here's perhaps the most fundamental reminder we've received. When you study introductory economics, perhaps the most important thing you learn is about the self-stabilizing character of markets. We go through lots of examples with students about the basic idea, which is that where there's an excess supply of wheat, prices fall, people grow less, people consume more and the market re-equilibrates. That's what Adam Smith had in mind when he talked about the invisible hand.

And the metaphor for this that we often use for this self-equilibrating property of the market is a thermostat, in which things return to their natural level. And that is the right way of thinking about markets the vast majority of the time.

But it was Keynes's central insight that two or three times a century the self-equilibrating properties of markets break down and stabilizing mechanisms are overwhelmed by mutually reinforcing vicious cycles. The right metaphor ceases to be a thermostat and becomes an avalanche.

Consider some of the vicious cycles we've seen in the last few years: a liquidation cycle where financial assets fall in value, which forces their sale by those on margin, which pushes the prices even lower; a deleveraging cycle where lower prices on assets cause institutions to have less capital, which leads to less lending and even more asset devaluation, continuing the downward spiral; a credit-accelerator cycle in which a weakening economy leads to a weaker financial system, which leads to less lending, which leads to a weaker economy; a Keynesian vicious cycle, in which lower spending leads to lower employment, leads to lower incomes, leads to lower spending, continuing the cycle; and a panic vicious cycle, in which individuals see financial institutions in trouble, rush to withdraw their funds, putting those institutions in more trouble, causing others to rush more to withdraw funds.

Starting in the summer of 2007, but accelerating a year ago this week, these five mutually reinforcing vicious cycles created a situation more dangerous than anything most of us have ever seen. They created a situation in which we could not rely on market's capacity to act, in which there was no alternative to strong public action.

And President Obama's economic recovery and financial stabilization program was premised on exactly this idea of containing vicious cycles, supporting spending, income, and the real economy in order to support the financial system through a direct program of increased spending and reduced taxing through the Recovery Act; and supporting the real economy by supporting the financial system through clear commitments to stand behind major institutions and through a major emphasis on transparency through the stress tests that ultimately forced substantial raising of private capital.

The results are becoming clear. The recovery program, the fiscal stimulus and the financial stress tests have served to quell panic, drive private capital raising and ultimately turn vicious cycles into virtuous circles. Today, instead of money going into financial institutions from the government, we're seeing money come back to the government.

With the passage of time, these efforts should permit the normal processes of economic growth to re-engage: rising incomes and employment, greater credit flows, increased spending, a stronger American and global economy. The consensus among private-sector forecasters is that we should expect to see economic growth at a significant rate during the second half of 2009.

Yet despite the normalization of financial conditions, despite the indications of economic growth returning, we must remain vigilant. Concerns remain in many sectors, such as commercial real estate, and the availability of capital and credit remain too tight for too many. As President Obama has said, “The crisis has been a long time in the making, and we know that we cannot turn it around overnight. Recovery will likely be measured in years, not weeks or months.”

But we also know that our economy will be strong for generations to come if we commit ourselves to the work that needs to be done today.

We will not make the mistake of prematurely declaring victory or withdrawing public support for the flow of credit. Such mistakes were made in the United States in 1937 and -8 and were made in Japan at several junctures during the 1990s, and they provide a cautionary tale.

And yet even as we remain vigilant to ensure continuing expansion, it would be irresponsible for us not to learn the lessons of what took place and focus our efforts on assuring that our system becomes much less vulnerable to this kind of instability in the future.

Whatever plausibility the view that the right posture for policy is to not seek to prevent crisis but simply to respond aggressively after crisis takes place may once have had, it is much less plausible after the events of the past two years.

Just as the Cuban Missile Crisis spurred a focus on arms control and a reconsideration of the then-prevailing system of “mutually assured destruction,” the events of the past two years have raised grave concerns about the soundness of current public policies towards the financial system.

These concerns are framed often as the need for regulators to do a better job, and they do need to do a better job. But to frame these issues only in terms of the quality of regulators' judgment is, I would submit, to frame the issue too narrowly.

Consider this. Much financial instability is the result of a very simple and natural human phenomenon. People do today what they wish they had done yesterday. Thus, on the upside of every financial bubble are a large number of investors who buy assets not based on fundamentals but instead based on an extrapolation from past price increases to future returns.

