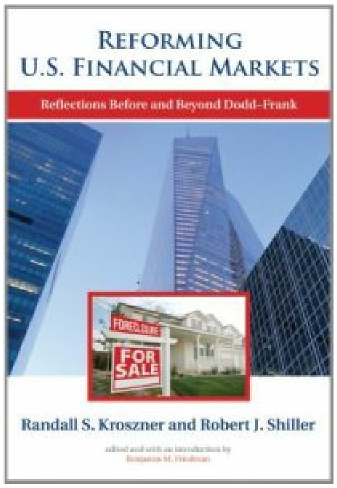

Book Reforming U.S. Financial Markets

Reflections Before and Beyond Dodd-Frank

Randall S. Kroszner and Robert J. Shiller
MIT Press, 2011
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Recommendation

When the US's top economists meet at a symposium on remaking America's financial system, they're bound to disagree. But in Randall S. Kroszner and Robert J. Shiller's new book – a brief collection of the papers they presented at Harvard University, along with comments by their equally esteemed colleagues – their divergence lies more in their methods than in their main conclusion: The US financial sector desperately needs a makeover. *BooksInShort* recommends their cogent, well-thought-out reasoning on the causes of the recent financial crisis.

Take-Aways

- In 2010, the US Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act in response to the 2007-2008 financial crisis.
- Yale economics professor Robert J. Shiller says the financial system needs "new rules of the game."
- Randall S. Kroszner of the University of Chicago argues for limited regulatory change.
- Shiller advocates a "democratized, humanized" revamping of finance so its products and technology benefit all.
- Regulators should consider how people really act and think in a market economy, based on human emotion and psychology.
- Markets, by their nature, demand rules and standards in order to operate.
- Kroszner believes in "making markets more robust."
- He advocates changes to credit rating agencies and mortgage securitizations.
- Greater transparency, better-defined rules and central clearinghouses offer stability.
- Financial leaders and regulators must take into account the market impact of their rules and practices.

Summary

Crisis and Its Aftermath

The 2007-2008 financial crisis affected most of the world's economies, but global financial institutions and the financial sector felt the brunt. The modern-day panic was the worst calamity to hit the finance industry since the 1930s' Great Depression. The perfect storm that began to unfold in 2007 featured banks trading securities at a turbo-charged rate, applying ever-increasing leverage to augment earnings and selling into a speculative market fueled by derivatives.

> The Dodd-Frank Act is "only a beginning of a dialogue on how to move our financial system into the 21st century."

In 2010, in an attempt to address the root causes of the crisis and to legislate measures to prevent a recurrence, the US government enacted the Dodd-Frank Wall

Street Reform and Consumer Protection Act.

Dodd-Frank's main components are:

- **"A new Financial Stability Oversight Council"** – This new entity, though made up of existing regulatory agencies, monitors potential threats to the economy.
- **"Reallocation of banking oversight responsibility"** – The Federal Reserve Bank now supervises nonbank financial organizations.
- **"Authority for regulators"** – Regulators may compel certain "systemically important" firms to raise more capital and maintain stronger liquidity.
- **"Resolution plans"** – Systemically important banks and nonbank financial entities must create "living wills" that specify how they will unwind their financial obligations in case of bankruptcy or illiquidity.
- **"A ban [on] proprietary trading"** – Banks and their corporate parents may no longer trade for their own benefit, nor set up or invest in certain types of investments.
- **Partial loan retention** – Banks' balance sheets will have to hold "at least 5%" of loans they sell to other parties.
- **"Prompt and orderly resolution"** – Regulators must take over any insolvent bank holding companies, broker-dealers and insurance companies. Prior to Dodd-Frank, the government could take control only of bankrupt banks; nonbank financial institutions went through the laborious, complex US bankruptcy process.
- **"Centralized clearinghouses"** – Most derivatives will settle through third-party clearinghouses that stand between contracting parties, and they will provide information to the market.
- **"Bureau of Consumer Financial Protection"** – This new agency creates and enforces rules for individuals or entities providing financial services to consumers, except for automobile financing.

