
Comparing and Contrasting Proposed Reforms with Solutions to the Current Crisis

JOSEPH R. MASON†

Many of the reforms offered by the administration over the weekend are items that have been discussed for years now and summarily rejected. Hence, those do not seem to be an obvious avenue for reform. Furthermore, even if they were politically and economically feasible, as I was quoted as saying on NBC Nightly News over the weekend and as Chris Dodd concurs, they do little to address the current crisis. Nonetheless, feasible reforms are quite simple and readily available. Hence, this week I am meeting with members of the House Financial Services Committee to propose real solutions to the crisis. Once those are constructed we can begin discussion of broader reforms to the regulatory landscape that – while indeed necessary – require much deeper consideration for the long run.

THE PROPOSED REFORMS

The administration proposes, among other things, empowering the Federal Reserve to manage “systemic risk,” merging the Commodities and Futures Trading Commission and the Securities and Exchange Commission, shuttering the Office of Thrift Supervision, and starting a national-level insurance industry regulator.

The proposals to shutter the OTS and provide for a national insurance regulator are both proposals that have died previously. Shutting one regulatory agency while opening another does nothing to reduce the overall number of regulatory agencies. Furthermore, the insurance industry lobby in Washington is arguably stronger than even the banking lobby, and the industry has defeated moves to establish a national regulator previously. Hence, there is little reason to believe such legislation will pass in the current round.

More interesting is the proposal to merge the CFTC and the SEC. Notwithstanding the administration’s stance, it is not immediately apparent what the justification for such a merger would be. The most immediate need is to plug gaps in the system whereby agencies deny regulatory responsibility for new financial products. Nothing in the proposal addresses that shortcoming, which also impugns the bank regulators, including the Federal Reserve.

Speaking of the Federal Reserve, it is not clear that you would want to choose the Federal Reserve as a primary regulator for nonbanks anyway. While

† Associate Professor of Finance, Drexel University LeBow College of Business, Senior Fellow at the Wharton School, and Financial Industry Consultant, Criterion Economics, LLC. Contact information: joseph.r.mason@gmail.com; (202) 683-8909 office. Copyright Joseph R. Mason, 2007. All rights reserved. Past commentaries and testimony are archived at http://www.criterioneconomics.com/pubs/articles_mason.php.

the Federal Reserve has some supervisory authority, the Office of the Comptroller of the Currency is arguably better at evaluating large-bank risks similar to those encountered on Wall Street and the Federal Deposit Insurance Corporation has by far the most expertise in shutting down institutions and arranging buyouts for distressed firms, as well as liquidating assets outright. At the same time the nomination of Randall Kroszner, the Federal Reserve Board Governor with the most experience on the institutional and supervisory side, is stalled in Congress. Kroszner's seat should be approved as soon as possible so he can get to work improving supervision.

Politicians tend to favor bailouts when they can control how the proceeds are distributed. Economists call this the "dark side" of bailouts. Most troubling, therefore, is the codification of the Federal Deposit Insurance Corporation Improvement Act of 1991's "Systemic Risk Exemption" to prompt corrective action procedures in the proposed Federal Reserve. The systemic risk exemption was the loophole left by FDICIA as a quid pro quo for removing legislative power in day-to-day bank supervision after the Keating Five and others were brought to light. It is not clear we want to step backward in this regard, allowing legislators more say in discretionary bailouts.

REAL REFORMS

As stated above, while some of the proposed reforms are necessary they will do little to address the current crisis. As Barney Frank notes, sensible regulation is the goal, and as Chuck Shumer notes that broad-based reform is not something we can do quickly. Thankfully, meaningful regulation is not difficult.

The trick is to focus the mind on the true nature of the crisis and not get lost in day-to-day headlines. This is a structured finance crisis, evidenced by the meltdown of a mortgage industry funded by structured finance, the municipal bond industry funded by structured finance, and – soon – the student loan industry funded by structured finance. Note further that there have not yet been meltdowns in certain other structured finance areas, like credit cards and auto structures that are built to higher credit-loss standards. The conclusion should be that financial engineering can create stable structures and can therefore be motivated to be part of the solution. I am meeting with several investment houses to discuss how those structures can be created and the possibility that financial reform legislation can help.

The proposed solutions are rooted in two key economic principles: economic game theory and economic theories of information asymmetries. The point of those two theories is that there can never be a true sale in a repeated sale market and opacity is the root of illiquidity and, when opacity masks insolvency, credit crises.

Viewed through those lenses, the obvious avenues for reform become clear. Elements like stable and meaningful ratings, "off-balance sheet" treatment, and REMIC tax law provisions can be altered to move the market forward and remove the key threat to economic growth: the ongoing credit crisis. "Reforms" that propose the Federal Reserve, the Federal Housing Administration, or the Government Sponsored Enterprises purchase offending structured finance instruments and hold them off the market are shown, through those same economic lenses, to be false "solutions" that neither address the limitations of repeated games nor reduce information asymmetry, the keys to ending the crisis.

CONCLUSION

Real reforms are not difficult. Legislators can get out of the crisis without a taxpayer-funded bailout of homeowners or the financial industry. With reopened mortgage markets, solvent borrowers with income can naturally refinance out of abusive “creative” loans and move on. (Neither market openness nor taxpayer-funded bailouts can help insolvent borrowers without income.) We primarily need “sensible regulation” to make regulatory rules match industry practices that have evolved from nearly thirty years of financial development. Anything short of that will just continue the credit crisis while sowing the seeds of the next, bigger, crisis in the future.