Financial crises are the result of an overly prevalent and complacent conventional wisdom. Complacency in this sphere is what Robert Merton called a self-denying prophecy, as the expectation that assets are safe and will continue to rise in value results in excessive investment and excessive lending. The sense of inevitable gains gives way to collapse.

I stress this point because it is important in thinking about the regulatory context. Even the most able and dedicated regulators, embedded in an environment that comprises those they regulate, and in a broadly political community, cannot be relied upon to be unfailing stalwarts against misguided conventional wisdom. Experience suggests that rather than trying to perfect human judgment, policy can succeed by making the inevitable imperfections less costly.

I've already compared the financial system to a jet plane. Let me suggest a different transportation analogy: automobile safety. From the time of Henry Ford through the late 1950s or early 1960s, we had a paradigm in this country for thinking about automobile safety. It was that drivers needed to be better.

We needed to have more driver education. We needed to have better deterrents for unsafe driving. And if we just got drivers to be better, then we would have more automobile safety. We had that paradigm for many, many years. And in every single year that we had that paradigm, the number of automobile fatalities in the United States increased.

The late Daniel Patrick Moynihan's first important contribution to the public policy debate was a paper he wrote on automobile safety in the late 1950s, in which he urged instead an epidemiological approach: the recognition that improving human performance was a necessary but insufficient strategy. Much better results could come from assuming that improvements in human performance alone could not make the system safe. Efforts towards crisis prevention, he suggested, must focus on managing the consequences of human psychology, rather than changing human psychology.

His conclusion, the one we have followed for the last 50 years in this country – and around the world – with enormously beneficial results, was that a much more effective approach to automobile safety would be one in which the automobiles and the highways would be built to be much safer, in the face of the human imperfections and errors that were inevitable.

So, too, in addressing financial regulatory reform, I would suggest as a first crucial insight that we focus not so much on making people better, but on recognizing that human psychology is what it is; and that what we can influence with public policy is the incentives that people face and the consequences of the errors that they will inevitably make.

In creating this safer system, a paramount issue must be incentives, a set of issues that economists refer to under the term “moral hazard.” Consider the consequences of enabling an institution to borrow in a free-market system with a government guarantee, either explicit or implicit. Its incentive to reduce capital,

since more capital reduces the return on equity. It encourages risk-taking, because with small amounts of capital and a government guarantee, increased risk-taking is a “heads-I-win, tails-the-taxpayer-loses” proposition.

It attenuates what would otherwise be a strong incentive for lenders to monitor carefully how financial institutions use their money. And it creates a lowest-common-denominator dynamic in which the imprudent – those who are willing to lend at too low a spread, to overpay for assets, or to operate on too thin a capital margin – make it difficult or impossible for competitors with better intentions to take the prudent course.

We cannot discount the risk that someday excessive reliance on the idea of “too big to fail” may lead to financial institutions that are too big to save, with disastrous consequences.

New regulatory approaches that recognize the importance of incentives, that recognize what is probably inherent in human psychology, are, we believe, essential, and we believe it is critical to move rapidly while the events of the last years are clearly in mind to put them in place.

Following from this philosophy, there are five common-sense principles that President Obama believes any regulatory reform must meet.

First, all systemically important financial institutions must have adequate capital.

Substantial capital requirements attenuate any moral hazard problems by ensuring that lenders are relying on capital rather than the perception of guarantee. They reduce the ability of shareholders to rely on a “heads-I-win, tails-taxpayers-lose” dynamic. They provide a reserve such that even when mistakes are made, the result is not to threaten the ability of institutions to meet their debt obligations and so support systemically stability.

Raising capital requirements in an enduring way was the subject of an important paper that Secretary Geithner discussed with his G-20 colleagues just a few weeks ago, and it will be a major issue on the agenda of the G-20 when it meets in Pittsburgh this week. I do not believe that any regulatory reform that does not succeed in raising capital levels will meet the challenges of this moment.

The second critical issue is resolution authority. Our financial system will not be fail-safe until it is safe for failure. Economic and financial historians will debate for a long time the wisdom of the choices, the alternatives that might or might not have been available to the authorities as they faced the problems at Lehman and AIG a year ago.

