The session began with Michael Lind’s noting that the current banking reform debate is unusual in two respects. Firstly, it is not constricted by a narrow consensus. There has been a willingness to ask a broad range of questions, i.e., what is banking for, what should be the fundamental architecture of national and international financial systems? Secondly, there are no clear-cut partisan lines. Rather than a debate between left and right, it’s a debate between the banking industry and its allies in Washington, and outsiders across the political spectrum.

William K. Black started by noting that in any discussion of regulation, the focus should be first on what you shouldn’t do. Firstly, you shouldn’t try to regulate things that can’t be successfully regulated; you should ban them or move them where they aren’t going to cause problems. Examples include systemically dangerous institutions - the “too-big-to-fails” and proprietary valuation models like the Basel process.

The second area that needs attention is ideology. Worldwide, regulation fails because those in charge believe it cannot work and is counterproductive. Because of this mythology that private market discipline prevents all fraud and cures itself, we are incapable of learning from crises.

So, to escape the ideological trap, we need to remember that, historically, the leading cause of bank failure has been insider fraud. Dr. Black proposed that every regulatory agency should include a chief criminologist to work on dismantling criminogenic environments (perverse incentive structures). Criminologists would look for the characteristic, distinctive patterns which indicate bank and accounting fraud. Additionally, regulatory agencies must be professionalized. And we must end the policy domination of economists.

Perry Mehrling addressed several questions. Why did the parallel, shadow banking system crash? What went wrong, and how can we fix it? Have we fixed it? In Dr. Mehrling’s opinion, two things broke: the funding system and the risk control system. Beginning in 2007, the funding system for the shadow market began a slow, piece-by-piece meltdown. Asset-backed commercial paper, the repo market, financial commercial paper: one by one they collapsed, until finally we moved the money market onto the balance sheet of the Federal Reserve. The exit strategy for the Fed will involve getting the money market working again, so the Fed no longer has to be an intermediary between parties that used to borrow and lend to each other. The broken risk control system includes credit default swaps, guarantees on super-senior tranches, etc. We have replaced, to some extent, these guarantees with government guarantees. This also involves an exit strategy problem because it is not clear that the private sector should be doing the kind of thing that AIG was doing - writing tail risk insurance for the system.
From this we should take three lessons: 1) markets and instruments need to be regulated more than do institutions; 2) rampant mis-pricing of funding and risk were the source of the trouble, and must be fixed; 3) derivatives reform and regulation are the sine qua non. If we get that right, we will be ok; if we don’t, we won’t.

Rob Johnson spoke about the relationship between the shadow banking system and the concept of “too-big-to-fail,” or too difficult to resolve. After the Great Depression, the US instituted deposit insurance for the liability side of banks’ balance sheets and controlled the asset side through regulation. Over time, regulation of the asset side has eroded, but our philosophies are still based on the Depression Era logic. We are now in a place where “too-big-to-fail” undermines the entire structure of our capitalist system. As we wrestle with a solution, it is important to appreciate the complexity of the situation.

First, we need the power to resolve financial holding companies, similar to the system which exists now for banks. However, when an institution is resolved, there is no way to know what the effects on the economy will be, how they are intertwined, or who else is going to be dragged down.

A second dimension has to do with international regimes of resolution. When an international bank is placed in receivership, its web of its exposure matrix will cross national, legal boundaries. Dr. Johnson suggests that the WTO should impose a Financial Stability Board-type system across the world.

Third, we need to simplify derivatives. We need real prices and real transactions. This will probably result in 6 – 9 billion dollars less profit for the top five banks. This points up one of the challenges in Washington: any group that stands to lose 9 billion dollars a year has a pretty good lobbying kitty. The recently released Dodd bill has delivered the architecture that will put the industry on hold, and Dr. Johnson predicts we will come back and fight about this again next year.

Good regulation actually makes a market more competitive, and well-regulated markets attract more investors, said Stephany Griffith-Jones. A smaller, simpler industry could also be more efficient, and would of course be easier to regulate. Counter-cyclical regulation would offset boom-bust cycles and reduce damage to the real economy. Dr. Griffith-Jones indicated that the discussion is moving towards a consensus that we need different instruments for different failures of financial markets. For instance, in the case of solvency, both counter-cyclical capital requirements and loan provisioning could be used. This counter-cyclical regulation has been quite successful in Spain over the last ten years. Who should this regulation apply to? According to Dr. Griffith-Jones, the best approach is for comprehensive counter-cyclical regulation for all institutions, especially instruments and markets. Finally, very strong global coordination of regulation is necessary to make it effective. We should take up the challenge of moving toward an international regulatory authority. Rather than decreasing
national sovereignty, this would pool power to increase control over financial markets.