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Financial Sector Regulatory Reform: Don't Mix Punishment and Rehabilitation



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Tim Geithner apparently occupies the Rodney Dangerfield chair at the U.S. Treasury Department. He can't get no respect, at least initially, for the plans he has put forward to address, first, the financial crisis itself and, more recently, the Obama Administration's proposal for regulatory changes aimed at preventing a future recurrence. His financial sector re-regulation approach is coming in for the same sort of faint praise that his emergency bank bailout scheme received when it was introduced in February. His failure then to propose outright nationalization in preference to rescue by less intrusive interventions was excoriated at the time as timidity, or worse.

The mood has hardly lifted, even as bank funding markets have once again begun to function. One critic of the Obama-Geithner re-regulation proposal held that "it isn't very radical." That wasn't meant as a compliment. Perhaps it's unreasonable to expect a balanced plan to get a good reception; villagers with pitchforks are not ideal problem solvers.

From the left, the preferred approach seems to be to roll back time to, say, the 1950s when banks were "narrow" institutions that made working capital loans to familiar local clients, funding those loans almost exclusively with locally sourced demand and time deposits. They were effectively proscribed from competing with each other and prevented from making serious mistakes by restrictive Federal Reserve regulations such as the one limiting the rates they could pay for money.

Those limitations had a price: most American savers were unable to get a rate of return on their money beyond the 3% or 4% of a passbook saving account. Radical reform plans might satisfy the political desire to punish the bankers by hobbling them again as in years past, but doing so will limit the options of bank customers, many of whom happen to be voters. I'll give odds that, in a dynamic and evolving world, we will not go back to a financial system that hoggies not only bankers but also their customers.

Some sorts of changes, however, clearly are necessary, as even Alan Greenspan admitted last week. The elegant solution, it seems to me, is to establish capital adequacy standards appropriate to the risks that a given institution undertakes in the course of its business. I should confess, however, that I thought we had such a system but the SIVs and conduits maintained off-the-books by banking institutions were, in effect, blatant evasions of then-existing capital adequacy rules. They were conducted in daylight right under the noses of regulators. What's the point of having rules if you're not going to enforce them? Burglar alarms are useless if the cops don't respond.

The *Financial Times* columnist Martin Wolf focuses on the interaction of leverage and limited liability. High leverage amplifies the payouts, positive or negative, of any bets placed while limited liability skews the matrix: heads, my shareholders (and I!) win; tails, the taxpayer loses. With limited liability, such as common stock companies, shareholders can't lose more than

their entire equity in the firm. With partnerships, such as used to be the norm on Wall Street, the entire net worth of the partners can be at risk. The incentives facing those who manage other people's equity – and whose compensation is geared to shareholder returns – are quite different from those who put their own wealth at risk.

Willem Buiters's Maverecon blog draws a distinction between too big to fail and too big to save. Iceland's banks, for example, grew so large relative to the resources of the Icelandic government that they bankrupted not only themselves but also their government.

Capital adequacy and leverage. Incentives and compensation. Enforcement. Size. "Narrowness," i.e., permissible activities for organizations backstopped by taxpayers. Regulatory efficiency, jurisdictions and

overlap. Somewhere within this mix of complexities lies a sweet spot of effective reform. If it proves to be politically possible to find it, it will almost surely disappoint radicals of both left and right.

Radical punitive reform of banks, shadow banks, insurance companies, and other financial intermediaries might feel good but big, deep, broad and flexible capital markets have been an American competitive advantage for many decades. It makes little sense to compound the self-inflicted wounds of bankers by inflicting new regulatory injuries. If it's broke, fix it, but don't get rehabilitation so mixed up with a punishment motive that the innocent too – the customers and the economy – are permanently impaired.

Here's hoping the Geithner proposal works as well as his unloved emergency rescue plan appears, so far, to be doing. ■

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