



Toward a Global Financial Regulatory Regime

Morris Goldstein says that Treasury Secretary Geithner's proposals for regulatory reform are a step forward that could be endorsed in principle at the G-20 summit in Pittsburgh.

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Steve Weisman: This is Steve Weisman at the Peterson Institute for International Economics with Morris Goldstein, senior fellow at the Institute, to talk about the accelerating pace of global financial regulation. Thanks for joining me, Morris.

Morris Goldstein: Well, delighted to be here, Steve.

Steve Weisman: I mentioned accelerating pace because Treasury Secretary Tim Geithner has presented more details about what the Obama administration wants to do with the financial regulatory system. Morris is the author of a 10-point set of proposals on this subject. Was the Treasury Secretary's proposal, released at the Finance Ministers' Meeting in London, a step forward?

Morris Goldstein: I think it's definitely a step forward. It's a good plan for bank capital requirements. I like it because it also contains most of the elements that I've been in favor of for some time now. Let me just mention a number of key advances. The first one is simply to have higher capital requirements for all banks. We had our own stress test during this crisis, and the banks failed. I mean in the sense that they simply didn't have enough capital to deal with the losses that they suffered, and we had to put a lot of public money in. So it makes sense to raise the capital requirement for all banks and, in particular, to raise it higher for the systemically important ones. That's what the report calls Tier 1 Financial Holding Companies, but those are the systemically important ones.

Steve Weisman: Would the major financial holding companies and bank holding companies have to increase their capital levels, let's say, next year?

Morris Goldstein: That's right. It looks like the time schedule is to try and get international agreement on a new bank capital regime by the end of next year, but not actually to implement it until 2012. But yes, that's the plan, to require them all to hold more capital.

Steve Weisman: Let me digress for a second. Why is it important to get international agreement on this?

Morris Goldstein: If you don't, then your own financial institutions will make the case that they're at a competitive disadvantage because they have to hold higher capital than their competitors. So the history of bank capital regimes is, you try and get them done internationally, going back really to the first one in the late 1980s. So that continues and given that the world is so globalized, it's also helpful. You want to have more safety and soundness; you need to do it internationally.

Steve Weisman: I'll come back to the international context in a second. But why don't you finish outlining the other major elements that you found positive?

Morris Goldstein: A second element is they want to make the bank capital regime more countercyclical. That's important.

Steve Weisman: Explain.

Morris Goldstein: Bank capital has an influence on how much banks can lend. So what you want to do is make the capital requirement higher during the boom years so that banks can lend a little less then, when you're trying to restrain the economy. And then, you can lower it when you have the downswing. So that makes it countercyclical because otherwise, you get too much lending in the upswing and too little in the downswing. So that's a positive element.

Another element is to introduce what's called the leverage ratio internationally. This is a capital requirement that's not risk weighted. The normal one puts different risk weights on different assets. So for example, if you think a loan to a company is more risky than holding a government bond, the loan to the company requires the bank to hold more capital. That's fine, that's a sensible thing to do, but if you get the risk weights wrong—for example, with all these complex structured products that were so prominent during this crisis, the risk weighting was tied to credit ratings and the credit ratings agencies got it wrong.

So you also want to have a check on the risk-weighted one by having one that isn't risk weighted that covers all assets. So you can't get around it, switching the kind of assets you invest in. It's a second check and it's a prudent thing to do. So that's also a step forward.

Steve Weisman: What else?

Morris Goldstein: Another important one is to introduce a conservative quantitative liquidity requirement. In addition to capital, you really need to worry about liquidity, which was a big problem during this crisis. And basically, banks have been running down their liquidity for decades.

Steve Weisman: What does that mean? How do banks possess liquidity?

Morris Goldstein: Liquid assets, for example, would be Treasury securities or cash. And the reason why banks don't want to hold a lot of those is because they're very low yielding. So they prefer to minimize that and get their liquidity by borrowing it in the repo market or other markets. That way, they don't tie up resources in low-yielding assets. The problem is then, when they get a big shock, they don't have enough liquidity to deal with it. So what you need to do is to require them to hold a set of very liquid assets that you can turn into cash under almost any circumstance.