Robert J. Schiller: Advocating for the Human Face of Finance

Dodd-Frank is one response to the economic crisis, but the depth and severity of the shakeout present an opportunity to re-evaluate and rewrite "the rules of the game." When emergency government interventions such as 2008's Troubled Asset Relief Program (TARP) steadied an unsettled economy, the need for "unifying principles" to guide the US capitalist market system in the future became clear. Any future laws should help to "democratize" finance. That means financial services' processes and technologies must work to help all individuals manage their monetary risks.

> "The free market is one of the most important inventions in human history...and the invention takes the form of regulation and standards enforced by some form of government."

Regulation should also "humanize" finance by recognizing how people really act and think in a market economy, according to principles of human nature and psychology. A progressive approach to government regulation of financial institutions – one that takes the interests of the people into account and employs the findings of "behavioral economics" – would result in rules that better approximate how people and markets react to incentives, risk and emotions.

It's Not How Much Regulation, but What Kind and by Whom

Federal, state and local authorities all issue rules governing financial service providers and transactions, so the US has no clear, coordinated approach to regulation. While government agencies specifically charged with supervising and controlling finance have existed for decades, they specialize according to outdated distinctions. For instance, regulatory agencies cover banks, but nonbank entities, such as hedge funds, function outside controls. Insurance companies operating nationwide hew to the rules of as many as 50 different states.

> "When what went wrong was the result of human action, taken in human-built institutions, the question at issue is not merely containment but prevention."

A good part of the American financial system generally has operated under "self-regulatory organizations" (SROs). These SROs are, in fact, industry groups – similar to the former National Association of Securities Dealers (NASD) – formed to monitor their members. SROs are based on the belief that insiders are best situated to know how to implement rules and supervise specific transactions as well as behaviors. Any reconsideration of the US financial game should include the cooperation of the financial industry in self-policing its members.

> "The human tragedy of the current financial crisis...forced...an embarrassing sequence of bailouts and special favors, which offend the notions of order and fairness."

Both the mortgage industry and the real estate appraisal industry need effective SRO oversight. Abuses in the mortgage and real estate markets led directly to the speculative bubble in home prices and to the inevitable collapse of those prices. The National Mortgage Licensing System, started in 2008, could provide an important deterrent to future home loan abuses. In New York State, mortgage lenders must now retain impartial appraisal services from independent "appraisal management companies."

Free and Fair

Rather than focusing on specific industries or transactions, future legislation should focus on "objectives-based regulation" that calls for "a systemic risk regulator, a prudential financial regulator and a business conduct regulator." Those who argue for totally "free" markets forget that markets must follow certain rules and standards, regardless of who imposes them. When individual parties transact in a market, they lend their faith to the proper functioning of that market, since they have no basis on which to judge the trustworthiness of their counterparties.

> "A properly functioning financial system has to be perceived as basically fair, otherwise political forces will be set in motion that inhibit its proper functioning."

Proponents of the efficient markets hypothesis, which says that markets perform best without interference, neglect the human tendency to operate, at times, irrationally or without full information. Markets are not infallible, because they are comprised of fallible human beings.

Some members of the financial industry tend to hold their regulators in low regard and to see them as poorly paid, ill-informed government flunkies. But, in truth, many of them are as well versed in finance and economics as their private sector counterparts. Equating their low salaries to their value is akin to disparaging teachers and nurses who work for low pay. Not everyone wants the pressures of a Wall Street career, despite its financial rewards, and many people do not feel comfortable compromising their principles to push products in which they don't believe.

> "The efficient markets hypothesis is one of the most remarkable errors in the history of thought, given its impact on our economic institutions and on the economy."

A good regulator serves the same purpose as a sports referee. No one denigrates the ref because he or she can't play the game as well as the players. Great players shine when a referee enforces the rules; otherwise, "rough play and cheap moves" would undermine the performance of top athletes and destroy the game.

Randall S. Kroszner: "Making Markets More Robust"

Any regulatory scheme legislators impose on the financial system needs to recognize that large, complex, interrelated financial institutions can bring down the entire system. "Too big to fail" and "too interconnected to fail" issues have created a hazard that compels authorities to intervene to prevent systemic collapse. The evolution of the securitization and sale of loans, particularly mortgages, demands that the "market and legal infrastructure" ensure transparent information for all participants in the future.

