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2010-05-17: Preventing the fire, next time

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Preventing the fire, next time

Karthik Krishnan answers questions about the possibility of a new financial reform package. *Photo by Mary Knox Merrill*

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The Great Recession was brought on, in large part, by risk-blind behaviors by banks, financial firms and insurers. Today, as Europe's own debt woes cast doubt on the sustainability of the U.S. economic recovery, Congress is debating a financial reform package to prevent such meltdowns in the future. Assistant Professor of Finance and Insurance Karthik Krishnan discusses the highlights of the reform legislation, the differences between the Democratic and Republican approach and the likelihood of passage.

How would proposed legislation seek to prevent the confluence of factors that led to the melt down?
The proposed law for the US financial system has three important features in terms of how future crises may be prevented: First, there will be a financial stability oversight council that will have the job of measuring the level of risk that any financial or non-financial entity may impose on the overall economy. This will ensure that the type of bailouts required for large and complex financial firms like AIG because of their impact on the rest of the economy (i.e., too big to fail) will be less likely.

Second, the bill seeks to prevent banks from engaging in proprietary trading activity as well as investing in risky assets such as hedge funds and private equity funds (known as the "Volcker rule"). The effect of the crisis was magnified when banks stopped lending even to creditworthy borrowers, in part because of the heavy losses they suffered on their investments and the resulting loss of confidence between financial institutions. Preventing banks from making overly risky bets may have the effect of keeping banks liquid at a time when liquidity is important.

Third, complex financial instruments known as derivatives will be regulated, which will make them easier to understand and give us a better idea of where risks are being concentrated.

Both political parties are putting forth bills requesting more regulations and more consumer protection. How they are they different? Are there better approaches that neither bill takes?
The proposals of both major political parties are similar in many dimensions, including creating systemic risk regulatory bodies, instituting the so called "Volcker rule" to prevent banks from investing in very risky investments, and regulating derivatives.

The differences seem to be in terms of the regulation of Freddie Mac and Fannie Mae (Republicans propose stronger regulation of these agencies), how strong a consumer protection agency will be (Republicans give such agency weaker regulatory powers), and how much power the Federal Reserve is given (Republicans do not provide more authority to the fed). Recent developments suggest that Democrats and Republicans are merging their ideas into a single package and the final bill will contain components of both packages.

One important problem that is not completely addressed in either proposal is how to immunize the U.S. economy so that the impact of international shocks such as the Greek debt crisis will have a smaller impact. Contagion, i.e., the spreading of financial problems elsewhere in the world to all parts of the world is a big concern in an interconnected global economy. Any systemic risk council will also have to consider the risks of international investments made by U.S. investors and vice-versa to reduce the impact of international financial crises on the U.S. economy.

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Who should be regulated and what authority is best suited to oversee this monumental task?
The simple rule should be: Can an institution's action have an impact large enough to affect the overall economy? If the answer is yes, such institutions should be regulated and regulated effectively. There is already quite a bit of consensus on who gets regulated: large banks, rating agencies, and hedge funds. Regulation can be tricky in that too little can create the kind of crisis that we just went through, and too much can negatively impact the competitiveness of the financial industry. So, there needs to be a balance.
The question of who should regulate these firms is a tougher one, and one answer is: whoever is in the best position to monitor and assess the risks taken by financial firms and the effect of such risks on the economy.

Who should pay for bailouts in the future if an industry is in trouble? Was it advisable for taxpayers to bear this burden in recent past?
The hardest part about assessing government interventions is to know what would have happened had such an intervention not occurred. In my mind, this was a necessary step to stabilizing the economy and unfreezing the credit markets. The bailout had the effect of unlocking the credit markets so that money started flowing through the economy. Without such an intervention, and I can only guess, businesses would not have been able to get loans, consumers would not have been able to obtain credit, and economic activity would have plummeted further still, creating a much worse recession than the one that we just experienced.

There is no doubt in my mind that taxpayer-funded bailouts will not end and will be at least a small part of government intervention policy. We cannot prevent, using any law, the unknown from happening next. The taxpayer will be on the hook for at least some level of financial support and this will be true for not just the financial industry. Two things will ensure this: First, a changing political scenario in which, at some point in time, business friendly politicians with little memory of the past will come to power and who will insist on weakening any policies that are implemented as a result of reforms; and second, the inherent unpredictability of the magnitude and the source of the next crisis.

Will a $50 billion fund that is being proposed really be enough to cover the costs the next time asset values decline? What is the right number? Where is the next crisis going to come from? The answer is, nobody knows. Regulation is usually reactive, and rarely proactive.

Do you think reform legislation will pass?
I think it will. Politically, there is significant pressure on Congress to punish, or at least, restrain Wall Street. What kind of reform will pass and which provisions remain in the final bill still remains to be seen. I think the common elements of the Democratic and the Republican proposals, such as the systemic risk regulator, restriction of proprietary trading, and enhanced transparency for derivatives will go through.

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