And in the past, we didn't have a quantitative liquidity requirement. We didn't say, "Well, all banks need to hold X percent of their assets in these very liquid assets." We just said, "Well, do a stress test. Here's a whole bunch of principles." And what

happened is the banks just didn't hold much liquid assets and then, when we ran into trouble of liquidity in this crisis, they didn't have enough. So this would end that. We would say, "Well, now, we have a number." We have a ratio just like we have a ratio, a quantitative minimum holding, for capital.

Steve Weisman: But, Morris, there are no numbers in the Treasury proposal. Aren't the numbers crucial?

Morris Goldstein: They are crucial. And that needs to be worked out. They'll need to be worked out internationally as well. So you're right, it makes a lot of difference if we say, for example, we're going to raise the capital requirement. If we raise it just a little, it may not be that helpful. If we raise it a lot, it could be an important reform.

Steve Weisman: What's the reception to this plan in the financial community so far in the United States and abroad?

Morris Goldstein: I think in the financial community, they generally prefer to have less guidance, more self-regulation. They don't want to have to hold much higher capital. No doubt, they would prefer something that's not this constraining. But of course, if we let them run their show, then we're going to have a repetition of the problems that we had. So I'd be worried if they liked it actually. If they gave it an enthusiastic reception, that would be a very bad sign.

Steve Weisman: You're watching also what's happening in Congress, as the House and Senate consider regulatory reform. What's your sense of whether the mood in Congress is going to be supportive?

Morris Goldstein: I think it will be supportive because the public is rightfully outraged over what's happened during the crisis, and I think they recognize that we need sweeping reforms. I mean the first two bills coming out of the Congress and the House, one dealt with consumer protection and then there's another one on Wall Street compensation. Those are two areas that the man on the street can understand. He understands about consumer protection and what kind of practices credit card companies follow and the like. And he also understands that the pay structure, the link between performance and pay on Wall Street was totally out of whack.

And so, those are the two that probably have the most public appeal. Some of these other things are very important but they're arcane and they're not so easy for the layman to understand.

Steve Weisman: It's also not clear in the legislation who's going to be the regulator either—to use the term, micro prudential regulator or the macro prudential regulator. The Obama administration has proposed that the Fed play the role of the systemic regulator, to look at the overall system. You're skeptical of that?

Morris Goldstein: I am. I think they should be the systemic risk monitor. That is, they should be able to go anywhere they need to go and have the authority to look at wherever they think systemic risk in the economy may be growing unduly. But in terms of regulating the largest financial institutions in this country, being the supervisor, I

would prefer that another institution, preferably a new institution, be created to do that. I think otherwise, we put too much power in the hands of a single institution. It will distract them from monetary policy and frankly, they didn't do a very good job as a potential regulator in the run-up to this crisis.

Steve Weisman: My reading of the news coverage of the congressional action on this so far is that Congress is pretty unenthusiastic about giving the Fed this authority as well.

Morris Goldstein: Well, that's my impression as well, although you need a credible candidate.

Steve Weisman: Right. Who?

Morris Goldstein: If it's not the Fed, then who?

Steve Weisman: Yeah. Creating something new will be challenging.

Morris Goldstein: Yes, it will be. The problem is the other candidates I think don't have the reputation to do the job. So I think the best alternative is create a new institution, which has no history of failure, and give it the proper authority and staffing. And I see no reason why it can't do a good job.

Steve Weisman: Now, just to wind up, this issue was a pretty big issue for the United States in London when the finance ministers met. But what about later in September, when the summit leaders meet in Pittsburgh? Is this going to be a major issue there as well?

Morris Goldstein: I think it will be. We're not likely to get agreement on specifics in Pittsburgh, for example, on the bank capital regime. I think they'll endorse principles that Tim Geithner has laid out, but it's going to take some time to negotiate the specifics because each country is concerned that its own banks not be put at a disadvantage. So for example, European banks don't have a leverage ratio. And so, when you introduce that, it's going to be constraining on them. Our banks, we already have a leverage ratio, so that's not as difficult for us. And there are many, many other examples of given regulation, which is easier on some countries than on others. So you're going to have some horse-trading.

Steve Weisman: Morris Goldstein, thanks very much for giving us your analysis of the administration's proposal and the state of play in Pittsburgh.

Morris Goldstein: Well thank you, Steve. I enjoyed it.

Steve Weisman: Thanks.

