Six principles for a new regulatory order

By Lawrence Summers

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After a modest interval with no big financial shocks, policy attention is turning to the task of preventing future crises and managing those that occur. While the deliberations will take quite a while to play out, there is some time pressure – because of the moral hazards created by the Federal Reserve's extension of credit to investment banks and authorities' desire to act before the sense of alarm created by recent events abates and complacency returns.

Proposals for changes in regulation and crisis response have come from many quarters, including the US Treasury and private sector groups. They offer important ideas on rearranging regulatory responsibilities – such as the Treasury's suggestion of an enhanced role for the Federal Reserve with respect to investment banks and its call for a consumer financial regulator – and raise critical issues, such as that of procyclicality induced by regulation. They also contain a certain amount of essentially content-free calls for worthiness. So far missing from the debate has been a set of principles describing the properties of any desirable regulatory regime, against which proposals can be evaluated. Different observers will assign priority to different issues – here would be my list of six principles.

First, there should be a strong presumption against having regulators competing to supervise particular institutions or activities. Experience suggests that even when firms do not have the option of switching, there are substantial risks that regulators will be co-opted. Adding "forum shopping" exacerbates the problem.

Second, it should be recognised that to a substantial extent self-regulation is deregulation. Allowing institutions to determine capital levels based on risk models of their own design is tantamount to letting them set their own capital levels. We have seen institutions hurt again and again by events to which their models implied probabilities of less than one in a million. Where it is desired to impose capital requirements, this should be done in a way that can be monitored by supervisors on the basis of balance sheet data.

Third, regulation must be premised on the inability of institutions or their regulators to predict future market conditions with much confidence. As obvious as the subprime crisis may look in retrospect, it was not widely foreseen 18 months ago even by those worried about complacency in credit markets. As the fact that the Dow Jones index was below 6,500 when Alan Greenspan famously spoke of irrational exuberance illustrates, it is also easy to see bubbles even when assets are undervalued or properly valued, as US stocks were in 1996. Rather than judging where and when the next crisis will occur, regulators need to try to assure the resilience of the system with respect to economic shocks or problems in any one sector or institution.

Fourth, the focus of regulation must shift from the prudential practices of individual institutions to the health of the financial system. The proper focus of government regulation is not on how good a job managements do of looking out for their shareholders and bondholders. It is on the potential external consequences of their actions. This will require efforts to limit excesses when times are good and institutions appear robust – and efforts to avoid deleveraging in difficult times if that increases pressures on others. Prudence at the level of any one institution does involve more leverage at times when volatility is low than when it is high. The problem is that when any institution seeks to do what is prudent for it and sell off assets, it impairs the environment in which all others are operating and creates the kind of vicious cycle, in which liquidations beget declining prices and further liquidations, that we have just been through.

Fifth, any regulatory regime must address the risks arising from "parallel banking activities" in a realistic way. We have been reminded by recent events of the old truth that borrowing short and lending long with limited capital is always at the root of financial crisis. This type of activity is not confined to banks and their offshoots. It is practised by bond guarantors, hedge funds, mortgage institutions and some insurance companies among others. If capital requirements are raised only on one set of institutions, problems may be exacerbated as activity migrates to those that are not regulated. On the other hand, regulating all potentially highly leveraged entities is a formidable task. There is no ideal answer. But the fear is that regulation that ensures the regulated can compete fairly with the unregulated is regulation that either promises government subsidy or does not raise capital requirements much above market levels.

Sixth, regulatory policy must to the maximum extent possible create a situation in which the failure of an individual institution is not itself a source of systemic risk. Only in this way is it possible to contain the moral hazards associated with government support. The authorities had no realistic choice but to provide support as Bear Stearns faced bankruptcy. They do have a choice as to whether to put in place a regime where such problems can be managed with no government financial support provided directly or indirectly to shareholders or unsecured creditors. A resolution regime that could apply to any financial institution that became a source of systemic risk should be an urgent priority.

These principles are more easily asserted than they are reflected in an actual regulatory system. I hope to return in future columns to the question of regulatory system design.

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