What is beyond debate is the unsatisfactory character of those choices. It is wrong that taxpayers thousands of miles from Wall Street should be at risk because our system gives authorities no choice but to commit taxpayer money or to accept collapse and chaos.

It is essential that we develop means of managing the failure of financial institutions, because without the prospect of failure, it is difficult to contemplate the application of market discipline.

There's a really good line here that makes this point very vividly, about financial institutions without failure not being like religion without death. But at Georgetown, I think, I'm best off not tempting to go into that sphere.

Third principle – again thinking about incentives and thinking about inevitable human imperfection: eliminate regulatory arbitrage. Financial institutions should not be able to choose among competing

regulators. If they can choose among competing regulators, they will, on the basis of who regulates least, choose whoever sets the lowest standard.

It is not reasonable to expect that regulators will happily see the set of institutions under their jurisdiction shrink dramatically. And so it is inevitable that if regulatory competition is possible, either between the regulatory agencies within a single country or between regulatory authorities in different countries – competing to regulate particular institutions – you will see a race to the bottom.

Fourth, and here the automobile analogy comes especially to mind, regulation needs to be approached from the viewpoint of the system. How should speed limits be set?

Should speed limits be set only with a view to how fast cars can go, without an excessive risk that they'll go off the road and hit a tree? Or should speed limits be set with a view to the possibility that if all the cars are going too fast, then when one car has an accident, the pileup will be too harsh?

No one would imagine setting speed limits without thinking about the possibility of multi-car accidents. And yet our traditional paradigm for financial regulation has focused on the prudential regulation of individual institutions, rather than the interconnections that come from their functioning together as a system.

We can no longer take an institution-by-institution approach. Similarly, any market, such as the derivatives market, that is so large and interconnected that its breakdown would threaten the stability of the financial system must also be subject to comprehensive authority.

Finally, it is our judgment, and it comes from the same kind of reflection on incentives, that consumer financial issues must be carried on by a regulator whose interest is the mandate of the consumer rather than the profitability or health of particular financial institutions. In light of the recent events in the mortgage market, the prevalence of predatory lending practices and the ubiquity of problematic practices in the credit-card market, we have become convinced that it is essential that consumer financial regulation be carried out by an independent body whose mandate is exclusively consumer protection.

Now, this idea, which one might not have supposed would be the most controversial among these principles, has generated substantial controversy. Advertisements are being run on behalf of florists and other Main Street merchants suggesting that somehow we envision a regulator that would make it impossible for a florist to extend credit to one of their customers. I doubt very much that any florists are paying for those ads. And I would suggest those ads are the financial regulatory equivalent of the "death panel" ads that are being run with respect to health care.

Those with an argument make it. Those without a good argument try to scare people. And that is what is happening here. This is a critical issue. It is one on which the president is determined. A separate consumer regulator will do much to protect consumers from the abuses that have become all too clear in recent years.

Taken together, if we can adopt this philosophy and implement a program based on these principles, and we can at the same time address other issues, like compensation, which is obviously a crucial aspect of incentives, I believe that we can create a system that is much less vulnerable than the system that we have today.

And we can create that system while at the same time preserving, and indeed strengthening, the very great benefits that a financial system performs, in terms of allocating capital and in terms of permitting the better sharing of risk.

That is a crucial challenge in the years ahead for all of us who are involved in finance. It is a crucial challenge for spurring the economy. And it is one piece of what ultimately is the mission of this presidency: to establish a foundation for a stronger, more inclusively growing American economy than we've seen in the last generation.

Well, if you think about it, the boom of the 1980s ended with the 1987 stock market crash and the S&L debacle; the boom of the 1990s ended in the bursting of the Internet bubble; and the boom of this decade ended with the financial crisis that began in 2007. Our challenge is to create economic expansion and growth not based on financial bubbles; but instead, based on real production and distribution of goods and services for the benefit of all the citizens of our country.

There are many parts of this agenda. The new American economy needs to be more export oriented and less consumption oriented, more environmentally oriented and less energy-production oriented, more bio- and civil-engineering oriented and less financial-engineering oriented, and more oriented to the interests of the middle class. I would suggest that a stronger, better-regulated financial system is crucial for all of that. And all of us working together can do much to bring about such a financial system.