Reforming and Renewing the Financial System

“Reforming and Renewing the Financial System”
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There’s room to discuss the subject of financial reform at several levels: the technical questions of how best to minimize systemic risk, to be sure, but also the broader question of how the society should approach this issue.

On that question, considerable doubts remain. A prominent political leader advised the banking industry yesterday, and I quote, “Don’t let those little punk staffers take advantage of you, and stand up for yourselves.”

I do not think of the people who work on this project as “little punk staffers.” I do not think that those who want to address these issues are “little punk staffers” who need to be stood up to. And at a time when the financial industry has spent $1 million on lobbyists per member of Congress, at a moment when there are four lobbyists per member of the House and Senate working on this issue, we in the Administration do not believe that the prominent issue is allowing bankers to stand up for themselves.

Rather, we believe that the events of the last two years point something up that is profoundly problematic. The function of the financial system is to allocate capital. It is to diversify and distribute risk. It has in many respects performed that function very well. But all too often a system that is designed to diversify and spread risk has instead been a source of risk.

The last generation has seen the Latin American debt crisis, the 1987 stock market crash, the S&L debacle, the Mexican financial crisis, the Asian financial crisis, Russia/LTCM and their aftermath, the bursting of the dot-com bubble and Enron, and now this.

It works out to about one occasion every three years when a large number of people had their lives profoundly disrupted by risks that emanated from within the financial system.

I would suggest to you that one crisis every three years is far too many. And I would suggest to that the experience of this last crisis should urgently point up the need for reform.

If you read about the debates within the Kennedy Administration and more broadly, they came to take arms control far more seriously after the Cuban Missile Crisis. I would suggest to you that questions of financial regulation and reform deserve far closer attention after the events of the last couple of years.

In large part, that is to protect the economy from the potential consequences of excesses within the financial system.

It is also, I would suggest, very much in the interests of the vast majority of those who participate in the financial sector. If you bought a portfolio of the largest financial institutions in the United States, you would have done very badly over the last decade. Not just badly in absolute terms, but badly relative to a stock market that has had a very poor performance over the last decade. So it is not as if the status quo has worked for the shareholders of major financial firms.

Nor has it worked in enabling what I believe is profoundly important in a market economy: the ability to reconcile profitability and conscience. When some are allowed to market products unfairly, when some are allowed to operate with excessive leverage, when some are encouraged to operate entirely free of

control, it becomes very difficult for those who want to operate responsibly to their customers and to the broader society to earn the rate of return that markets demand.

A substantial virtue of proper regulation and a level playing field is that it enables the reconciliation of profitability and conscience.

Economists will debate – until it becomes the preserve of historians, and then historians will debate – what caused this crisis.

Take some of the factors:

- Actors in the private sector overextended themselves.
- Financial incentives were misaligned.
- Institutions and markets were allowed to assume far too much risk.
- As we continue to learn, most recently with the revelations regarding Repo 105, transparency was manifestly inadequate.
- American consumers were not provided adequate protection.
- And regulators lacked the authority they needed and failed to use the authority they had. While not all of these factors are readily amenable to change, and while it is beyond anyone's reach to eliminate the phenomenon of waves of fear and greed that have been part of market economies for centuries, many things can be changed, and one of them is the structure of regulation.

We have seen strong progress in both chambers, with the passage of a financial reform bill under Chairman Frank's leadership in the House and the announcement of a financial reform bill under Chairman Dodd's leadership this week in Senate.

As we move forward, I would suggest six areas of particular importance that warrant the attention and advocacy of everyone with an interest in real reform.

First, we need comprehensive requirements for capital and liquidity.

Stronger capital and leverage requirements attenuate moral hazard problems by ensuring that lenders will rely on capital rather than the perception of a guarantee. They curtail the ability of shareholders to rely on a "heads-I-win, tails-the-taxpayers-lose" dynamic. And they provide a reserve, so that institutions can still meet their obligations when serious mistakes are made.

But in addition to capital, it is essential that we reduce the prospect for the kind of panic we saw in 2008 by formulating – and this is a crucial intellectual challenge – properly framed liquidity requirements.

Second, firms should not be able to choose their own regulator. We must limit regulatory competition.

If firms are able to choose their own regulator, the inevitable result will be races to the bottom. Races to the bottom between institutions in a single country as regulators compete to widen their reach, races to the bottom between institutions that are functionally identical and structurally different as they seek more light regulation, and races to the bottom internationally.

As recently as the first half of 2007, the year the financial crisis began, a review was undertaken by the U.S. government of financial regulatory issues. The overwhelming thrust was to promote New York's competitiveness relative to London. Without a commitment to regulatory harmonization, commitments to strengthened regulation will not be ultimately viable and effective.

We need to replace races to the bottom with races to the top as the dominant paradigm of financial regulatory activity.

Third, we must strengthen regulation of institutions and activities broadly and close loopholes that would allow any players to evade regulation.