> "In principle, mortgage securitizations make good economic sense."

The regulatory framework, largely imposed during the 1930s, has not kept up with the transformations within banking during recent decades. In the past, banks financed their lending by taking deposits; now, they increasingly turn to overnight and short-term money markets to fund loans, which they then sell, effectively removing the assets from their balance sheets. Other entities such as investment banks then securitize these loans and sell them to investors.

> "What might seem like 'herd' behavior in some markets may be at least in part a response to the fragile interconnections affecting the stability of those markets."

Money market mutual funds now take in half as much in deposits as banks and provide important funding to them, so any disruption in the funds environment impinges on banks. These new intermediaries "create chains of interlinkages" that expose the entire system to problems occurring within any one set of relationships.

> "Since the last major round of regulatory reform in the 1930s, financial intermediation has grown much more complicated and interconnected, but the regulatory framework has not kept pace."

These issues call for resolutions that, while critically necessary, don't warrant a wholesale upending of the financial system.

Five aspects of reform need particular attention:

1. **Credit rating agencies** – The major rating agencies – Moody's, Standard & Poor's and Fitch – play an important role in markets. The Securities and Exchange Commission has endowed these Nationally Recognized Statistical Ratings Organizations (NRSROs) with its imprimatur. But many experts believe NRSROs receiving fees for rating securities from the very parties who issue the securities compromises the NRSROs' independence and impartiality. Reforms to the credit rating system should concentrate on making transparent information available to everyone – not just the rating agencies – to ensure more reliable, realistic ratings.
2. **Mortgage securitization** – The packaging of mortgage loans for sale allows banks to extend financing to homeowners, so regulators should look to revive this product for the sake of consumers. Problems erupted when sellers and investors did not conduct proper "due diligence" on the underlying loans in these products. Many relied on Fannie Mae's and Freddie Mac's guarantees, inferring that these government-supported entities would bear the risk. Financial institutions need to standardize mortgage loan investment instruments and make them less complicated to give market participants the ability to analyze and assess their risk. Banks should improve their credit approval process to make sure the underlying mortgages are sound.
3. **"Improving resolution of financial institutions"** – Uncertainty surrounding potentially vulnerable financial intermediaries led many clients to withdraw their money from nonbanks during the crisis, thus worsening those firms' financial standing. Investors and clients of nonfinancial companies find reassurance that, in bankruptcy, these companies are subject to clear, enforceable rules. Banks, too, by force of the Federal Deposit Insurance Corporation's protection, no longer face the death spiral brought on by unrestrained runs on their deposits. Nonbank institutions also need a transparent, well-defined resolution process: "'Prepackaged' bankruptcy" and living wills reduce the possibility that a problem in one organization could cascade to other institutions.
4. **Clearinghouses** – Requiring a counterparty to sit in the middle of derivatives transactions will help reduce the fragility of a system made up of interconnected organizations. By ensuring the proper functioning of transactions, a clearinghouse removes some of the risk from these dealings and provides buyers and sellers with more readily available information. This change also would help regulators monitor any unusual or excessive buildups of risk. The products included under a clearinghouse system call for standardization to make the process work, but the trade-off to achieve smoother functioning derivatives trading would make standardization well worth the effort.
5. **"Potentially destabilizing contracts"** – Market participants can help enhance stability by reassessing the contracts underlying certain debt and derivative instruments. For example, some contracts call for increased cash collateral if one of the parties in the contract suffers a ratings downgrade. This works in normal times, particularly when the decline affects only one firm, but such a demand can cause systemic disruption if the downgrade occurs when a counterparty is nearly bankrupt. The call for more collateral – and the need to sell assets in a distressed market – could force an ailing company over the brink and pull down all other participants in a daisy-chain of failures. Industry groups and counterparties need to consider the overall market impact of such potentially dangerous clauses.

About the Authors

Randall S. Kroszner is an economics professor at the University of Chicago and a former governor of the Federal Reserve System. **Robert J. Shiller** is an economics professor at Yale, the author of *Irrational Exuberance* and the co-author of *Animal Spirits*.