One crucial area in this respect is the over-the-counter derivatives that were originally developed to help manage and reduce risk and have an important role to play in that regard. And yet, in this financial crisis, they ended up concentrating and amplifying risk, inflicting tremendous pain on financial markets and on the real economy.

Any market, such as the derivatives market, that is so large and interconnected that its breakdown would threaten the stability of the financial system and put millions of jobs at risk must also be subject to comprehensive regulation by an accountable regulatory authority. The principle is only common sense, and yet it has not been in place historically.

We need a comprehensive regulatory framework for over-the-counter derivatives. It should apply to all dealers and all derivatives – wherever they are traded, wherever they are marketed, whatever they call themselves.

That is why we should require that derivatives trades be reported to a repository and under the direct oversight of regulators. That's why we should insist on the use of exchanges and clearinghouses wherever possible.

Fourth, American consumers deserve a strong, independent Consumer Financial Protection Agency – an independent regulator to defend consumers against predatory practices and to set and enforce clear rules of the road for financial products across the marketplace

As President Obama said just a few days ago: "I will not accept attempts to undermine the independence of the consumer protection agency, or to exclude from its purview banks, credit card companies or nonbank firms such as debt collectors, credit bureaus, payday lenders or auto dealers."

You know, there is an aspect of what some regard as the behavioral economics revolution that has not gotten the attention that it deserves.

There's an enormous amount of insight from behavioral economics that can have a positive impact – automatic elections that encourage people to save, for example, or providing information in clearer ways that promote better choices.

But what behavioral economics has also demonstrated is that because all of us are subject to being influenced in major ways by the way in which our choices are framed, we often can be induced to act in ways that are often at very substantial variance from our medium-term or long-term interests by the way in which choices are framed.

Anyone who studies financial history has to recognize that there are a large number of those involved in marketing of financial products who understood at some level behavioral economics before economists coined the term and have been preying on the natural myopia inherent in each of us, the inability to frame risks and do calculations accurately, for a very long time.

And it is that propensity to error and a natural tendency of unregulated markets to take advantage of it that provides an important part of the rationale for stronger consumer financial regulation.

Those who focus on the alignment of incentives need to recognize that the alignment of incentives applies for regulators as well. Any regulatory agency whose primary criterion for success is the continuing health of the regulating industry will find it very difficult to elevate consumer interests relative to the interests of profitability of the industry.

After 30 years when the errors in the mortgage area, in the credit card area, in the operation of ATM machines, in the use of algorithms that maximize the number of overdraft fees that people have to pay, in the spectacle of people being charged $30 to withdraw $15 from an ATM machine – any system that continues to privilege those practices and the resulting profitability over consumer issues is, I believe very strongly, the wrong system.

Fifth, resolution authority.

We could debate at nearly infinite length how the authorities could or should have dealt with the problems at Lehman and A.I.G. But these two cases make it clear that the choices the authorities faced at that time were manifestly unsatisfactory.

It is wrong that taxpayers thousands of miles from Wall Street should be at risk because our financial system gives authorities no choice but to commit taxpayer money or to accept collapse and chaos. Without the prospect of failure, it is difficult to contemplate the application of market discipline.

That is why we must develop a means to manage the failure of financial institutions. That is why we must insist that that institutions go through the exercise of planning for their dissolution in the event of crisis before a crisis comes.

Our financial system will not be fail-safe until it is safe for failure.

One important aspect of this is the President's proposal for a Financial Crisis Responsibility Fee, which would apply to the largest and most highly leveraged firms – those with more than $50 billion in consolidated assets. This fee would deter excessive leverage for such financial firms.

There are, no doubt, a large number of issues that are extraordinarily technical, and we have a great deal to learn, as this legislation is crafted, from practitioners, from those with the closest experience in financial markets.

But what surprised me was hearing the industry and prominent members of the industry argue, within successive weeks, perhaps in some cases within successive days or hours, that any suggestion that the payment of bonuses by paying capital out of the financial institutions would inhibit lending was just a demagogic suggestion that nobody who understood industry could possibly make – but then later suggest that a $10 billion a year fee would cost the economy $1 trillion in lending, based on some calculation about depleted capital – I had to wonder.

Let's have real debates on real issues.

Finally, an additional important aspect of maintaining stability is appropriate restrictions for those who benefit from the safety net.

Many financial activities play a valuable role in a market economy. Speculators perform an important function. But not every activity that is socially beneficial and can be socially beneficial needs to be carried on within institutions whose liability holders rely on the prospect of government support.

That's why Paul Volcker has usefully advocated restricting the activities of banks where those activities are not directed at serving customers directly.

We can ultimately pass legislation that addresses these six areas and many more issues that are addressed in this legislation, rating agencies and processes of securitization, to name just two examples.

I believe we can make a very important contribution to the promotion of economic stability in the United States.

I believe we can make a very important contribution to the welfare of U.S. families.

And I believe we can do something very important in demonstrating once again, as the country has often over the last 200 years, that a market system is capable of renewing itself in ways that assure that the basic energy of the market system is preserved, but that it functions in a way that works for all its stakeholders.

Thank you very much.